NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Medium-term forecast

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2014

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1 Summary

This Medium-Term Forecast (MTF-2014Q3) is based on national accounts for the second quarter of 2014 and on monthly indicators from the third quarter of the year. Technical assumptions are taken from the ECB's latest projections. Nevertheless, figures for oil prices and the exchange rate also take account of current developments, including the impact on the exchange rate of the **ECB's monetary-policy decision of September**. The forecast also factors in the **current deterioration in available forward-looking indicators** for the euro area. These have been partly affected by geopolitical tensions, whose impact is expected to continue until the end of the first half of 2015. The end of the projection horizon should see an upturn related to the ECB's recently adopted monetary-policy measures.

Slovakia's **economic growth** in the second quarter was **in line** with the previous forecast (MTF-2014Q2). **As regards the sources of growth, however, the actual figures diverged from the projections**, with a weakening of the export component offset by marked growth in domestic demand. That pattern is expected to continue in the second half of the year. Hence in 2014, for the first time since the crisis, growth is expected to be far more balanced. Exports are expected to make a positive contribution, but not as large as projected in the previous forecast. **The GDP growth projection for 2014 is therefore revised down to 2.3%** (by 0.1 percentage point). **For 2015, the growth forecast is 2.9%** (revised down by 0.3 p.p. owing to lower foreign demand growth), **and for 2016 it is 3.5%** (unchanged). The downward revision of the growth figure for 2015 projected in the previous forecast is based on the expected weakening of external demand.

The labour market saw positive tendencies in the second quarter, as employment growth surpassed expectations with a rate of 0.5%. The economy created new jobs in almost all sectors, and wage growth was also relatively strong. For 2014, employment growth is projected to be 1.1% and nominal wage growth 4.3%. Wages will reflect labour productivity gains from the previous period. It is assumed that the upturn will continue over the medium-term horizon, albeit with slower growth in employment and wages. Thus, wages are expected to reflect labour productivity growth.

Risks to the outlook for the real economy are balanced. However, the possibility of a further escalation of geopolitical tensions represents a downside risk to the growth forecast. A specific technical risk to the forecast is the new ESA 2010 methodology.

The annual rate of **decrease in prices** stabilised in recent months at around -0.2%, **which is slightly lower** than projected in the previous forecast. The negative inflation rate was largely caused by falling food prices. Prices are assumed to rise gradually towards the end of this year and then more quickly over the medium-term horizon, resulting from the expected continuing pick-up in demand-pull pressures. **The average inflation rate is projected to be 0.0% in 2014, rising to 1.2% in 2015 and 1.9% in 2016**. The risks to the inflation forecast are balanced.

2 Current developments in the external environment and in Slovakia

Global economy grew in the second quarter

Global economic growth accelerated slightly in the second quarter of 2014. This increase stemmed largely from developments in the United States, where growth corrected significantly upwards, after falling sharply earlier in the year due to the effects of a severe winter. The UK economy continued to post solid growth, benefiting mainly from rising consumer confidence and buoyancy in the property market. From among emerging economies, the main contributor to global growth was China, although its performance continued to be based on fiscal stimuli and surging lending. Renewed growth in Mexico reflected the beneficial effects of structural reforms and of developments in the United States. Activity slowed across central and eastern European countries, and while these countries were affected to varying degrees by the Russia–Ukraine conflict, its impact has so far been limited. The euro area economy remained flat, with private consumption and net exports increasing and investment declining. In Japan, as expected, the economy contracted following an increase in VAT rates in April.

Current developments in the world economy confirm that despite short-term volatility in certain countries, growth in the advanced world is gathering momentum and recovery in certain emerging countries is becoming stronger.

Moderate recovery of world economy to continue

Global activity is expected to increase in the short term, although the recovery should be relatively modest. Looser monetary policy in advanced countries is expected to continue bolstering financial markets and global recovery. Growth is projected to be boosted by an easing-up in the repair of private sector balance sheets, the moderation of fiscal consolidation efforts, and an improving labour market situation. But although emerging countries are expected to benefit from developments in advanced economies, growth in some of them will be curbed by inadequate infrastructure, capacity restrictions and macroeconomic imbalances. Furthermore, these countries will to have to adjust to constraining financial conditions brought on by the normalisation of US monetary policy. That the OECD's Composite Leading Indicator for OECD countries has remained largely unchanged since end of 2013 suggests that the global economy recovery will remain modest over the short-term horizon.

Euro area economy remained flat in second quarter

According to Eurostat's flash estimate, the euro area economy remained flat in the second quarter of 2014, after reporting moderate growth (0.2%) in the first quarter. The only major euro area countries to report GDP growth were Spain (0.6%) and the Netherlands (0.5%); the French economy stagnated, while Germany and Italy each experienced a contraction of 0.2%. Private and public consumption contributed positively to euro area GDP growth, as did net exports, while investment and changes in inventories had a negative impact. Business and consumer confidence moderated further, as forward-looking indicators in several euro area economies deteriorated or declined. How growth will develop in the second half of the year is made more uncertain by the geopolitical situation and related repercussions, which for the moment remain difficult to estimate.

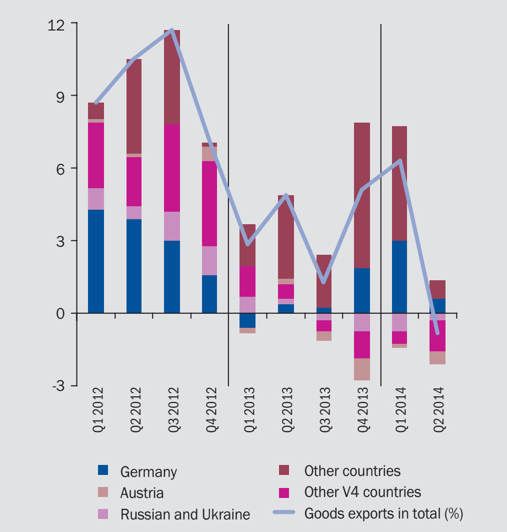
No second-quarter growth in the Czech economy

The Czech economy remained flat in the second quarter of 2014 on a quarter-on-quarter basis, after growing in the first three months by 0.8%. Private consumer demand slowed, while investment and public consumption declined. At the same time, net exports ceased to be the main component of GDP. Česká národní banka reiterated its commitment to using the exchange rate as an additional instrument of accommodative monetary policy at least until 2016.

The Slovak economy continues to grow…

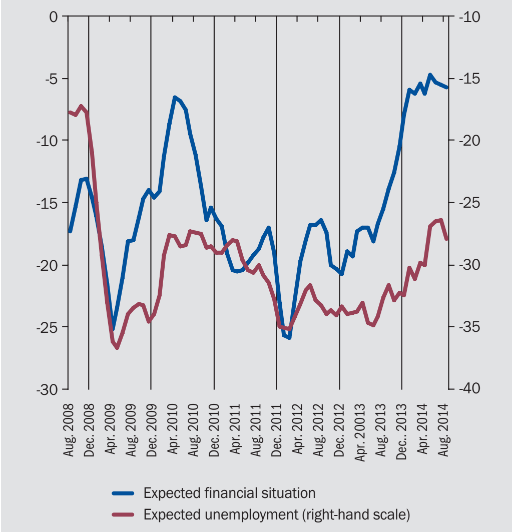
Despite stagnation in the euro area economy, the Slovak economy maintained relatively robust

Chart 1 Breakdown of exports by destination (annual percentage changes; contributions in p.p.)



Source: SO SR, NBS calculations.

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

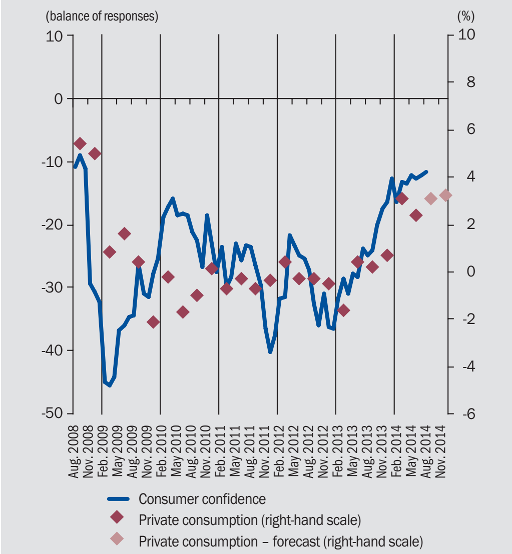


Source: European Commission.

quarter-on-quarter growth in the second quarter, which at 0.6% was in line with projections. However, the composition of growth changed. In contrast to previous quarters, the main driver of growth was not exports but domestic demand. Export performance reflected the base effect of very strong export growth in the first quarter and probably to some extent the effects of geopolitical tensions. The impact of the Ukraine-Russia conflict on Slovak exports was not direct, through bilateral trade, since only a small proportion of the exports go to these countries, but rather indirect through a slowdown in exports to other regions.

The most recent monthly figures for July indicate a pick-up in exports, but given the current uncertainty arising from tit-for-tat measures between Russia and the European Union, that improvement may be short-lived.

Chart 3 Private consumption and consumer confidence



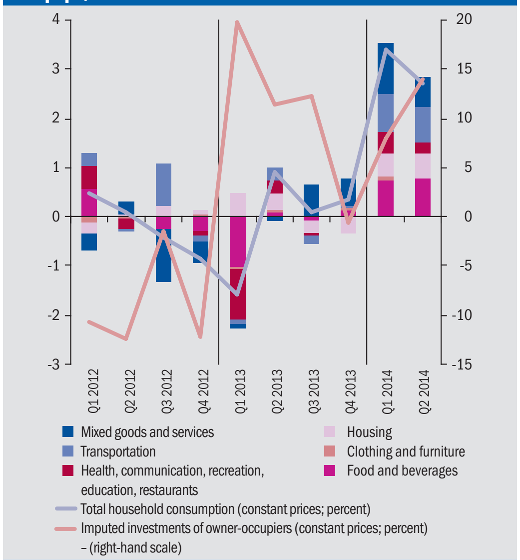
Source: SO SR and European Commission.

...WITH INCREASED HOUSEHOLD CONSUMPTION,...

Domestic demand saw growth in its consumer component in the second quarter. It was the third successive quarter in which household final consumption had increased, which may suggest that the recovery in private consumption is a more permanent trend. This consumption was boosted mainly by strong wage growth and an increase in employment. The brightening of household sentiment supported growth in consumer spending, particularly on durable goods.

Household consumption growth was largely accounted for by spending on food and transport. Household car purchases drove up transport expenditure and were reflected in car imports and in new car registrations, which in the second quarter

Chart 4 Composition of private consumption growth (year-on-year changes; contributions in p.p.)



Source: SO SR.
Note: The imputed investments of owner-occupiers are investments made by apartment and house owners independently.

increased by 10% year-on-year. Food spending included a shift towards buying more expensive goods (especially those produced domestically).

…RISING PUBLIC CONSUMPTION,…

General government final consumption accelerated in the first half of 2014. The highest increase was in compensation of public sector employees, particularly in central government; this diverged from the previous forecast, which projected austerity measures focused on the area of employment. Increases in expenditure on intermediate consumption and in social benefits in kind were also substantially higher than projected.

…AND MARKEDLY HIGHER INVESTMENT.

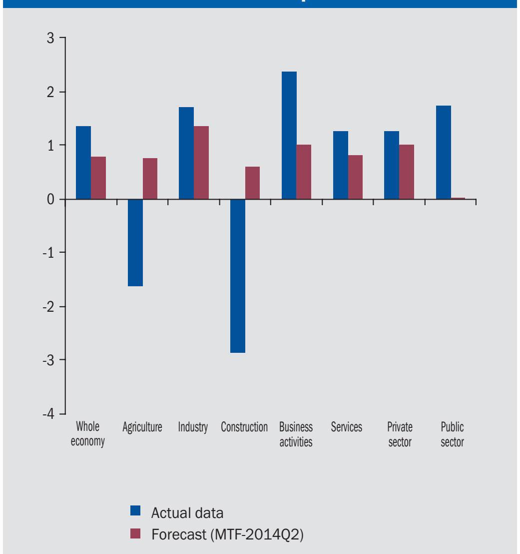
Investment demand increased sharply in the second quarter, driven up mainly by firms and government. The corporate sector was investing in new equipment, buildings and other infrastructure, with funding coming mainly from own reserves and partly from loans. Long-term lending rose moderately in the second quarter, as banks eased their standards amid low nominal interest rates. Although investment in buildings was boosted by a high number of apartment construction completions, its growth is expected to slow in the short to medium-term given that construction apartment starts fell in the second quarter. Public investment accelerated in the second quarter, based mainly on higher central government investment. While local government investment growth was expected to increase ahead of local elections in November 2014, this has not yet happened.

Imports fell in parallel with the decline in exports, even though domestic demand was relatively robust. It may therefore be assumed that domestic demand was being met from the previous quarter's high imports and through destocking.

STRONG DOMESTIC DEMAND GENERATED JOBS

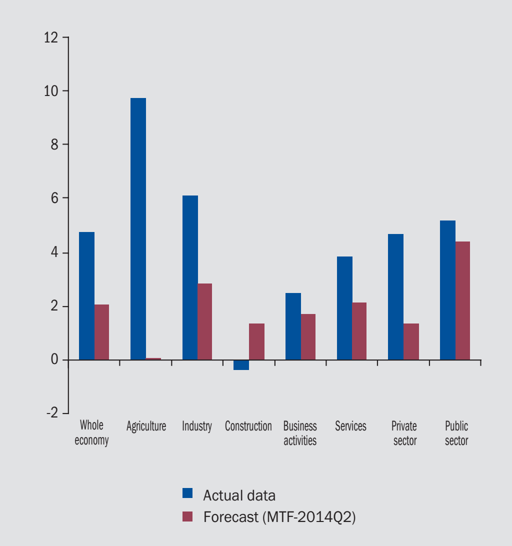
The labour market situation improved, with employment rising and wages increasing quite sharply. Employment growth was greater than projected in the previous forecast. Strong domestic demand increased job creation, particularly in the services and trade sectors, and also in industry. Public spending cuts previously announced by the government were not introduced and whereas public sector employment had been expected to remain flat, it increased. Firms expect, for the time being, that this favourable situation will continue in the period ahead. As employment grew, the unemployment rate fell to its lowest level since the second quarter of 2011.

Chart 5 Annual rate of change in employment (ESA) in the second quarter of 2014 (%)



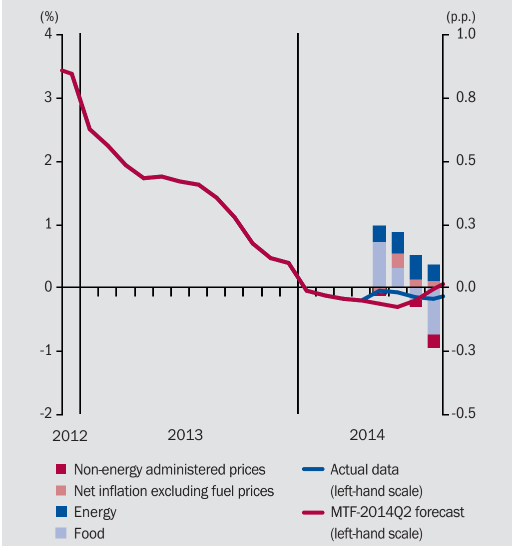
Source: SO SR.

Chart 6 Average nominal wages in the second quarter of 2014 (annual percentage changes)



Source: SO SR.

Chart 7 Inflation compared projections (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

The positive labour market trends included wages, which in the second quarter maintained strong growth, far higher than projected in the previous forecast. Wages went up significantly in all sectors apart from construction, which remains in crisis. Abstracting from agriculture (which accounts for a small share of value added), the highest wage growth was in industry. Private sector wage growth is assumed to have reflected labour productivity gains from the previous period, which, in conjunction with stagnating consumer prices, paved the way for nominal wage growth of 4.3% for the first half of 2014. Robust wage growth was also observed in the public sector and was even higher than that in the private sector.

Inflation stabilised at a slightly negative rate

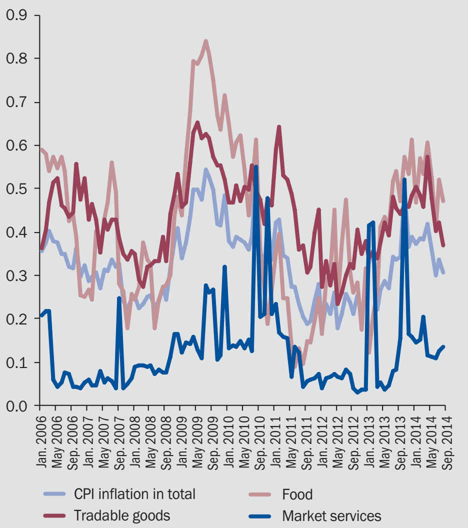
Consumer prices as measured by the HICP continued in the second quarter to record a moderate annual rate of decline of around -0.1%. The inflation rate diverged slightly from that projected in the previous forecast, which envisaged for the second quarter a sharper fall in prices followed by a return to positive inflation. The discrepancy was largely accounted for by food prices, which fell more than projected until the beginning of the third quarter. Energy price inflation was slightly higher than forecast, owing to fuel price increases. Differences between other HICP components and the projections were only marginal.

A closer look at the consumer price index and its components shows that the weighted number of CPI components reporting a negative six-

Chart 8 Developments in the shares of six-mnoth price change bands

Source: SO SR, NBS calculations.
Note: below 0 – price change below 0%; 0 to 1 – price change from 0% to 1%, etc.

Chart 9 CPI components with a negative annual rate of change as a share of the overall CPI



Source: SO SR, NBS calculations.

month rate of change (excluding those with administered prices) increased at the beginning of the year. After peaking, this number corrected slightly downwards and the number of components with rising prices increased. The consequent assumption is that the risk of deflation will diminish and inflation will gradually increase, although this outlook may be affected by the as yet unclear repercussions of tit-for-tat measures between the EU and Russia.

Of CPI weighted components whose rate of change is lower than 0%, food prices account for the largest share, as they reflect the current slump in vegetable and fruit prices brought on by a good harvest. Tradable goods also make up a significant share of the deflationary components, owing to low import prices.

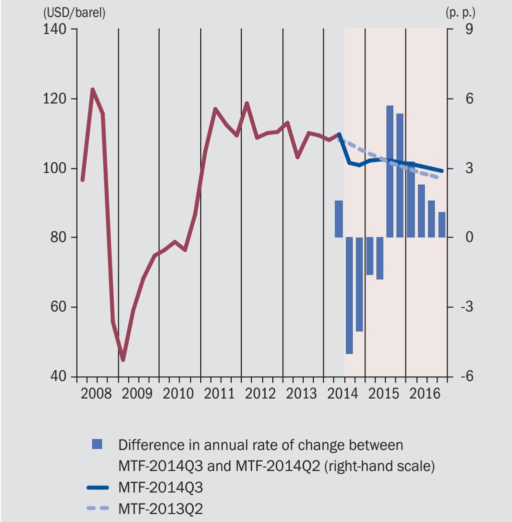
3 Technical assumptions[1]

In the period between the production of the previous forecast and mid-July, the **exchange rate** of the euro against the US dollar was relatively stable, at around 1.36 USD/EUR. Subsequently, however, the rate began to depreciate and by the beginning of September it had fallen to 1.31 USD/EUR. Following September's meeting of the ECB's Governing Council, the exchange rate weakened significantly further, to 1.29 USD/EUR. This forecast assumes that the average exchange rate of USD per EUR will be 1.34 in 2014[2] and 1.29 in both 2015 and 2016, which in each case is weaker than projected in the previous forecast, by 3% in 2014 and around 6% in 2015 and 2016.

Brent **crude oil prices** fluctuated significantly from mid-May to the beginning of September, within a range between USD 99 and USD 115 per barrel. At the beginning of that period, oil was trading at around USD 110 per barrel, with its price particularly affected by the ongoing conflict between Russia and Ukraine, unfavourable outlooks for oil supplies from Libya, and positive economic news from the United States. In the second half of June, the escalating violence in Iraq pushed oil prices up to USD 115 per barrel. Prices subsequently began to fall amid an easing of concerns about the security of oil supplies from Iraq and the resumption of Libyan oil exports. In early September the oil price was around USD 100 per barrel. This forecast assumes that the average barrel price will be USD 105.1 in 2014, falling to USD 102.1 in 2015 and USD 100.2 in 2016, and that the price in euro will be €78.3 in 2014, €78.9 in 2015 and €77.4 in 2016. Compared with the previous forecast, the oil price in dollars is assumed to be slightly lower in 2014, almost the same in 2015 and slightly higher in 2016, while the price in euro is higher, especially in 2015 and 2016, owing to exchange rate depreciation.

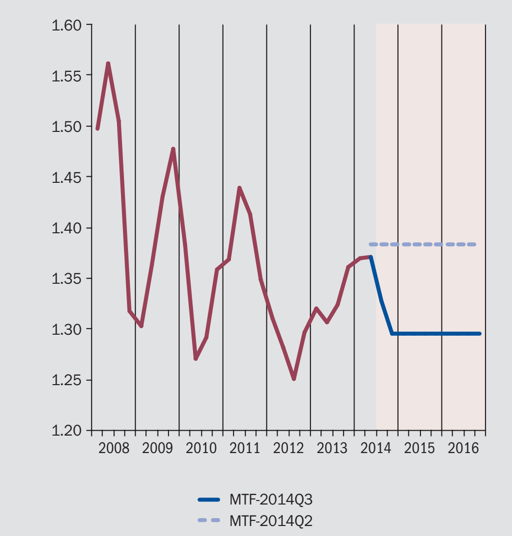
Commodity prices followed a declining path in the period between the publication of the previous forecast and this forecast. This reflected significant downward pressure from food commodity prices, which fell as a result of plentiful harvests around the globe. Metals prices decreased until June owing to supply exceeding demand and to expectations of lower demand from China. As supply side conditions tightened, however, metals prices stopped falling. The assumption for this forecast is that non-energy commodity prices will drop by 4.8% in

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



Source: NBS and ECB.

Chart 10 USD/EUR exchange rate

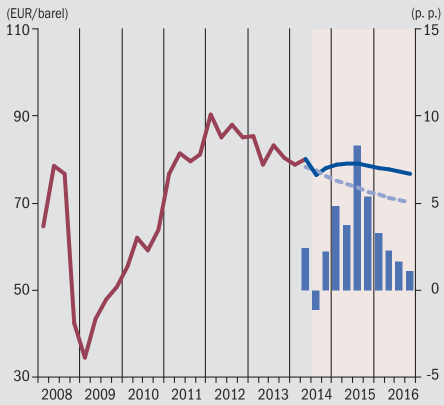


Source: NBS and ECB.

1 *The technical assumptions of the Medium-Term Forecast are based on the "September 2014 ECB Staff Macroeconomic Projections for the Euro Area" with a cut-off date of 13 August 2014, with the exception of the assumptions for the USD/EUR exchange rate and the Brent crude oil price. In this forecast, the USD/EUR exchange rate is assumed to be at its level of 5 September 2014, i.e. after the September decision of the ECB's Governing Council which resulted in weakening of the rate. The oil price assumption was similarly updated.*

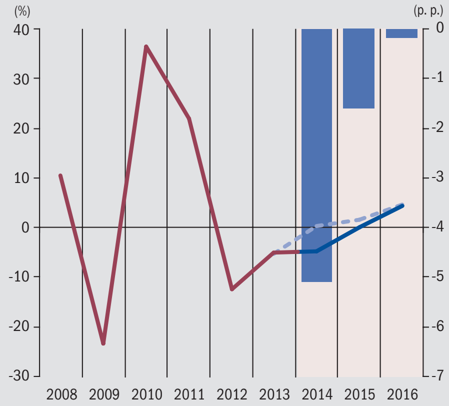
2 *The bilateral USD/EUR exchange rate is assumed to remain unchanged from 5 September 2014 to the end of the projection horizon, at 1.29.*

Chart 12 Price per barrel of Brent crude oil (EUR)



Source: NBS and ECB.

Chart 13 Non-energy commodity prices (annual percentage changes)



Source: NBS and ECB.

2014, before rising by 0.1% in 2015 and 4.4% in 2016. There were no significant changes from the previous forecast.

Short-term interest rates[3] (three-month EURIBOR) are assumed to average 0.2% in 2014, 0.2 % in 2015, and 0.3 % in 2016.

3 *The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 13 August 2014. The assumption for short-term interest rates is of a purely technical nature.*

4 Forecast for the external environment[4]

World economic growth[5] is projected to accelerate from 3.1% in 2013, to 3.4% in 2014, 3.9% in 2015 and 4.0% in 2016. The risks that advanced countries pose to the global growth outlook are balanced, with these countries having implemented policies which over a short-term horizon have reduced the risks weighing on economic activity. Most of the risks to global growth are concentrated in emerging countries, which are marked by external and internal imbalances that make them vulnerable to any shift in financial market sentiment as well as to external shocks. China represents a risk to the global economy in that its growth is driven by a surge in lending. Furthermore, the ongoing conflict between Ukraine and Russia is increasing uncertainty about the outlook for this region and consequently for the world economy as a whole. Hence emerging economies currently represent the main downward risk to global economic growth.

It is assumed that **euro area GDP growth** will be moderate in 2014 and gradually accelerate in 2015 and 2016. The projected pick-up in activity will be supported by a strengthening of domestic demand – owing partly to the accommodative monetary policy stance – a broadly neutral fiscal stance following years of substantial fiscal tightening, and a return to neutral credit supply conditions. In addition, private consumption should benefit from a pick-up in real disposable income stemming from the favourable impact of low commodity price inflation and rising wage growth. Private residential and non-residential investment should be supported by the fading adverse impact of balance sheet adjustment needs and a catching-up effect following years of subdued investment. Activity will also be increasingly supported over the medium term by a gradual strengthening of external demand, enhanced by the recent depreciation of the effective exchange rate of the euro and past gains in competitiveness. Nevertheless, a number of factors continue to dampen progress towards faster growth. The adverse impact on the outlook for private consumption from high unemployment rates in some countries is expected to diminish only gradually over the projection horizon, while ample spare capacity in some countries and, possibly, labour supply constraints in other countries are expected to continue to hold back investment spending. Furthermore, the ongoing geopolitical tensions dampen the near-term outlook for investment and exports. In annual average terms, GDP growth is expected to increase by 0.9% in 2014, 1.6% in 2015 and 1.9% in 2016.[6]

Euro area HICP inflation remains subdued. After recording a rate of 0.6% in the second quarter, inflation was further curbed by supply-side factors in the next two months, falling to 0.4% in August. This downward trend in August reflects a decline in energy and food prices as well as subdued trends in non-energy industrial goods and services prices. The headline HICP inflation rate is projected to be 0.4% in the third quarter of 2014, rebounding moderately to 0.7% in the last quarter. The rate is envisaged to average 0.6% in 2014, increasing to 1.1% in 2015 and 1.4% in 2016.[7] The narrowing of the negative output gap in the context of the firming recovery, leading to rising wage and profit growth, should have an upward impact on inflation over the projection horizon. This impetus is expected to be further supported by increasing non-energy commodity prices and euro area import prices, reinforced by the lower euro area exchange rate. Food price inflation is projected to remain close to zero in the third quarter of this year but to rebound strongly in the following quarters until mid-2015, when the large downward weather impact on unprocessed food prices and downward base effects should fade. Thereafter, food price inflation is envisaged to continue rising further, albeit more gradually, and to reach rates of 2.0% at the end of the projection horizon. HICP inflation excluding food and energy is expected to increase from 0.9% in 2014 to 1.2% in 2015 and 1.5% in 2016, as the recovery gains momentum, with the output gap narrowing, and as wage and profit growth strengthens. HICP inflation excluding food, energy and changes in indirect taxes is assumed to rise over the projection horizon, from 0.8% in 2014, to 1.2% in 2015 and 1.5% in 2016.

With regard to domestic price pressures in the euro area, the improvement in labour market conditions is envisaged to lead to some accel-

4 The assumptions for developments in the international economy are based on the "September 2014 ECB Staff Macroeconomic Projections for the Euro Area", which were prepared using information available up to 21 August 2013.

5 GDP weights were updated on the basis of purchasing power parity, which is used in the compilation of aggregate world output figures. Further details can be found at www.ecb.int

6 The figures are in the middle of the forecast range for GDP growth. The ECB's projection ranges for GDP growth are 0.7% – 1.1% in 2014, 0.6% – 2.6 % in 2015, and 0.6% – 3.1% in 2016.

7 The figures are in the middle of the forecast range for the HICP rate. The ECB's projection ranges for the HICP rate are 0.5% – 0.7% in 2014, 0.5% – 1.7% in 2015, and 0.7% – 2.1% in 2016.

eration in compensation per employee growth, from 1.6% in 2014 to 1.8% in 2015 and 2.2% in 2016. Unit labour cost growth is projected to moderate from 1.0% in 2014 to 0.8% in 2015, owing to modest dynamics in compensation per employee growth combined with strengthening labour productivity growth. In 2016, unit labour cost growth is expected to recover slightly, owing to a pick-up in compensation per employee growth accompanied by broadly stagnant productivity growth.

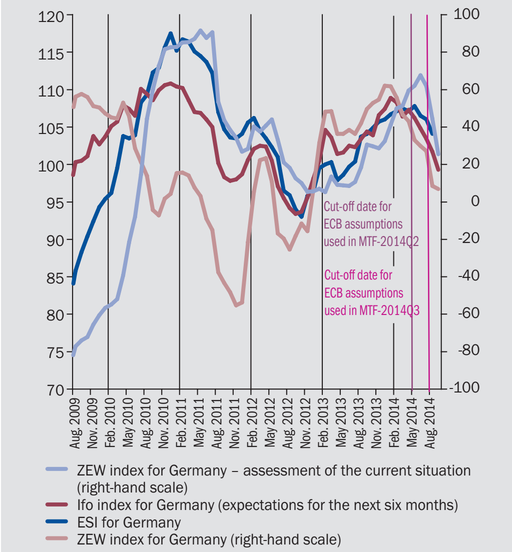
Profit margins (as measured by the difference between the GDP deflator at factor cost and unit labour cost growth) are expected to decline somewhat in 2014. Thereafter, they are foreseen to strengthen gradually, supported by the cyclical recovery of the economy.

Rising investment in advanced economies is expected to spur a gradual rebound in **global trade**. However, structural factors are also judged to be playing a role, including the slowing pace of integration through global supply chains. As a consequence, projection assumes a smaller elasticity of global trade to activity than observed before the global financial crisis. It remains the assumption, however, that global trade will accelerate, from 2.7% in 2013, to 3.9% in 2014, 5.3% in 2015 and 5.8% in 2016.

GDP growth in **Slovakia's export markets** is projected to moderate from 4.3% in 2014 to 4.1% – given the deterioration in current developments and expectations of slower growth in Slovakia's trading partners – while it should accelerate to 5.6% in 2016 as the effects of fiscal consolidation fade.

Turning to the ongoing economic and political tensions between Russia and Europe, they do not so far appear to have had a direct impact on the Slovak economy through its links with Ukraine and Russia. What seems important, however, is their indirect impact, through the repercussions of economic sanctions on Slovakia's trading partners. Based on the latest figures showing stagnation in euro area activity in the second quarter, and in particular the deterioration in available forward-looking indicators (affected by geopolitical tensions), the projection for economic growth in Slovakia's export markets for this year and early next year has been revised down in this forecast (also taking into account geopolitical tensions).

Chart 14 Forward-looking indicators for Germany



Source: European Commission, Ifo institute, ZEW Centre for European Economic Research.
Note: ESI (long-run average = 100), Ifo index (2005 = 100), ZEW (balance of responses).

Given the continued worsening of economic sentiment (reflecting uncertainty about the impact of the situation vis-à-vis Russia), particularly in Germany, this forecast revised down the external demand projection for Slovakia even after the cut-off date for the ECB's technical assumptions used herein. Growth in Slovakia's export markets is assumed to be lower by 0.2 percentage point this year and by 0.6 percentage point next year. The impact of such slowdown on Slovak economic growth is projected to be around -0.1 percentage point in 2014 and up to -0.4 in 2015.

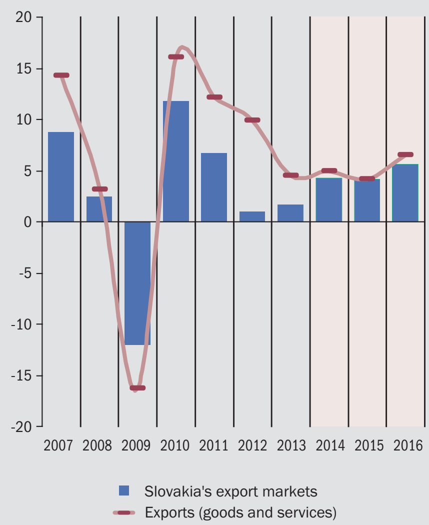
5 Macroeconomic forecast for Slovakia

5.1 ECONOMIC GROWTH

Temporary slowdown in export performance

The current deterioration in available euro-area forward looking indicators (reflecting also geopolitical tensions) has resulted in a downward revision of the external demand forecast for coming quarters and consequently of annual export growth, particularly in 2015. Although figures for July showed a pickup in exports, this was offset by export expectations, which indicate firms' concerns about the period ahead. Towards the end of the medium-term horizon, it is assumed that geopolitical tensions will fade and the ECB's latest monetary-policy measures will begin to have a positive impact, which altogether should see export performance pick up. Furthermore, Slovakia's export growth should again move moderately ahead of external demand growth, and thus the Slovak economy is expected to gain foreign market share.

Chart 15 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 recovery is expected to continue, albeit more moderately

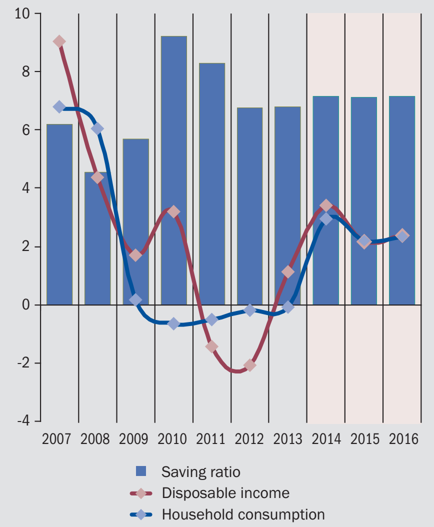
Investment demand, after picking up appreciably this year due to improving sentiment and belated upgrading of machinery and equipment, is expected to increase somewhat more moderately next year. Current euro area indicators point to such correction, while deteriorating sentiment may weigh on the investment decisions of firms in Slovakia. The construction sector still shows no signs of significant recovery, despite housing affordability being at highest level since 2006. In the area of residential property, the number of apartment and house construction starts is falling, and that will adversely affect investment in the period ahead. With the euro area recovery stalling, firms remain cautious about expanding production. Further pressure to defer investment is expected to come from the current geopolitical situation. Towards the end of the projection horizon, investment is expected to accelerate moderately as activity gathers momentum and the factors weighing on euro area sentiment fade; it should also be supported by accommodative monetary policy. Given expected developments in the utilisation of EU funds, the new programming period is projected to develop slowly. Therefore, government investment will record increasingly weaker growth over the projection horizon and is projected to fall year-on-year in 2016.

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

	2013	2014	2015	2016
Gross fixed capital formation	**-4.3**	**5.2**	**3.4**	**3.6**
– private sector	-3.3	5.0	3.2	4.2
– adjusted to exclude one-off investment in the automotive industry	-4.7	8.9	3.2	4.2
– general government sector	-14.0	7.6	5.0	-2.5

Source: SO SR and NBS.

Chart 16 Household income, consumption and saving ratio



Source: SO SR and NBS.

Private consumption continuing to pick up

Consumer demand picked up in the last three quarters, boosted mainly by increasing real income and improving consumer sentiment. It was also supported by several other factors, most notably a lack of price inflation and the level of labour productivity gains from previous years. Consumption is assumed to continue recovering over the projection horizon, albeit more slowly than in 2014 owing to the expected gradual increase in prices and stabilisation in the relationship between nominal income and labour productivity. The saving ratio is projected to remain constant over the forecast period.

Public expenditure to stimulate demand in the near term

Current developments have had an upward effect on expectations for general government final consumption expenditure. Whereas the previous forecast projected a decline in the number of public sector employees, this forecast envisages a slight increase in each year from 2014 to 2016. Compensation per employee in the public sector is expected to continue rising strongly, and although its growth should then slow slightly, it is still assumed to be around 3%. The forecast for social benefits in kind has also been revised up over the projection horizon in response to recent developments. As for intermediate consumption expenditure, its pace of growth next year is expected to be half of the current robust level (owing to the estimated impact of measures triggered by the debt brake). In 2016, however, intermediate consumption expenditure should accelerate again, based on assumed expenditure related to Slovakia's scheduled Presidency of the Council of the European Union.

Imports in line with export developments

Import growth will be higher than export growth this year, owing to the increase in domestic demand. In subsequent years, imports are expected to increase in line with the economy's import intensity. Import and export prices are assumed to rise at a similar pace, and so are not foreseen to have an impact on foreign trade. The balance of payments current account surplus is projected to increase moderately in nominal terms.

Economic growth to accelerate over the medium term

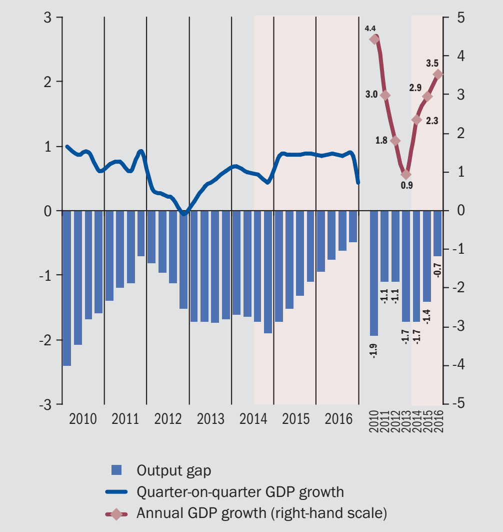
This year domestic demand has replaced exports as the main driver of Slovakia's GDP growth, accounting for all three of the largest components of that growth. Exports had previously been the principal component for a considerable time. The contributions of investment demand and consumption demand (both private and government) will be relatively high this year. **GDP growth is projected to be 2.3% in 2014, accelerating gradually to 2.9% in 2015 and 3.5%**

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

	2013	2014	2015	2016
General government final consumption (constant prices)	1.4	4.1	1.4	1.2
Public investment (constant prices)	-14.0	7.6	5.0	-2.5
Contribution of public consumption and investment to GDP growth (p.p.)	-0.1	0.8	0.3	0.1

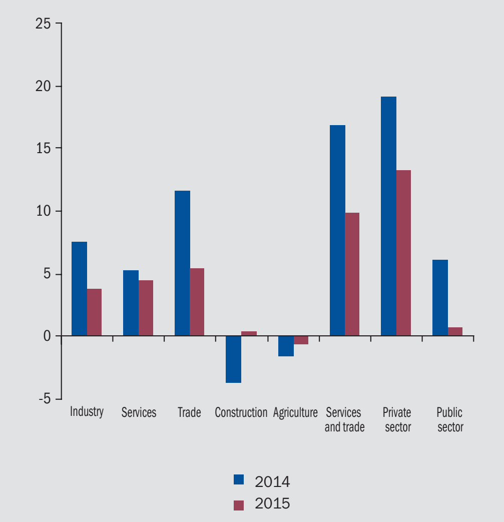
Source: SO SR and NBS.

Chart 17 GDP growth and the output gap (%)



Source: SO SR and NBS.

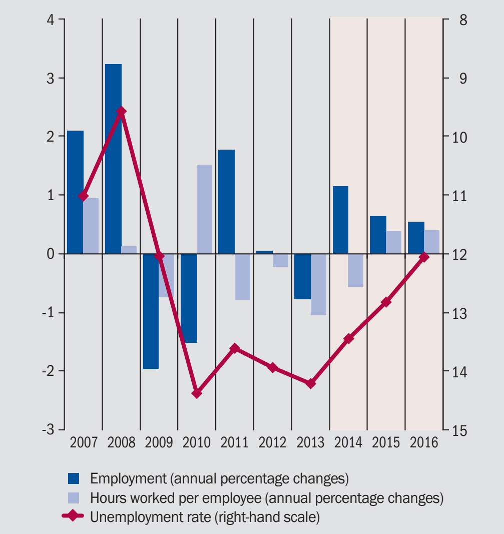
Chart 18 Employment broken down by sector (change in thousands of people)



Source: SO SR.

in 2016. Over the projection horizon, export growth is expected to be the engine of growth, although domestic demand should continue to have a positive impact. The output gap is foreseen to widen in the second half of this year as growth decelerates temporarily, but it is projected to close over the projection horizon.

Chart 19 Employment, hours worked and the unemployment rate (%)



Source: SO SR and NBS.

5.2 LABOUR MARKET

Labour market continues to improve

With GDP growth based increasingly on resurgent domestic demand, the economy generated relatively many new jobs in the first half of 2014, and employment growth for the year is expected to be as high as 1.1%. However, the substantial rate of job creation in the first half of the year is not expected to be repeated in the second half, owing mainly to an assumed moderate slowdown in economic growth. Firms' expectations nevertheless remain relatively optimistic, and so employment should continue to rise modestly. Over the projection horizon, employment is expected to grow in line with activity acceleration, and this will be reflected in a declining unemployment rate.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

MARKED ACCELERATION IN LABOUR COST GROWTH THIS YEAR

Unit labour costs are expected to increase by 2.7% this year, which will be their fastest growth rate for the last five years. In the crisis year of 2009 labour cost growth was based on declining labour productivity, but this year it will be accounted for by nominal growth in compensation per employee, which is projected to be far higher than labour productivity growth. Thereafter, unit labour costs are expected to increase more slowly, by around 1%. This situation, together with a moderate rise in prices in the economy, may after some time begin to boost profit margins and therefore give firms scope to increase investment.

Chart 20 Nominal variables (annual percentage changes)

Source: SO SR and NBS.

Table 3 Unit labour costs (annual percentage changes)

	2013	2014	2015	2016
Nominal compensation per employee (ESA)	0.8	4.0	3.2	4.1
Real productivity	1.7	1.2	2.3	3.0
Unit labour costs	-0.9	2.7	0.9	1.1
GDP deflator	0.5	-0.3	1.0	1.8

Source: SO SR and NBS calculations.

Table 4 Wages (annual percentage changes)

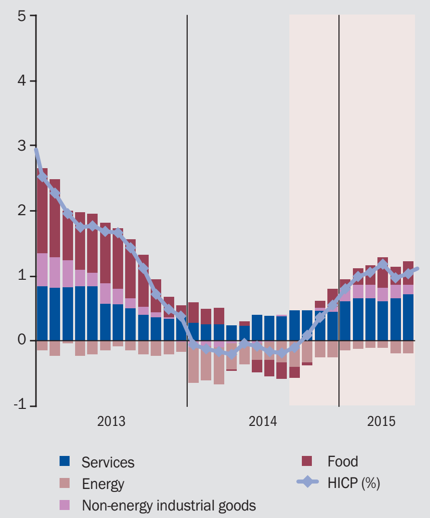
	2013	2014	2015	2016
Nominal labour productivity	2.2	0.8	3.3	4.8
Whole economy – nominal	2.4	4.3	2.7	4.1
Whole economy – real	1.0	4.3	1.4	2.1
Public administration, education and health care – nominal	3.6	5.1	3.2	3.4
Public administration, education and health care – real	2.1	5.1	2.0	1.5
Private sector – nominal	2.0	4.1	2.4	4.2
Private sector – real	0.6	4.1	1.2	2.3

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 4.4% in 2014, 2.7% in 2015 and 3.3% 2016.

Prices expected to remain flat this year

The annual inflation rate is expected to remain negative in the third quarter of 2014, before turning moderately positive in the latter part of the year, when prices of good and non-energy industrial goods are projected to increase moderately. Their growth is expected to reflect a gradual increase in import prices featured in the technical assumptions. Over the rest of the projection horizon, inflation is foreseen to accelerate under upward pressure from ongoing growth in both domestic and external demand. Services prices are assumed to increase, and the downward impact of food prices is expected to fade, in line with the technical assumptions and rising market expectations. Based on the technical assumptions, energy prices are expected to continue declining over the projection horizon.

Chart 21 Expected composition of annual inflation in 2014 (p.p.)



Source: SO SR and NBS.

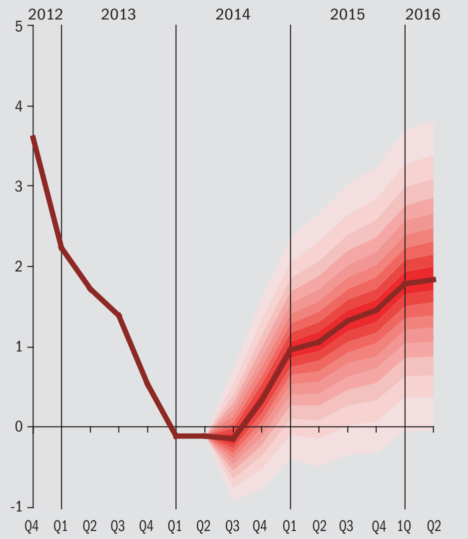
6 Risks to the forecast

Based on the available information and taking into account the estimated fall in external demand pointed to by declining economic sentiment indicators in the euro area, the risks to the real economy and price outlooks are seen as balanced. However, the possible escalation of geopolitical tensions represents a downward risk to economic growth.

This year, the decline in external demand is expected to be offset by stronger domestic demand, especially private consumption. In 2016, external demand is a downward risk to the forecast. On the other hand, upside risks to the growth include public expenditure growth and further significant gains in market share, which could improve assumptions under the baseline scenario.

The upward risks to the inflation forecast for 2015 and 2016 are an increase in oil prices and/or depreciation of the euro's exchange rate. Downside risks include a plentiful harvest, external inflation, and, in 2016, also external demand.

Chart 22 Inflation forecast (%)



Source: SO SR and NBS.

Table 5 Risks to the forecast

	2014	2015	2016
GDP	↓ Export performance (geopolitical risks) ↑ Private consumption		↓ External demand ↑ Export performance, public consumption
Inflation		↑ Oil prices, exchange rate ↓ Food (good harvest), external inflation	↑ Oil prices ↓ External demand

Source: NBS.

Box 1

NEW ESA 2010 METHODOLOGY

Methodological changes (ESA 2010) constitute a particular risk to the forecasts and forecasting GDP, GDP composition, and GDP growth. Their implementation will result in revised national accounts, to be published by Eurostat on 17 October 2014.

The European System of National and Regional Accounts (ESA) 2010 will replace the current ESA 1995. The changes contained in ESA 2010 will extend and improve the whole system of national accounts. The new methodology is a response to the increasing share of international transactions undertaken by multinational companies, where the transactions across borders are between parents, subsidiaries and affiliates. Under ESA 2010, the application of rules on change of ownership will be more consistent, expenditure on research and development will be recorded as fixed capital formation, the approach to recording military expenditure on weapons systems will be changed, and modifications will be made to the classification of institutional sectors, non-financial and financial assets, and transactions and other flows.

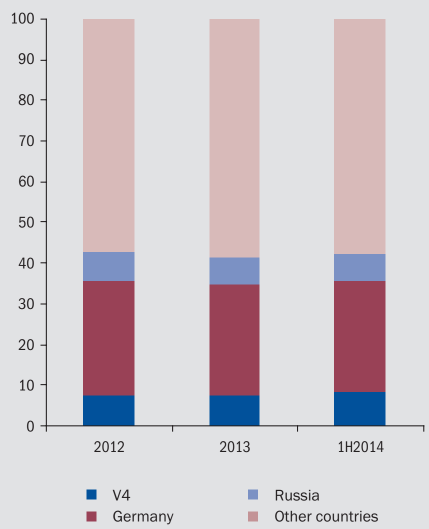
Furthermore, past GDP figures will be revised in line with ESA 2010. The new methodology will result in higher GDP figures, as well as changes in the composition of GDP according to the production approach (both output and intermediate consumption will be revised), expenditure approach (all expenditure components, but most of all gross capital formation, will be affected), and the income approach (the main changes will be to gross operating surplus and mixed income). All these changes could lead to GDP being revised up by around 2%. Final consumption of households and final consumption of general government will also increase, both in absolute and relative terms. On the other hand, the more consistent application of the rules on change of ownership will result in a decline in export volumes as well as changes in import volumes.

Box 2

NEGATIVE RISK TO THE SLOVAK ECONOMY FROM THE IMPACT OF SANCTIONS

An embargo on exports of European cars and motor parts to Russia would cause Slovak exports to decrease by more than €270 million per quarter, which represents 1.5% of Slovakia's exports under the ESA methodology and 6% of its exports of cars and components according to foreign trade statistics. With import intensity at 50%, the trade balance would consequently decline by €135 million. A three-month loss of car exports to Russia would reduce GDP growth, in quarter-on-quarter terms, by 0.7 percentage point, assuming that increases in the import and export prices of cars and components were approximately the same (0.4% qoq).

Chart A Exports of cars and components broken down by destination



Source: SO SR, NBS calculations.

Table A Average monthly exports of cars and components (EUR millions)

	2012	2013	Q1 – Q2 2014
Cars and components	**1,223.6**	**1,334.0**	**1,369.6**
of which:			
AT	22.8	21.3	43.5
CZ	44.3	50.9	58.2
DE	344.8	362.2	374.4
HU	18.8	18.8	20.7
PL	28.3	30.1	34.1
RU	87.8	90.5	90.1
UA	5.2	6.9	1.5

Source: SO SR, NBS calculations.

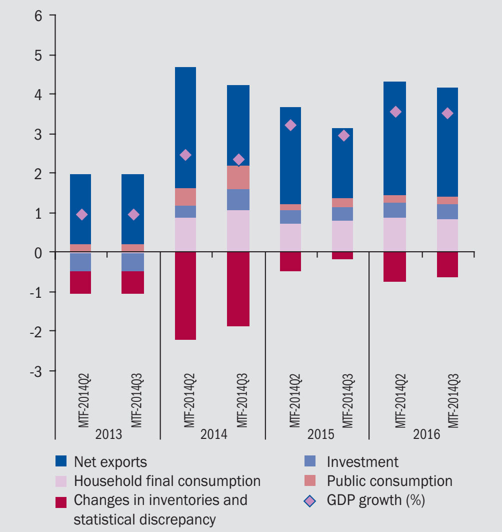
7 Comparison with the previous forecast

Comparing the technical assumptions of this forecast with those of the previous forecast, external demand is projected to be lower; the exchange rate is weaker, which means oil prices in euro are higher, and external inflation is slightly lower.

Although GDP growth has been revised down, the underlying tendencies remain unchanged

The revised outlook for the Slovak economy reflects the fact that the recent decrease in external demand has outweighed the acceleration in domestic demand. Factoring in the current deterioration in available forward-looking indicators in the euro area (partly affected by geopolitical tensions), the projection for external demand over coming quarters has been revised down, and thus the annual rate of export growth is lower, particularly in 2015 (the impact of declining external demand on GDP over the projection horizon is estimated to be around -0.4 percentage point). The GDP growth projection in this forecast is lower than in the previous forecast, by 0.1 percentage point in 2015 and 0.3 p.p. in 2015. Lower export growth will be reflected in lower labour productivity with a consequential impact on the price of labour. The decline in exports indicated by national accounts has been incorporated into the near-term forecast. On the other hand, the worsening of export figures has been partially offset by the improved current figures for the domestic side of the economy.

Chart 23 Comparison of forecasts for GDP growth composition (annual percentage changes; contributions in p.p.)

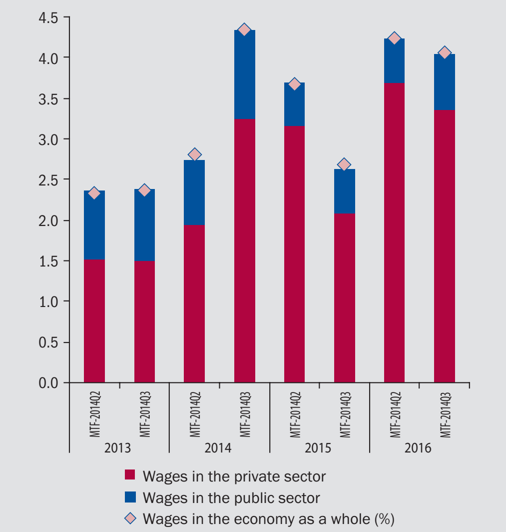


Source: SO SR and NBS.
The item ‚Changes in inventories and statistical discrepancy' includes uncategorised imports that remained after the calculation of import intensity.
1) The composition of GDP growth is calculated as the contributions of components to GDP growth after deducting their import intensity. 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.

Employment and wages expected to accelerate only this year

The labour market projections for this year reflect better than expected figures in the second quarter. The projections for employment growth and wage growth in 2014 have been revised up by, respectively, 0.5 percentage point and 1.5 p.p., in comparison with the previous forecast. The acceleration in employment growth is expected to be most marked in sectors dependent

Chart 24 Comparison of forecasts for wages (annual percentage changes; contributions in p.p.)



Source: SO SR.

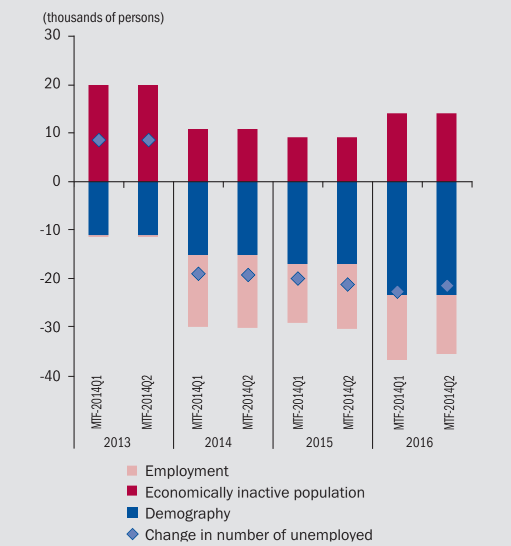
on domestic demand (trade and services). Job creation in industry is also expected to be slightly higher than previously projected. The forecast for public sector employment has been revised significantly, after its substantial increase this year. Wage growth projections have been adjusted upwards, especially in industry, trade and services.

The medium-term outlook for the labour market has not changed significantly. Employment remains on the same trajectory. The slight slowdown in projected wage growth stems mainly from the assumed pass-through effect of declining external demand and lower labour productivity. The unemployment rate forecast is largely unaltered, with the effect of moderately better developments expected to be offset by a worse outlook for economically inactive population. With a greater number of previously economically inactive people entering the labour market, the unemployment rate forecast remains broadly the same despite the improved projections for employment.

Downward revision of price inflation forecast for this year and next

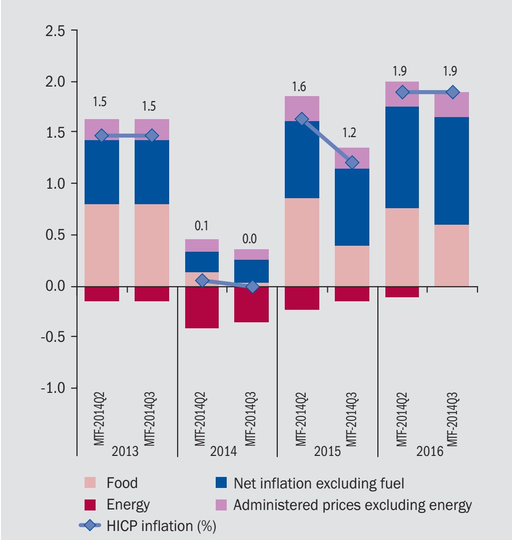
Price developments in the third quarter and lower assumptions for agricultural commodity prices prompted downward adjustments to projected price inflation in 2014 and 2015. The inflation rate forecast for 2014 is marginally lower, owing to lower food prices, while the forecast for 2015 has been revised down more substantially, by 0.4 percentage point. Although this forecast projects a higher increase in oil prices over the projection horizon, energy prices are not expected to offset the downward impact of the revised forecast for food price inflation. Since the oil prices expressed in euro are assumed to be higher, the negative effect of energy prices on the inflation rate over the projection horizon has been revised.

Chart 25 Comparison of forecasts for labour market indicators (contributions to change in unemployment)



Source: SO SR and NBS.

Chart 26 Comparison of inflation forecasts (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

8 Impact of the MTF-2014Q3 macroeconomic forecast on public finances

If the macroeconomic projections of this forecast (MTF-2014Q3) were incorporated in the forecast produced by the Ministry of Finance's Financial Policy Institute (FPI) – following September's meetings of the Tax Revenue Forecasting Committee and Macroeconomic Forecasting Committee – projected tax and social contribution revenues in the FPI forecast would be higher by €53 million (0.1% of GDP) in 2014, €60 million (0.1% of GDP) in 2015 and €87 million (0.1% of GDP) in 2016. Compared to the FPI's assumptions, the improved expectations for the collection of tax and social contribution revenues in 2014 are based mainly on increased optimism about the wage base and developments in government intermediate consumption and investment. Since MTF-2014Q3 assumes higher government consumption and government investment than does the FPI, its projections for VAT revenues are higher over the projection horizon. On the other hand, MTF-2014Q3's projections for the wage base growth in 2015 and 2016 are lower than those of the current FPI forecast, and therefore MTF-2014Q3 assumes lower revenues from person income tax and from social and health contributions. This forecast envisages that GDP will be lower than the level assumed in the general government budget approved for 2014-2016, and under these lower levels (expressed as a percentage of GDP) fiscal targets would be attained with a lower budget deficit (greater fiscal consolidation).

Table 6 Differences in projections for tax and social contribution revenues in Slovakia's public finances (EUR millions, unless otherwise stated)

How the tax collection outlook under MTF-2014Q3 macroeconomic assumptions differs from the outlook according to FPI assumptions	2014	2015	2016
Personal income tax	5	-2	-4
Corporate income tax	0	6	5
Withholding tax	4	-10	16
VAT	26	76	88
Excise taxes	0	1	-1
Social and health insurance	19	-11	-17
Total (impact of taxes and contributions)	53	60	87
Total (impact of taxes and contributions; % of GDP)	0.1	0.1	0.1
Impact of nominal GDP on the deficit target	-18	-35	-18
Total (EUR millions)	**36**	**25**	**69**
Total (% of GDP)	**0.0**	**0.0**	**0.1**

Source: NBS – based on FPI calculations (made in accordance with assumptions approved by the Tax Revenue Forecasting Committee) 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-2014Q3) for key macroeconomic indicators

Indicator	Unit	Actual	MTF-2014Q3			Difference versus MTF-2014Q2		
		2013	2014	2015	2016	2014	2015	2016
Prices								
HICP inflation	year-on-year changes in %	1.5	0.0	1.2	1.9	-0.1	-0.4	0.0
CPI inflation	year-on-year changes in %	1.4	0.0	1.2	1.9	-0.1	-0.4	0.0
GDP deflator	year-on-year changes in %	0.5	-0.3	1.0	1.8	-0.2	-0.4	-0.1
Economic activity								
Gross domestic product	year-on-year changes in %, constant prices	0.9	2.3	2.9	3.5	-0.1	-0.3	0.0
Final consumption of households	year-on-year changes in %, constant prices	-0.1	3.0	2.2	2.4	0.5	0.2	-0.1
Final consumption of general government	year-on-year changes in %, constant prices	1.4	4.1	1.4	1.2	0.9	0.4	0.0
Gross fixed capital formation	year-on-year changes in %, constant prices	-4.3	5.2	3.4	3.6	2.3	-0.1	-0.1
Exports of goods and services	year-on-year changes in %, constant prices	4.5	5.0	4.2	6.5	-2.4	-1.5	-0.1
Imports of goods and services	year-on-year changes in %, constant prices	2.9	6.1	4.0	6.0	-2.2	-1.6	-0.2
Net exports	EUR millions in constant prices	9,528	9,373	9,898	10,845	-1,006	-1,256	-1,181
Output gap	% of potential output	-1.7	-1.7	-1.4	-0.7	-0.1	-0.4	-0.4
Gross domestic product	EUR millions in current prices	72,134	73,619	76,557	80,711	-517	-1,415	-1,873
Labour market								
Employment	thousands of persons, ESA 95	2,192	2,217	2,231	2,244	9.2	10.7	9.3
Employment	year-on-year changes in %, ESA 95	-0.8	1.1	0.6	0.6	0.5	0.0	0.0
Number of unemployed	thousands of persons [1]	386	365	347	325	-2.1	0.2	1.3
Unemployment rate	%	14.2	13.4	12.8	12.1	-0.1	0.0	0.0
Unemployment gap [2]	p. p.	1.7	1.1	0.9	0.6	0.3	0.3	0.3
Labour productivity [3]	year-on-year changes in %	1.7	1.2	2.3	3.0	-0.6	-0.3	0.0
Nominal productivity [4]	year-on-year changes in %	2.2	0.8	3.3	4.8	-1.3	-1.3	-0.4
Nominal compensation per employee	year-on-year changes in %, ESA 95	0.8	4.0	3.2	4.1	1.0	-0.5	-0.2
Nominal wages [5]	year-on-year changes in %	2.4	4.3	2.7	4.1	1.5	-1.0	-0.2
Real wages [6]	year-on-year changes in %	1.0	4.3	1.4	2.1	2.1	-0.6	-0.2
Households								
Disposable income	constant prices	1.1	3.4	2.2	2.4	1.3	0.3	0.0
Savings rate	% of disposable income	6.8	7.1	7.1	7.1	0.7	0.8	0.9
Balance of payments								
Goods balance	% of GDP	5.9	5.8	5.8	6.4	-1.2	-1.9	-2.0
Current acount	% of GDP	2.1	1.8	2.0	2.1	-1.2	-2.0	-2.1
External environment and technical assumptions								
External demand growth for Slovakia	year-on-year changes in %	1.7	4.3	4.1	5.6	0.4	-1.0	0.0
Exchange rate (USD/EUR) [7]	level	1.33	1.34	1.29	1.29	-2.8	-6.4	-6.4
Oil price in USD	level	108.8	105.1	102.1	100.2	-2.0	-0.1	2.01
Oil price in USD	year-on-year changes in %	-2.8	-3.5	-2.8	-1.9	-1.9	1.8	2.0
Oil price in EUR	year-on-year changes in %	-5.9	-4.4	0.6	-1.9	0.9	5.4	2.0
Non-energy commodity prices in USD	year-on-year changes in %	-5.0	-4.8	0.1	4.4	-5.1	-1.6	-0.2
EURIBOR 3M [8]	% p. a.	0.2	0.2	0.2	0.3	0.0	-0.1	-0.2
10-Y Slovak government bond yields	%	3.2	2.3	2.1	2.4	-0.5	-1.0	-1.1

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 13 August 2014.*

The time series of selected macroeconomic indicators can be found at
http://www.nbs.sk/_img/Documents/_Publikacie/PREDIK/2014/MTF-2014Q3.xls