NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Medium-term forecast

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1 Summary

This Medium-Term Forecast (MTF-2014Q4) was produced with reference to the official flash estimates for GDP growth and employment for the third quarter of 2014, as well as to monthly indicators and forward-looking indicators. The forecast also incorporates common technical assumptions of the European Central Bank (ECB) regarding developments in the exchange rate, oil prices, interest rates, and other price indicators. The projections have been prepared using the new ESA 2010 methodology for national accounts, which required historical data to be revised.

According to **the flash estimate**, Slovakia's GDP grew by 0.6% in the third quarter of 2014, which is consistent with the projections of the previous forecast. **GDP growth for 2014 is expected to accelerate to 2.3%**, and to have a more balanced composition than in previous years. The assumption is that growth will then increase to **2.6% in 2015** and **3.3% in 2016**. The projections for 2015 and 2016 have been revised down moderately from the previous forecast by, respectively, 0.3 p.p. and 0.2 p.p., following reassessments of external demand and its impact on GDP. Domestic demand is expected to be the main contributor to GDP growth in 2015, while the contribution of exports should increase in 2016.

The annual inflation rate has stabilised this year at -0.1%. The downward pressure on the headline rate has come mainly from falling prices of food and energy, given their large weight in the consumer price index. Looking ahead, inflation is expected to increase moderately owing to projected developments in prices of food and non-energy industrial goods, which should reflect also depreciation of the exchange rate. **The average inflation rate is assumed to increase modestly in 2015, to only 0.5%**, and then rise to **1.8% in 2016**. The projections for 2015 and 2016 are lower than those in the previous forecast by, respectively, 0.7 p.p. and 0.1 p.p. The sharp downward revision of the 2015 forecast is based on lower technical assumptions for prices of energy and agricultural commodities, as well as on reassessments of price developments in the food and services components. Furthermore, oil prices continued falling after the cut-off date for this forecast,[1] and in this light there is a **downward risk to the inflation outlook in** that the headline rate in 2015 could be closer to zero.

In the post-crisis period, lower employment growth proved to be enough for an increase in employment.[2] Furthermore, domestic demand is a stronger source of growth in the 2014-2015 periods. These two effects have resulted in unusually positive developments in employment, with 2014 expected to see annual employment growth reaching its second highest level since the crisis. The pace of growth is projected to fall in subsequent years, with activity growth being covered more by increases in the number of hours worked. As employment grows, the unemployment rate is expected to maintain a decreasing trend.

Nominal wage growth remained relatively strong in the third quarter despite the zero inflation environment. This created scope for robust real growth in household consumption. The gap between labour productivity and wages widened significantly. Going forward, nominal wage growth is expected decelerate and to reflect productivity to a greater extent. The outlook for wage growth has not been changed from the previous forecast, although expectations for real wage growth in 2015 have increased on the basis of lower projections for inflation next year.

1 The MTF-2014Q4 was finalised on 14 November 2014.

2 Net job creation is beginning to require a GDP growth rate of around 2.25%, whereas in the past it required growth of 3%.

2 Current developments in the external environment and in Slovakia

Global growth increased moderately

Global economic growth was slightly higher in the third quarter than in the previous quarter. Despite slowing, growth in both the US and UK remained relatively robust. In the United States, the economy benefited from diminished fiscal restrictions, accommodative monetary policy, and falling unemployment. All GDP components contributed positively to growth. In the United Kingdom, the slowdown may have been partly caused by the persisting sluggishness of activity in the euro area, its largest trading partner. The Japanese economy surprisingly recorded a further contraction in the third quarter. After consumption taxes were hiked at the start of the second quarter, leading to a fall in private consumption and then a strong contraction of activity, it was expected that Japanese economy would pick up. The third quarter, however, saw investment fall further, and with the tax increases continuing to bite and the country experiencing a cool summer, private consumption expenditure was dampened significantly.

Emerging economies varied in their impact on the global economy during the third quarter. China's economy slowed moderately, in line with expectations. Its annual growth rate, although more than 7%, was at its lowest level since the beginning of 2009, with a slowdown in the property market putting downward pressure on both investment and imports. In Indonesia, GDP growth maintained its robust rate of the previous quarter, while other economies of emerging Asia are expected to have seen an increase in growth.

Current developments in the world economy confirm that its recovery is only moderate and will remain heterogeneous across countries. Overall, however, activity is expected to gather momentum over the projection horizon.

Euro area growth edged up in the third quarter

According to Eurostat's flash estimate, the euro area economy grew by 0.2% in the third quarter of 2014, after an increase of 0.1% in the second quarter. The major euro area economies that contributed positively to that growth were Spain (with growth of 0.5%), France (where activity surprisingly accelerated to 0.3%), the Netherlands (0.2%), and, albeit only very slightly, Germany (0.1%). Italy's economy had a negative impact, as it contracted by 0.1%. The third-quarter increase in euro area growth occurred despite deterioration in several forward-looking indicators. Developments in industrial production and construction also pointed to weaker performance. The uncertain outlook for fourth-quarter growth is reflected in available forward-looking indicators that are sending out mixed signals and falling below their third-quarter average. Growth outlooks for exports and investment have worsened, while private consumption remains relatively strong. Global trade growth projections are still weak, with repercussions for Slovakia's principal trading partner – Germany. Investment may also be adversely affected by geopolitical tensions.

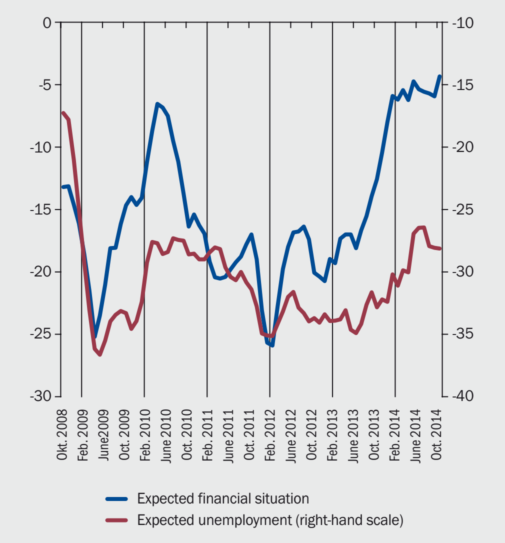
Czech economy maintained growth in the third quarter

In the Czech Republic, according to preliminary figures, GDP grew by 0.3% in the third quarter, the same as in the previous quarter. This growth was supported by manufacturing industry, particularly the transport equipment industry and chemicals and chemical products industry.

Slovakia's economic growth remains relatively robust, in line with expectations

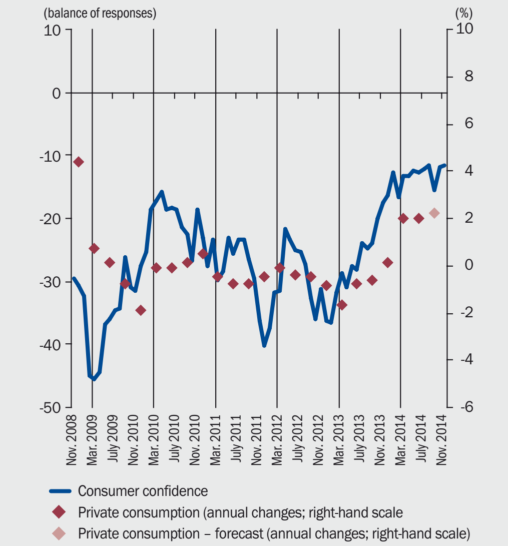
The risks, mentioned in the previous forecast, relating to unfavourable pass-through of the euro area's deteriorating forward-looking indicators to the real economy have not so far materialised, and therefore activity in Slovakia has not been significantly affected. According to preliminary figures, Slovak GDP growth in the third quarter was a relatively robust 6% (quarter-on-quarter), largely accounted for by the continuing strength of domestic demand. **Overall, economic growth was in line with the**

Chart 1 Household expectations (3-month moving average; balance of responses)



Source: European Commission.

Chart 2 Private consumption (annual percentage changes; right-hand scale) and consumer confidence (balance of responses)



Source: SO SR and European Commission.

projections of the previous forecast, although its composition diverged somewhat from that outlook. In particular, exports declined again after being projected to pick up, and, as a result, imports also fell.[3] Nevertheless, the marked drop in imports stemmed also from reduced gas flows from Ukraine.

Household consumption increased and boosted GDP growth, as retail sales picked up and retail trade confidence improved. Consumption growth is being further supported by a zero inflation environment conducive to increasing both consumption expenditure and savings. Public consumption was more subdued in the third quarter than in the previous quarter (owing mainly to weaker social benefits in kind).

Investment demand made a significant positive contribution to GDP growth in the third quarter. The pick-up in investment financing that could help firms renew fixed capital may have been stimulated by the current accommodative monetary policy. The marked upturn in investment can be partly explained by firms having to replace capital stock after years of underinvestment, and partly also by the ongoing implementation of infrastructure projects. Nevertheless, investment remains the weakest point of the economy and is still 10% below its pre-crisis level.

Net job creation continued in the third quarter

Domestic demand continued to generate new jobs in the third quarter. According to the flash estimate, employment increased by 0.3% quarter-on-quarter, in line with the projections of the previous forecast. Although that rate was marginally lower than the second-quarter increase, it was still relatively high. Monthly employment figures (reported for larger firms) pointed to a slowdown in recruitment, and, therefore, the new jobs were probably created mainly in smaller firms and the public sector. At the sectoral level, the positive effect of new job creation faded in both services and industry. As employment increased, the unemployment rate decreased. Furthermore, job vacancy statistics indicate that the rate will remain on a downward track.

Turning to wage growth in the third quarter, it was, as expected, lower than the somewhat high level observed in the second quarter. Nevertheless, the wage dynamics remain conducive to private consumption growth. The sectors reporting the largest wage growth were trade and industry, i.e. those sectors that had sufficient labour productivity gains from the previous period. In services, wage growth was surprisingly subdued, but relatively robust em-

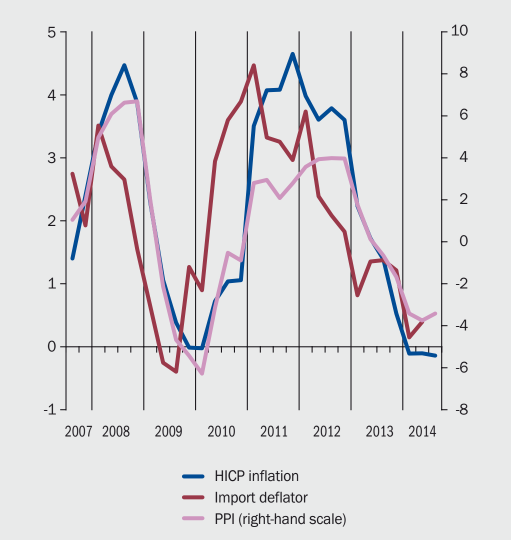
3 The decline in export performance may have resulted from methodological changes to reported data, including the exclusion of transactions of non-residents who are registered in Slovakia only for VAT purposes. In the case of such non-residents, the transactions they state in border-crossing documentation are excluded from export figures in order to reflect more accurately the change in ownership of the traded goods. This corrects the overvaluation of exports and undervaluation of imports caused by the "cross-border concept" in the recording of external trade.

ployment growth more than compensated for that.

Price stagnation continues

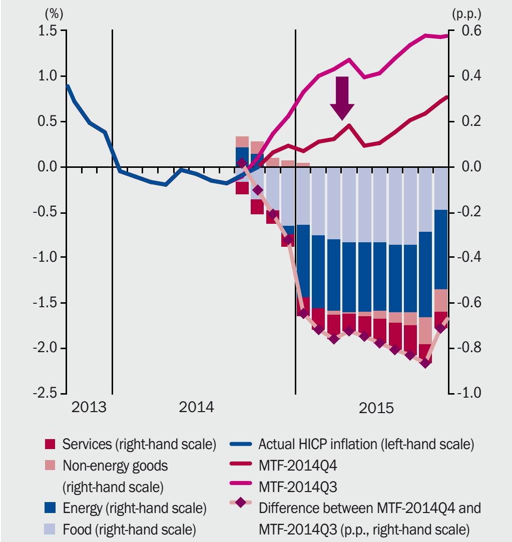
The annual rate of change in consumer prices in October was -0.1% on average. The downward pressure on prices came mainly from falling prices of energy and agricultural commodities. On the other hand, prices of non-energy industrial goods are increasing moderately, owing to import price developments. The most recent sharp drop in the oil price, from USD 85 to USD 70 per barrel, occurred after the cut-off date for this forecast, and therefore represents a downside risk to the inflation outlook for 2015. This risk may be moderated by the latest decision on developments in administered energy prices.

Chart 3 Price indicators (annual percentage changes)



Source: SO SR and NBS.

Chart 4 Inflation compared with projections (annual percentage changes; contributions in p.p.)

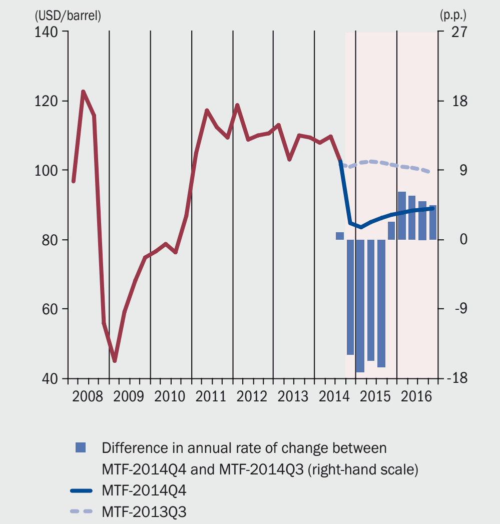


Source: SO SR and NBS.

3 Technical assumptions[4]

In early September, after the meeting of the ECB's Governing Council, a sharp correction in the **exchange rate** of the euro against the US dollar saw the euro depreciate to 1.29 USD/EUR. The rate continued to weaken until mid-November, when it stood at around 1.25 USD/EUR. This forecast assumes that the average exchange rate of USD per EUR will be 1.25 in both 2015 and 2016, which in each case is 4% weaker than projected in the previous forecast.

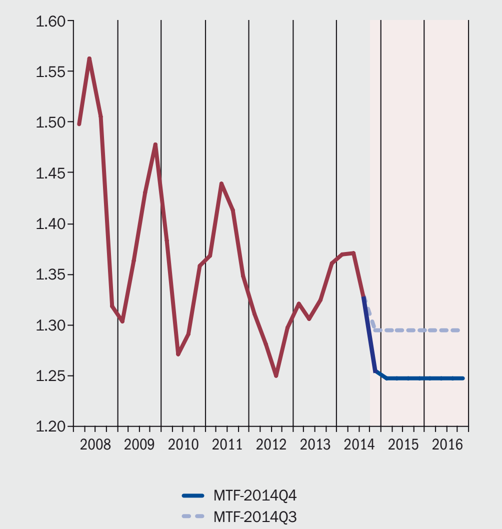
Chart 6 Price per barrel of Brent crude oil (USD)



Source: NBS and ECB.

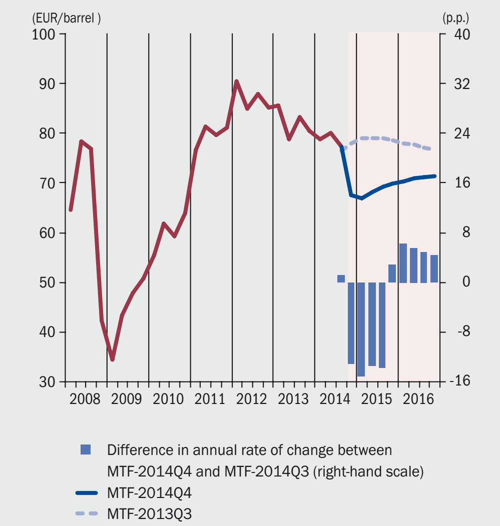
The Brent **crude oil price** followed a downward trajectory after the publication of the previous forecast. At the beginning of September the price was still in region of USD 100 per barrel, but with oil stocks rising and demand contracting sharply (owing mainly to developments in China), the price trended downwards until mid-November, when it stood at around USD 80 per barrel. This forecast assumes that the average barrel price will be USD 101.2 in 2014, USD 85.6 in 2015 and USD 88.5 in 2016. Compared with the previous forecast, the oil price in both dollar and euro is assumed to be lower over the projection horizon, and significantly lower in 2015 and 2016. Owing to the euro's weaker exchange rate, the differences between the forecasts are less marked for the price in euro than for the price in USD. After the cut-off date for this forecast, the oil price fell significantly again, to USD 75 per barrel.

Chart 5 USD/EUR exchange rate



Source: NBS and ECB.

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



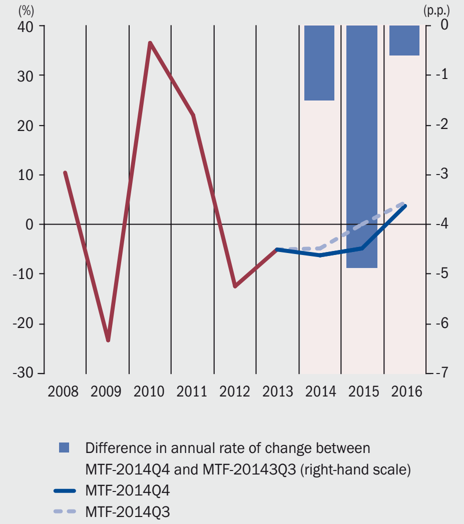
Source: NBS and ECB.

4 *The technical assumptions of the Medium-Term Forecast are based on the "December 2014 Eurosystem Staff Macroeconomic Projections for the Euro Area", with a cut-off date of 13 November 2014.*

Prices of non-energy commodities declined between the publication of the previous forecast and this forecast, and there were also decreases in food commodity prices and metals prices. Farm-gate food prices came under downward pressure from strong global harvests and increased production, particularly in the United States. In the case of some agricultural commodities, the decline may have been partly caused by the embargo on exports to Russia. The drop in metals prices reflected the impact on overall global demand of decelerating growth in China, and further downward pressure on these prices came from mounting inventories in certain countries. The assumption for this forecast is that non-energy commodity prices will fall by 6.3% in 2014, 4.8% in 2015 and 3.8% in 2016.

Short-term interest rates[5] (three-month EURIBOR) are assumed to average 0.2% in 2014 and 0.1% in both 2015 and 2016.

Chart 8 Non-energy commodity prices (annual percentage changes)



Source: NBS and ECB.

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

4 Forecast for the external environment[6]

World economic growth remains subdued, but is expected to gather momentum gradually amid improving financial conditions, continuing support from monetary policy, and a slowdown in fiscal consolidation in advanced economies. The assumption is that global GDP growth will increase slightly in 2014, to 3.3% (from 3.2% in 2013), and then accelerate to 3.7% in 2015 and 4.0% in 2016. Despite the recovery, global growth will be more moderate than previously projected. The US economy is expected to maintain robust growth, as private consumption is buoyed by positive developments in the labour market, and owing to favourable financial conditions. The United Kingdom, too, is expected to continue reporting relatively strong growth. As for the euro area, which has recently been facing stagnation risks, it is expected to benefit from more moderate fiscal measures, easier financial conditions (related in part to the banking union), and monetary policy impulses. In Japan, despite continuing fiscal consolidation, the economy is expected to return to a growth trajectory on the basis of accommodative monetary policy and of export growth predicated on a depreciating exchange rate. Developments across emerging economies will be heterogeneous. China may see growth slow as its focus gradually shifts to domestic consumption, but it will continue to be one of the fastest-growing emerging economies. The global economy will also be affected by the Russian economy, which will be subdued by low oil prices and restrictions on external trade. The Composite Leading Indictor (CLI) for OECD countries has remained flat in recent months, which further suggests that the global recovery will be no more than moderate over the short-term horizon.

The risks to the global growth forecast remain tilted to the downside, and include in particular the risk of financial instability in emerging economies, which vary considerably in terms of monetary and fiscal policy. Furthermore, several emerging economies have serious internal and external imbalances and are therefore more vulnerable to shifts in financial market sentiment and to external shocks. Among other downside risks are geopolitical tensions in the Middle East and the imposition of trade sanctions on Russia, which could reduce external demand for certain countries.

Euro area GDP growth is expected to be relatively muted in 2014 and to pick up only moderately in 2015 and 2016. As for factors supporting the pick-up in activity, domestic demand should benefit from the accommodative monetary policy stance and an improved functioning of the monetary policy transmission process – further strengthened by the standard and non-standard measures recently taken by the ECB – a broadly neutral fiscal stance following years of substantial fiscal tightening, and some improvement in credit supply conditions. In addition, private consumption should benefit from a pick-up in real disposable income stemming in particular from the favourable impact of falling commodity prices, but also from rising, albeit moderate, wage and employment growth. Furthermore, overall activity will be increasingly supported over the projection horizon by the favourable impact on exports of an assumed gradual strengthening of external demand, further bolstered by the impact of euro depreciation. However, the recovery is projected to remain subdued as a number of factors continue to dampen growth. The ongoing need for the adjustment of private and public sector balance sheets is expected to diminish only gradually over the projection horizon. Moreover, the drag on private consumption from high unemployment rates in some countries is expected to abate only gradually, while ample spare capacity in some countries will continue to hold back investment spending. Economic growth is also facing headwinds from geopolitical tensions. In terms of annual averages, GDP growth is expected to be 0.8% in 2014, 1.0% in 2015 and 1.5% in 2016[7].

Euro area HICP inflation decelerated further in the third quarter and remained subdued in the next two months, reflecting mainly falls in energy prices (only partly offset by depreciation of the euro exchange rate), as well as modest trends in prices of non-energy industrial goods and of services. Over the projection horizon, average HICP inflation is projected to increase only grad-

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

7 The figures are in the middle of the forecast range for GDP growth. The ECB's projection ranges for GDP growth are 0.7% – 0.9% in 2014, 0.4% – 1.6 % in 2015, and 0.4% – 2.6% in 2016.

ually, from 0.5% in 2014 to 0.7% in 2015 and 1.3% in 2016. This increase is expected to result from the gradual narrowing of the output gap and rising external price pressures. The latter reflect in particular a swing from downward to upward pressures stemming from commodity prices and from the pass-through of the past weakening of the euro exchange rate.

HICP inflation excluding food and energy is assumed to increase from 0.8% in 2014 to 1.1% in 2015 and 1.3% in 2016,[8] owing to the expected pick-up in activity, narrowing output gap, and growth in wages and profits. HICP excluding food, energy and changes in indirect taxes is projected to increase over the projection horizon, from 0.7% in 2014, to 1.0% in 2015 and 1.3% in 2016.

The impact of domestic price pressures is expected to be subdued. Compensation per employee growth is projected to rise slowly in 2014, to 1.6%, and to be 1.5% in 2015 and 1.8% in 2016. Stronger productivity growth is expected to be reflected in unit labour cost growth, which is projected to decrease to 1.1% in 2014 and then to 0.8% in both 2015 and 2016. Unit labour costs should be the main source of low domestic cost pressures until the end of the projection horizon.

Profit margins are expected to decline slightly in 2014, stabilise in 2015 and then rebound moderately.

Global trade weakened markedly at the beginning of 2014 as trade declined mainly in emerging economies. With integration proceeding more slowly, the elasticity of world trade growth to global activity has fallen. In consequence, global trade growth is projected to increase only moderately in 2014, by 2.9% (compared with 2.8% in 2013). Going forward, however, investment activity of advanced economies should catalyse global trade growth, up to 4.1% in 2015 and 5.3% in 2016. The **growth in Slovakia's external demand** will be affected by the expected developments in global trade and particularly in the country's main trading partners. External demand growth is projected to be 3.5% in 2015, unchanged from 2014, and then to increase to 5.0% in 2016.

8 The figures are in the middle of the forecast range for the HICP rate. The ECB's projection ranges for the HICP rate are 0.5% – 0.5% in 2014, 0.2% – 1.2% in 2015, and 0.6% – 2.0% in 2016.

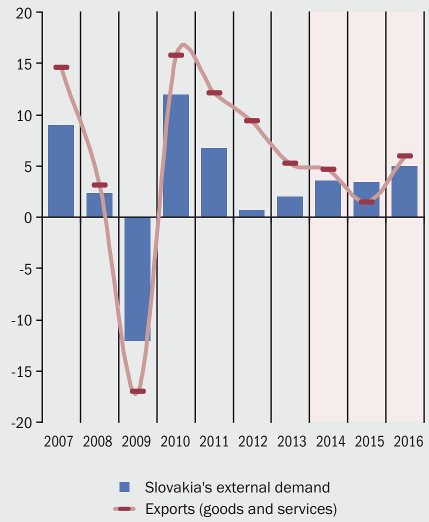
5 Macroeconomic forecast for Slovakia

5.1 ECONOMIC GROWTH

Temporary worsening of export performance

In an environment of rising external demand, the decline in export performance in the third quarter was reflected in a fall of market shares. Considering the potential impact of methodological changes (resulting from the migration to ESA 2010), this situation is not expected to continue over the medium-term horizon. In the short-term, export growth is assumed to fully reflect external demand for Slovak goods and services; however, market share gains are not envisaged, given the continuance of current developments and firms' deteriorating expectations for exports over coming quarters. Over the medium-term horizon, market share gains are expected to re-emerge and exports should increase more than external demand, owing to the positive impact of competition supported by an undervalued real exchange rate.

Chart 9 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 gather momentum gradually over medium-term horizon after temporary slowdown

Investment activity is expected to weaken temporarily over the short term horizon, owing to the current elevated uncertainty implied by forward-looking confidence indicators. No signs of a significant change in residential construction are to be found either in construction sector developments or apartment prices. Private investment activity is expected to gather pace from the second half of 2015, as economic growth increases and the factors weighing on sentiment in Slovakia and the euro area begin to fade, and with support from accommodative monetary policy. After increasing significantly in 2014, government investment is expected to grow more slowly in 2015 and to decline markedly in 2016. This should reflect a reduced inflow of EU funds, as the EU's new programming period is expected to have a slow start.

Private consumption to continue recovering

With private consumption figures currently favourable and consumer confidence at a high level, household consumption is expected to continue increasing. At the same time, appreciable growth in nominal income within a low-inflation environment should have an upward effect on private consumption.

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

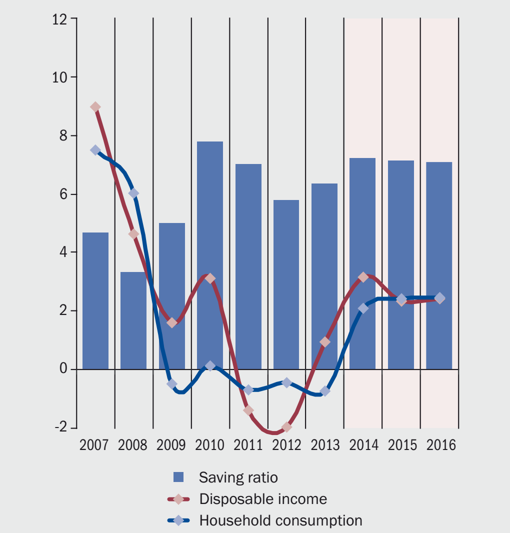
	2013	2014	2015	2016
Gross fixed capital formation	**-2.7**	**3.6**	**3.3**	**3.0**
– private sector	-3.1	2.7	3.3	4.9
– adjusted to exclude one-off investment in the automotive industry	-4.5	6.3	3.3	4.9
– general government sector	0.5	8.7	3.5	-8.4

Source: SO SR and NBS.

From the beginning of 2015, wages and consumption are assumed to be affected by the following changes in labour market legislation.

1. The minimum wage will be raised to €380 while employers will receive compensation to ensure their labour costs do not rise. The positive impact of this change on wage growth is estimated at 0.25 percentage point.
2. The introduction of a deductible item reducing the social contributions payable by lower-income workers will have a positive impact on the net wages and disposable income of such people. The impact of both measures will pass through fully to private consumption, without affecting savings.
3. Collective agreement extensions have been in force from this year, but they are not expected to have a real impact until 2015. That positive impact on wage growth is estimated at 0.1 percentage point, and should be reflected in the final consumption and savings of households.

Chart 10 Household income, consumption (annual percentage changes; constant prices) and saving ratio (%)



Source: SO SR and NBS.

Public expenditure to stimulate demand to a gradually lesser extent

After rising sharply in the first half of 2014, final consumption of general government is expected to grow moderately. Based on current information, the forecast assumes that the nominal annual growth rate of government final consumption slowed to 3.9% in the third quarter of 2014, owing mainly to lower growth in social benefits in kind. Compensation and intermediate consumption are expected to continue increasing. The projected real growth in public consumption for the whole of 2014 is therefore 4.1%. That exceptionally high level is not, however, expected to be maintained over the rest of the forecast period, with the growth rate projected to slow to 1.8% in 2015 and 1.4% in 2016. The changeover to the ESA 2010 methodology resulted in government debt for 2013 being revised down to below the debt brake threshold of 55% of GDP, and since the debt is not expected to exceed that threshold during the projection horizon, this forecast does not envisage debt brake effects.

Imports to reflect mainly improving export performance

As a consequence of increasing domestic demand, import growth is temporarily quite high this year. Looking ahead, imports are expected to increase in line with export growth, while import intensity should remain at the current level. The terms of trade are expected to support Slovakia's external trade, with a consequent gradual increase in the balance of payments current account surplus over the projection horizon.

Economic growth to accelerate moderately over the medium-term horizon

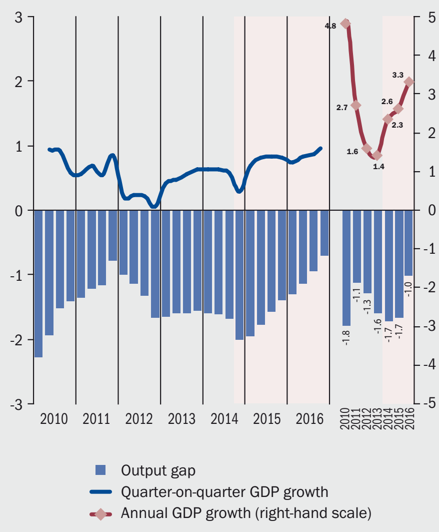
Economic growth is expected to be more balanced in 2014 than in previous years. **GDP growth is projected to be 2.3% in 2014, rising**

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

	2013	2014	2015	2016
General government final consumption (constant prices)	2.4	4.1	1.8	1.4
Public investment (constant prices)	0.5	8.7	3.5	-8.4
Contribution of public consumption and investment to GDP growth (p.p.)	0.4	1.0	0.4	0.0

Source: SO SR and NBS.

Chart 11 GDP growth and the output gap (%)



Source: SO SR and NBS.

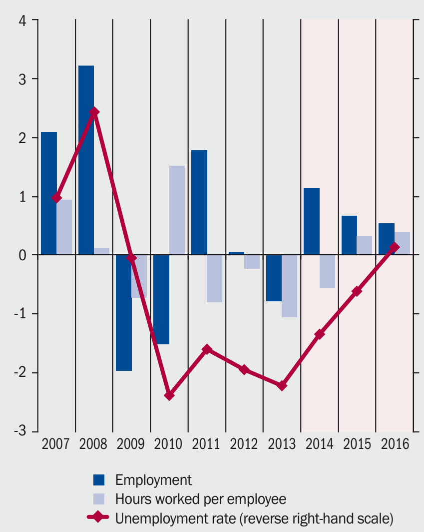
to 2.6% in 2015 and 3.3% in 2016. Domestic demand should be the main driver of growth in 2015, as it has been this year, and external demand and export performance are expected to pick-up significantly in 2016. The output gap is not expected to close before the end of the projection horizon, while the continuing slack in production capacity should have a disinflationary effect.

5.2 LABOUR MARKET

NET JOB CREATION CONTINUES

Turning to the labour market, net job creation is expected to moderate in the fourth quarter of 2014 after marked growth during the first three quarters. This is inferred from forward-looking indicators, with employers now less optimistic about employment than they were at the beginning of the year. But in 2014, despite the last-quarter slowdown, annual employment growth is expected to reach its second highest level since the crisis. Thus in their response to higher production, employers are recruiting to a greater extent. Going forward, the pace of employment growth is expected to decelerate, with activity growth being covered more by increases in the number of hours worked. It is assumed that employment growth will continue to put downward pressure on the unemployment rate, which is projected to fall to 11.6% by the end of the forecast period.

Chart 12 Employment, hours worked (annual percentage changes) and the unemployment rate (%)



Source: SO SR and NBS.

Table 3 Break-even point for employment in the private sector (annual export growth; domestic demand in brackets)

	Past (2005 – Q22014)	Present including forecasts (2010 – 2016)
Growth driven exclusively by external demand	8.25% (0.00%)	6.20% (0.00%)
Growth driven by external demand and domestic demand to a similar extent	3.60% (1.80%)	2.00% (1.00%)
Same pace of growth of external demand and domestic demand	2.35% (2.35%)	1.20% (1.20%)

Source: SO SR and NBS calculations.
Note: The estimation methodology is explained in, for example, Ball et al. (2012) "Okun's Law: Fit at Fifty?".

Whereas, in the pre-crisis period, net job creation required higher rates of economic growth, today it is happening at lower growth rates. According to historical data for the period 1999 –2014, employment growth in the private sector required annual GDP growth of around 3%. However, according to estimates based on a shortened time series, this relationship changes over time and in the recent period (2005–2014) employment growth required annual GDP growth of only around 2.25%. Applying a projected time series trajectory, the estimated figure for the period 2010–2016 is 1.1%. Differences in the GDP growth rate required for job creation are also caused by whether the growth is driven mainly by external or domestic demand. Domestic demand growth supports job creation to a greater extent than does export growth.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

Marked labour cost growth this year

The sharp rise in unit labour costs this year is expected to stem mainly from high employee compensation that is not covered by labour productivity. Since productivity gains were generated in previous years, there has been scope this year for compensation growth to exceed productivity growth on a one-off basis. Looking forward, unit labour cost growth is expected to be around 1%. In 2015, labour cost growth is expected to be moderately higher than price growth, and firms' profit margins are assumed to be falling. The situation is expected to turn around in 2016, as profit margins increase and firms should have greater capacity for investment.

Prices to increase gradually from the last quarter of this year

The annual average inflation rate for 2014 is projected to be -0.1%, and price growth is expected to start picking up in the first quarter of 2015. This increase should be reflected in the projected development of import prices, with their assumed growth expected to have an upward effect on non-energy industrial goods inflation. Domestic price pressures are expected to remain weak and hence services price inflation should rise only marginally. Food prices are projected to be low, albeit rising moderately over the projection horizon in accordance with technical as-

Table 4 Unit labour costs (annual percentage changes)

	2013	2014	2015	2016
Nominal compensation per employee (ESA)	2.6	3.8	2.8	4.0
Real productivity	2.2	1.2	1.9	2.8
Unit labour costs	0.3	2.6	0.9	1.2
GDP deflator	0.5	-0.3	0.3	1.7

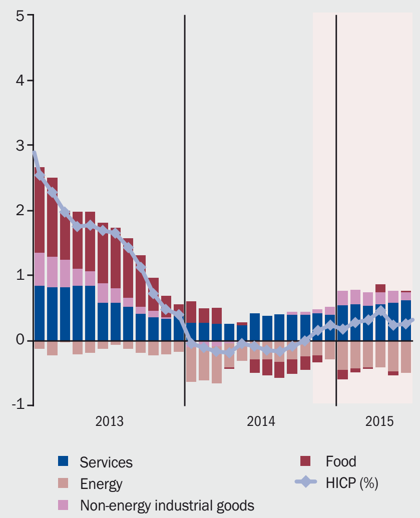
Source: SO SR and NBS calculations.

Table 5 Wages (annual percentage changes)

	2013	2014	2015	2016
Nominal labour productivity	2.7	0.7	2.2	4.5
Whole economy – nominal	2.4	4.2	2.8	4.0
Whole economy – real	1.0	4.2	2.2	2.2
Public administration, education and health care – nominal	3.6	4.2	3.7	3.5
Public administration, education and health care – real	2.1	4.3	3.2	1.6
Private sector – nominal	2.0	4.1	2.5	4.2
Private sector – real	0.6	4.1	1.9	2.3

Source: SO SR and NBS calculations.
Note: Deflated by the CPI.

Chart 13 Expected composition of annual inflation in 2014 (p.p.)



Source: SO SR and NBS.

sumptions. Their rate of change is expected to remain in negative territory in the first half of 2015, but that state should only be temporary. As a result of falling energy commodity prices, energy prices are expected to put downward pressure on the headline inflation rate over the projection horizon. Towards the end of the projection period, the inflation rate is expected to return to close to 2%, which, given the convergence of Slovakia, is considered to be lower than equilibrium inflation.[9]

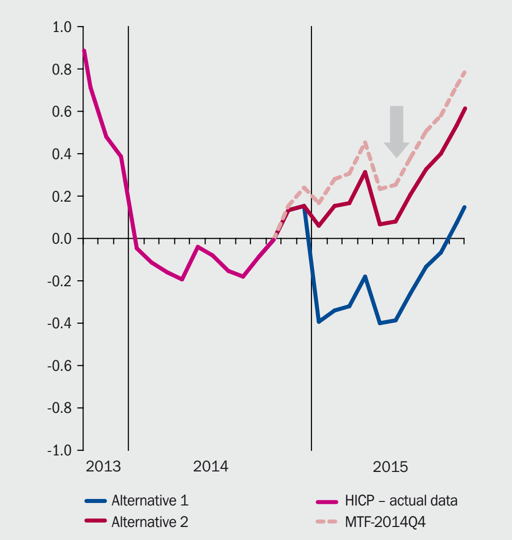
9 *Equilibrium inflation for Slovakia is estimated at close to 3%. Further information is available, in the Slovak language, in the analytical commentary entitled "Perspektívy dlhodobejšieho vývoja slovenskej ekonomiky (do roku 2020)" (Outlooks for longer-run developments in the Slovak economy (until 2020)). http://www.nbs.sk/_img/Documents/_komentare/AnalytickeKomentare/2014/AK08_Trendy.pdf*

6 Risks to the forecast

The risks to the real economy forecast are balanced. On the one hand, growth could be boosted by accommodative monetary policy and low oil prices, while, on the other hand, there are persisting geopolitical risks and weak outlooks for global trade growth.

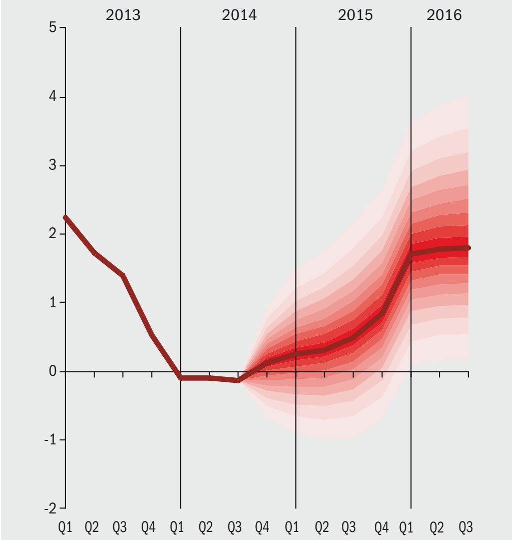
The risks to the inflation outlook for 2015 are tilted to the downside owing to the continuing decline in oil prices.

Chart 14 Alternative HICP inflation developments showing the impact of a decrease in oil prices (annual percentage changes)



Source: NBS calculations.
Alternative 1: Technical pass-through to the HICP of the current decrease in oil prices (an average annual drop of 23%).
Alternative 2: Technical pass-through to the HICP of the decrease in oil prices, as well as of administered energy prices according to the most recent information (published after the cut-off date for the forecast).

Chart 15 HICP inflation forecast (%)



Source: SO SR and NBS.

Table 6 Risks to the forecast

	2014	2015	2016
GDP	Balanced	Balanced	Balanced
Inflation		↓Oil	Balanced

Source: NBS.

7 Comparison with the previous forecast

The previous forecast was produced using data according to ESA 95, and therefore the comparison of GDP composition projections between MTF-2014Q3 and MTF-2014Q4 is substantially distorted.

Comparing the technical assumptions of this forecast with those of the previous forecast, the estimation of external demand is appreciably lower in 2015. In addition, the exchange rate is weaker, oil prices are lower, and external inflation is slightly reduced.

Changeover to ESA 2010 methodology affected both historical data and the outlook for the period ahead

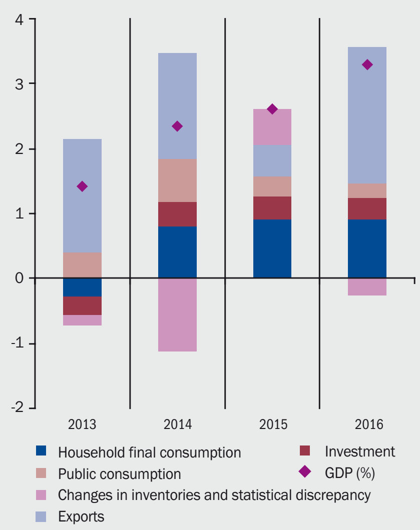
Since the changeover in national accounts methodology, from ESA 95 to ESA 2010, resulted in substantial revisions to previous GDP figures (including the level, growth and composition of GDP), it is difficult to make comparisons between this forecast and the previous forecast. Furthermore, owing to the revisions, domestic demand in 2014 is not as positive as was envisaged in the previous forecast (it is lower due to the revised outlook for growth in investment and also in private consumption). The forecast for 2014 factored in the flash estimate for GDP growth in the third quarter of 2014, but while the growth level was in line with the previous forecast, the composition differed from it (in particular, exports and imports were weaker, and investment was stronger). The latest forecast for GDP composition in 2014 includes downward revisions to exports, investment and private consumption; however, with imports expected to fall even further than previously projected (more than exports) and inventory changes assumed to make a less negative contribution, the outlook for overall GDP growth in 2014 remains unchanged. Over the medium-term horizon, the largest revision is to the forecast for export growth, which, owing to reassessments of external demand, has been revised down and is reflected in lower projections for economic growth in 2015 and 2016.

The revised amounts of exports and imports reduced the level of net exports and the net exports-to-GDP ratio. In both 2014 and 2015 the ratio is reduced from 5.8% in the previous forecast, to 4.5%, and in 2016 from 6.4% to 4.8%.

Labour market outlook remains unchanged

The official flash estimate for employment in the third quarter of 2014 matched the projections of the previous forecast, and therefore the outlook for employment developments over the projection horizon remains unchanged. The unemployment rate forecast is broadly the same, although monthly data from the third quarter imply a slightly greater rate of decrease in the rate and this fact is reflected in the projection for the period ahead.

Chart 16 Composition of GDP growth[1)] (annual percentage changes; contributions in p.p.)

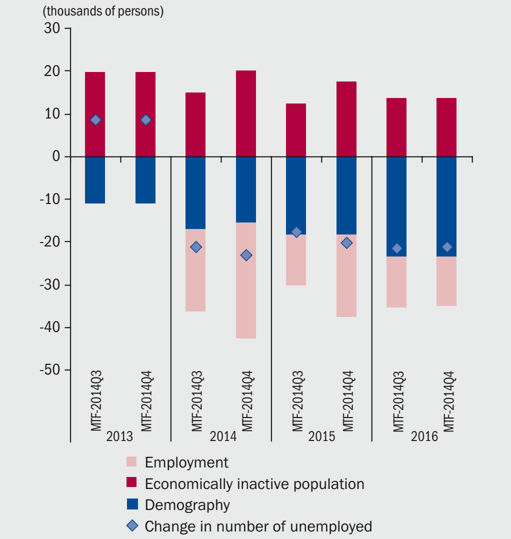


Source: SO SR and NBS.
Note: The item "Changes in inventories and statistical discrepancy" includes uncategorised imports that remained after the calculation of import intensity.
1) The composition of GDP growth is calculated as the contributions of components to GDP growth after deducting their import 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 – 62.5%). Remaining imports were included under changes in inventories and the statistical discrepancy.

Inflation forecast for next year revised significantly down

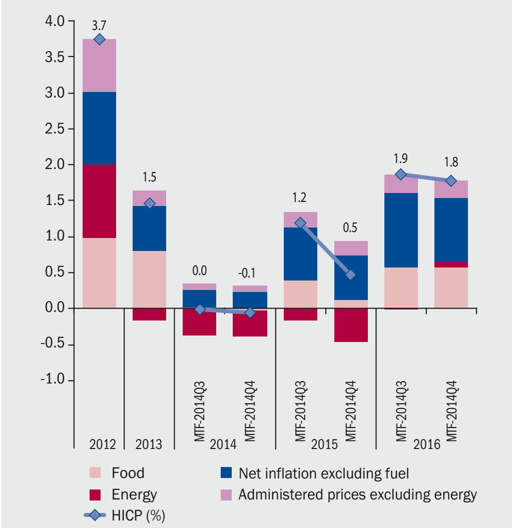
The inflation outlook for 2015 is substantially revised in this forecast. Technical assumptions for inflation in agricultural commodity prices in 2015 were revised down, and this change was reflected in lower food price inflation. Projected inflation in energy commodity prices in 2015 was also adjusted downwards, and therefore the forecast for energy prices in that year has been revised down significantly. The revision to the 2015 inflation forecast from the projections of the previous forecast also reflected lower than expected food and services price inflation.

Chart 17 Comparison of labour market indicators (contributions to unemployment)



Source: SO SR and NBS.

Chart 18 Comparison of inflation forecasts (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

8 Impact of the MTF-2014Q4 macroeconomic forecast on public finances

The impact of the macroeconomic projections of this forecast (MTF-2014Q4) would constitute only a slight upward revision to the collection of taxes and contributions over the projection horizon, following the legislative assumptions and collection efficiency assumptions taken into account at November's meeting of the Tax Revenue Forecasting Committee. While this forecast assumes slower wage growth in the second half of 2014 compared with the assumptions followed at September's meeting of the Macroeconomic Forecasting Committee, this difference is outweighed by more positive expectations for nominal household consumption and government intermediate consumption.

Table 7 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-2014Q4 macroeconomic projections differs from the outlook according to FPI assumptions (November 2014)	2014	2015	2016
Personal income tax	-7	-10	-15
Corporate income tax	-1	-19	-27
Withholding tax	-3	0	5
VAT	40	87	76
Excise taxes	18	42	37
Social and health insurance	-29	-34	-49
Total (impact of taxes and contributions)	17	66	26
Total (impact of taxes and contributions, % of GDP)	0.0	0.1	0.0
Impact of nominal GDP changes on the deficit target[1)]	-1	-14	-13
Total (EUR millions)	**16**	**51**	**13**
Total (% of GDP)	**0.0**	**0.1**	**0.0**

Source: NBS – based on the estimated impact of macroeconomic developments on the general government balance, as calculated by the Finance Ministry's Financial Policy Institute (FPI).
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-2014Q4) for key macroeconomic indicators

Indicator	Unit	Actual	MTF-2014Q4			Difference versus MTF-2014Q3		
		2013	2014	2015	2016	2014	2015	2016
Prices								
HICP inflation	year-on-year changes in %	1.5	-0.1	0.5	1.8	-0.1	-0.7	-0.1
CPI inflation	year-on-year changes in %	1.4	0.0	0.5	1.8	0.0	-0.7	-0.1
GDP deflator	year-on-year changes in %	0.5	-0.3	0.3	1.7	0.0	-0.7	-0.1
Economic activity								
Gross domestic product	year-on-year changes in %, constant prices	1.4	2.3	2.6	3.3	0.0	-0.3	-0.2
Final consumption of households	year-on-year changes in %, constant prices	-0.7	2.1	2.4	2.4	-0.9	0.2	0.0
Final consumption of general government	year-on-year changes in %, constant prices	2.4	4.1	1.8	1.4	0.0	0.4	0.2
Gross fixed capital formation	year-on-year changes in %, constant prices	-2.7	3.6	3.3	3.0	-1.6	-0.1	-0.6
Exports of goods and services	year-on-year changes in %, constant prices	5.2	4.6	1.4	5.9	-0.4	-2.8	-0.6
Imports of goods and services	year-on-year changes in %, constant prices	3.8	5.1	1.2	5.1	-1.0	-2.8	-0.9
Net exports	EUR millions in constant prices	5,106	5,067	5,263	6,094	-4,306	-4,636	-4,751
Output gap	% of potential output	-1.6	-1.7	-1.7	-1.0	0.0	-0.3	-0.3
Gross domestic product	EUR millions in current prices	73,593	75,082	77,290	81,223	1,463	734	511
Labour market								
Employment	thousands of persons, ESA 2010	2,192	2,217	2,232	2,244	-0.1	0.7	0.4
Employment	year-on-year changes in %, ESA 2010	-0.8	1.1	0.7	0.5	0.0	0.1	-0.1
Number of unemployed	thousands of persons [1]	386	363	343	321	-2.0	-4.4	-4.0
Unemployment rate	%	14.2	13.3	12.6	11.9	-0.1	-0.2	-0.2
Unemployment gap [2]	p. p.	1.7	1.2	1.0	0.7	0.1	0.1	0.1
Labour productivity [3]	year-on-year changes in %	2.2	1.2	1.9	2.8	0.0	-0.4	-0.2
Nominal productivity [4]	year-on-year changes in %	2.7	0.7	2.2	4.5	-0.1	-1.1	-0.3
Nominal compensation per employee	year-on-year changes in %, ESA 2010	2.6	3.8	2.8	4.0	-0.2	-0.4	-0.1
Nominal wages [5]	year-on-year changes in %	2.4	4.2	2.8	4.0	-0.1	0.1	-0.1
Real wages [6]	year-on-year changes in %	1.0	4.2	2.2	2.2	-0.1	0.8	0.1
Households								
Disposable income	constant prices	1.0	3.2	2.3	2.4	-0.2	0.1	0.0
Savings rate	% of disposable income	6.3	7.2	7.1	7.1	0.1	0.0	0.0
Balance of payments								
Goods balance	% of GDP	4.6	4.5	4.5	4.7	-1.3	-1.3	-1.7
Current acount	% of GDP	0.9	0.6	0.6	0.7	-1.2	-1.4	-1.4
External environment and technical assumptions								
External demand growth for Slovakia	year-on-year changes in %	2.0	3.5	3.5	5.0	-0.8	-0.6	-0.6
Exchange rate (USD/EUR) [7]	level	1.33	1.33	1.25	1.25	-0.8	-3.6	-3.6
Oil price in USD	level	108.8	101.2	85.6	88.5	-3.6	-16.2	-11.7
Oil price in USD	year-on-year changes in %	-2.8	-7.0	-15.5	3.4	-3.5	-12.7	5.3
Oil price in EUR	year-on-year changes in %	-5.9	-7.1	-9.9	3.4	-2.7	-10.5	5.3
Non-energy commodity prices in USD	year-on-year changes in %	-5.0	-6.3	-4.8	3.8	-1.5	-4.9	-0.6
EURIBOR 3M [8]	% p. a.	0.2	0.2	0.1	0.1	0.0	-0.1	-0.1
10-Y Slovak government bond yields	%	3.2	2.1	1.5	1.8	-0.2	-0.6	-0.6

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 2010.*
4) *Nominal GDP divided by employment (quarterly reporting by SO SR).*
5) *Average monthly wages based on nominal GDP and employment 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 November 2014.*

The time series of selected macroeconomic indicators can be found at
http://www.nbs.sk/_img/Documents/_Publikacie/PREDIK/2014/MTF-2014Q4.xls