NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Medium-term forecast

Update Q4 2014

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1 Update of the MTF-2014Q4 Medium-Term Forecast[1]

For this update (MTF-2014Q4U) of the Medium-Term Forecast published in December, Národná banka Slovenska factored in the detailed composition of GDP growth for the third quarter of 2014. It also took account of monthly data for the real economy from the fourth quarter and of forward-looking indicators[2] pointing to economic developments in the short-term horizon.

Compared with the previous forecast, the most significant revisions concern the technical assumptions[3]. The updated forecast incorporates the collapse in oil prices, whose impact was slightly offset by a weaker exchange rate. As a consequence of this positive supply shock, the projections for the Slovak economy over the medium-term horizon have improved.

Given the impact of this positive shock on Slovakia's most significant trading partners, demand for Slovak goods and services is expected to increase in 2015 and 2016. This year, however, the impact of this growth will be cancelled out by a moderate deterioration in current developments. Therefore, the increase in GDP growth will be driven mainly by the domestic side of the economy. Consumer demand will be buoyed by falling prices of essential goods and services. At the same time, investment growth is expected to be higher than projected in the previous forecast, owing to the impact of economic growth, current developments in the credit market, and accommodative monetary conditions. **Full-year GDP growth is expected to accelerate to 2.9% in 2015** (revised up by 0.3 percentage point from the previous forecast) **and then to 3.6% in 2016** (up by 0.3 p.p.).

Employment developments in the last quarter of 2014 were fully in line with the previous forecast. The assumed improvement in domestic demand over the projection horizon should enable stronger growth in employment than that projected in MTF-2014Q4. Employment growth is therefore expected to be 0.9% in 2015 (revised up by 0.2 p.p.) and 0.7% in 2016 (up by 0.2 p.p.)**,** which should put downward pressure on the unemployment rate. **Wage growth will reflect lower price inflation,** the assumption being that nominal wages will increase by less than projected in the previous forecast while at the same time **households should be better off in real terms**.

The most pronounced change is in the inflation forecast. As a result of the revisions to the technical assumptions, energy price projections for 2015 and 2016 are significantly lower, and the inflation forecast has been revised down accordingly. **Prices are expected to remain flat this year, as in 2014**. Inflation is not expected to increase until 2016, and then only to a moderate 1.4%, based on a marked rise in domestic demand and the fading of the impact of the oil price slump.

The risks to the updated projections are seen as balanced, with the significantly revised real economy and inflation outlooks now including the materialisation of risks specified in the December forecast.

1 The update of the Medium-Term Forecast MTF-2014Q4 is hereafter referred to by the abbreviation MTF-2014Q4U. The need to update December's medium-term forecast relates to the participation of Národná banka Slovenska on the Macroeconomic Forecasting Committee, which under the Fiscal Responsibility Act is required to produce a macroeconomic and tax forecast by 15 February. The cut-off date for the last forecast of the year (published in December) is usually around the third week in November, when updated figures (e.g. the detailed GDP data for the third quarter) are not yet available. An update of the December medium-term forecast has been produced since 2013.

2 The cut-off date for data used as the basis for this forecast is 18 January 2015.

3 The previous forecast, MTF-2014Q4, had a cut-off date of 14 November 2014.

2 Technical assumptions[4]

This updated forecast, MTF-2014Q4U, incorporates technical assumptions that are based on both external data (oil prices and the exchange rate) and NBS staff projections (for external demand and administered prices).

The exchange rate[5] of the euro against the US dollar depreciated quite markedly between the publication of December's forecast and the cut-off date for this update. The average rate over the projection horizon is assumed to be USD 1.20 per EUR, which in comparison with the corresponding assumption in the December forecast is weaker by around 4%.

The period after the cut-off date for the previous forecast also saw **oil prices** slump by almost 40%. Based on developments in oil price futures, the per-barrel price of oil is assumed to average USD 53.1 in 2015 (revised down by 38% from the December forecast) and USD 61.9 in 2016 (down by 30%). The assumed weaker USD/EUR exchange rate is expected to reduce only partially the decline in oil prices in euro.

Forecast for the external environment

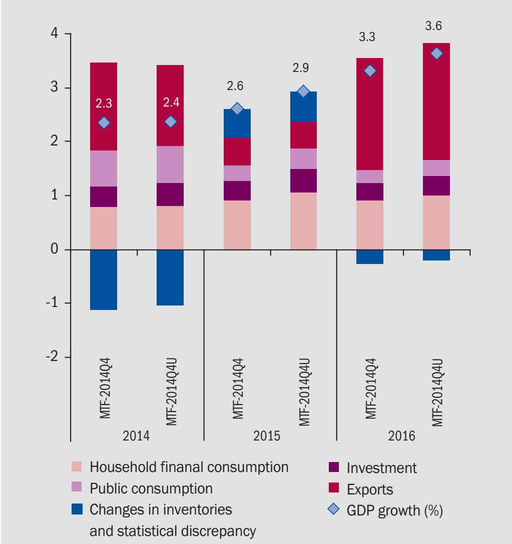
The latest forward-looking indicators suggest that economic sentiment has stopped declining after its deterioration in the third quarter of 2014. Most euro area indicators have stabilised (including the economic sentiment indicator, the Purchasing Managers' Index, and the Eurocoin index), and in Germany some indexes have even strengthened (ZEW, Ifo). In October and November 2014 both manufacturing production and retail trade surpassed their average levels recorded in the third quarter, thus providing a further sign of continuing moderate activity growth in Germany and in the euro area as a whole. These indicators add credence to the outlook for Slovakia's external demand, although the substantially reduced oil price is expected to act as a major stimulus to that demand. The assumption is that the positive supply shock from oil prices will fuel growth in Slovakia's trading partners and boost their demand for imports. Consequently, the updated forecast assumes that Slovakia's external demand growth will be higher than projected in the previous forecast, by 0.4 p.p. in 2015 and 0.2 p.p. in 2016.

Macroeconomic forecast for Slovakia

In this forecast, the projections for Slovakia's economic growth in 2015 and 2016 are each revised up by 0.3 p.p. from the projections in the previous forecast. This reflects adjustments to both the domestic environment and export outlooks. **Hence the economy is now expected to grow by 2.9% in 2015 and by 3.6% in 2016. The increase in the growth outlook is largely accounted for by higher domestic demand**.

Recent monthly figures pointed to an increase in private consumption growth, **but the principal stimulus to this growth is expected to be falling prices and their upward effect on real**

Chart 1 Comparison of economic growth forecasts[1)] (annual percentage growth in GDP at constant prices; contributions to growth in p.p.)



Source: NBS.
1) The composition of GDP growth is calculated as the contributions of components to GDP growth after deducting their import intensity. In this case the calculation uses constant coefficients of 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.

4 The technical assumptions of MTF-2013Q4U, as well as the assumptions for external demand developments, are based on data with a cut-off date of 12 January 2015.
5 The bilateral USD/EUR exchange rate is assumed to remain unchanged over the projection horizon at the average level prevailing in the ten-working day period ending on the cut-off date.

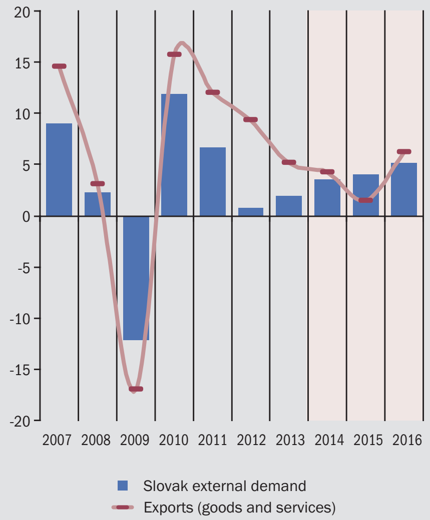
wages. The pass-through of subdued inflation to nominal wage bargaining is expected to be only partial, since higher labour productivity growth is expected to contribute to higher wage growth. Overall, the positive supply shock of the oil price slump, with its downward impact on prices of essential goods and services, is expected to boost the consumption expenditure of households.

Public consumption growth is higher than projected in the previous forecast owing to current developments. These include an increase in compensation per employee growth, although its impact has been partly offset by a decline in intermediate consumption. Public expenditure growth is expected to be influenced mainly by the impact of lower inflation, which, in the context of unchanged nominal consumption, should support economic growth.

Investment growth over the production horizon is expected to be supported by stronger economic growth, higher profits, and accommodative monetary policy. Further evidence for this view is provided by current indicators of investment demand, in particular lending activity. In comparison with the previous forecast, the assumption for investment demand over the projection horizon has been revised up slightly.

Turning to exports, this MTF-2014Q4U forecast encompasses two counteracting tendencies. On the one hand, the most recent export figures suggest that the weaker export performance observed since the second quarter of 2014 has continued, with exports and industrial production having fallen further than projected in the December forecast. On the other hand, the positive supply shock of the oil price slump in the last quarter of 2014 is expected to stimulate external demand for Slovak goods and services, which should in turn boost export performance. Over the medium-term horizon, with the positive impact of the external environment expected to predominate, it is assumed that export performance will drive an increase in economic growth. However, the positive and negative impacts on GDP growth will be more balanced. Slovakia began to lose market shares during 2014, with a pass-through effect on average growth going into 2015. This may have been partially affected by the real exchange rate, which had been increasingly undervalued but became less so in

Chart 2 Slovak exports and external demand (annual percentage changes; constant prices)



Source: NBS.

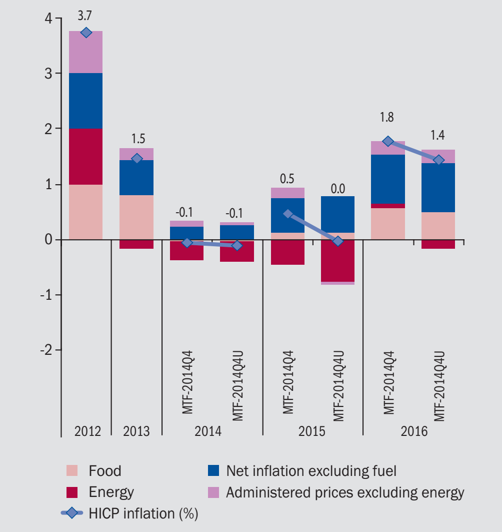
the last period as wage growth started exceeding productivity growth. Import growth is expected to be slightly stronger than projected in the previous forecast, since the outlook for domestic demand has been revised up.

As regards the **labour market,** a moderate increase in job creation is projected, based mainly on increased growth in domestic demand. **Employment growth is therefore expected to be higher than projected in the December forecast, by 0.2 percentage point in both 2015 and 2016.** The net number of jobs created in the Slovak economy is expected to be 18,000 in 2015 and 15,000 in 2016. The positive employment trend will have a downward effect on the unemployment rate, which is assumed to fall to 11.2% by the end of the projection horizon.

Looking at **wage developments,** nominal wage growth is expected to be slightly lower than projected in the previous forecast, since the low level of current and expected inflation may have been factored into wage bargaining. In real terms, however, income from labour is expected to be 0.4 p.p. higher this year, thus supporting private consumption growth.

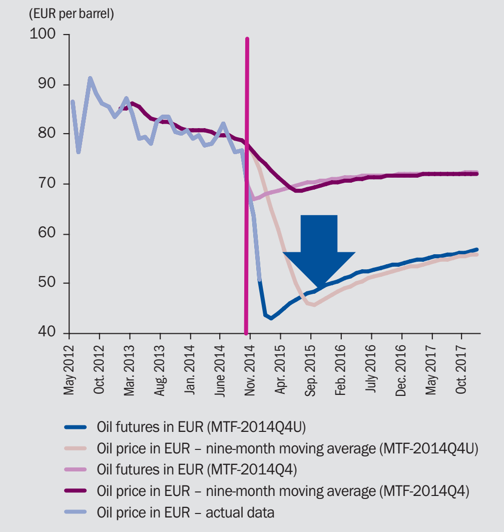
The most substantial changes in the updated forecast concerned **inflation.** The average annual inflation rate projection is revised down by 0.5 p.p. in 2015 and 0.4 p.p. in 2016, owing mainly to the significant revision of technical assumptions (in particular oil prices). Thus prices are expected to remain flat and therefore inflation should be, as in 2014, at historically low levels. Energy prices are expected to make the largest negative contribution to the headline inflation rate.[6] Assumptions for prices of agricultural commodities remain unchanged, and therefore food price projections are expected to remain largely the same as in the previous forecast. The inflation forecast for 2016 has been adjusted down owing to the revision of energy price developments. The fall in energy commodity prices may therefore create scope for a further reduction in gas and heat prices. The outlook for other components of inflation is unchanged.

Chart 3 Comparison of inflation projections broken down by component (annual percentage changes; contributions in p.p.)



Source: NBS.

Chart 4 Assumptions for Brent oil prices (EUR per barrel)



Source: NBS and ECB.

6 *The forecast includes the assumption that energy prices will fall by 4.8% (including prices of fuel, gas – by around 7% over the course of the year – heat, and electricity); their negative impact on the inflation rate is estimated at around 0.8 percentage point, approximately 0.3 p.p. more than the impact projected in the previous forecast.*

Table 1 Update of the MTF-2014Q4 Medium-Term Forecast for key macroeconomic indicators								
Indicator	Unit	Actual	MTF-2014Q4			Difference versus MTF-2014Q4		
		2013	2014	2015	2016	2014	2015	2016
Prices								
HICP inflation	year-on-year changes in %	1.5	-0.1	0.0	1.4	0.0	-0.5	-0.4
CPI inflation	year-on-year changes in %	1.4	-0.1	0.1	1.5	0.0	-0.5	-0.3
GDP deflator	year-on-year changes in %	0.5	-0.3	0.0	1.6	0.0	-0.4	-0.1
Economic activity								
Gross domestic product	year-on-year changes in %, constant prices	1.4	2.4	2.9	3.6	0.0	0.3	0.3
Final consumption of households	year-on-year changes in %, constant prices	-0.7	2.1	2.8	2.7	0.0	0.4	0.2
Final consumption of general government	year-on-year changes in %, constant prices	2.4	4.2	2.2	1.7	0.1	0.5	0.3
Gross fixed capital formation	year-on-year changes in %, constant prices	-2.7	4.2	4.2	3.4	0.6	0.8	0.4
Exports of goods and services	year-on-year changes in %, constant prices	5.2	4.3	1.4	6.2	-0.4	0.0	0.3
Imports of goods and services	year-on-year changes in %, constant prices	3.8	4.8	1.4	5.3	-0.3	0.2	0.2
Net exports	EUR millions in constant prices	5,106	5,008	5,087	5,968	-59	-176	-126
Output gap	% of potential output	-1.6	-1.7	-1.3	-0.4	0.0	0.4	0.6
Gross domestic product	EUR millions in current prices	73,593	75,081	77,252	81,357	0	-38	134
Labour market								
Employment	thousands of persons, ESA 2010	2,192	2,217	2,237	2,253	0.2	4.6	9.2
Employment	year-on-year changes in %, ESA 2010	-0.8	1.2	0.9	0.7	0.1	0.2	0.2
Number of unemployed	thousands of persons [1]	386	362	338	312	-0.4	-4.9	-9.5
Unemployment rate	%	14.2	13.3	12.4	11.5	0.0	-0.2	-0.4
Unemployment gap [2]	p. p.	1.9	1.4	1.0	0.6	0.2	0.0	-0.1
Labour productivity [3]	year-on-year changes in %	2.2	1.2	2.0	2.9	0.0	0.1	0.1
Nominal productivity [4]	year-on-year changes in %	2.7	0.9	2.1	4.5	0.2	-0.2	0.0
Nominal compensation per employee	year-on-year changes in %, ESA 2010	2.6	3.3	2.5	3.6	-0.5	-0.3	-0.4
Nominal wages [5]	year-on-year changes in %	2.4	4.2	2.7	3.7	0.0	-0.1	-0.3
Real wages [6]	year-on-year changes in %	1.0	4.2	2.6	2.1	0.0	0.4	-0.1
Households								
Disposable income	constant prices	2.4	3.7	3.1	2.7	0.5	0.8	0.2
Savings rate	% of disposable income	7.5	9.1	9.4	9.4	1.9	2.3	2.3
Balance of payments								
Goods balance	% of GDP	4.6	4.5	5.7	5.7	0.0	1.2	0.9
Current acount	% of GDP	1.5	0.4	1.8	1.6	-0.1	1.1	0.9
External environment and technical assumptions								
External demand growth for Slovakia	year-on-year changes in %	2.0	3.5	3.9	5.2	0.0	0.4	0.2
Exchange rate (USD/EUR) [7]	level	1.33	1.33	1.20	1.20	-0.1	-4.2	-4.1
Oil price in USD	level	108.8	99.3	53.1	61.9	-1.9	-37.9	-30.1
Oil price in USD	year-on-year changes in %	-2.8	-8.7	-46.5	16.5	-1.7	-31.0	13.1
Oil price in EUR	year-on-year changes in %	-5.9	-8.8	-40.6	16.5	-1.7	-30.7	13.1
Non-energy commodity prices in USD	year-on-year changes in %	-5.0	-6.3	-4.8	3.8	0.0	0.0	0.0
EURIBOR 3M [8]	% p. a.	0.2	0.2	0.1	0.1	0.0	0.0	0.0
10-Y Slovak government bond yields	%	3.2	2.1	1.5	1.8	0.0	0.0	0.0

Source: NBS, ECB, SO SR.

1) *Labour Force Survey.*
2) *Difference between unemployment rate and NAIRU (non-accelerating inflation rate of unemployment). A 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 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 12 January 2015.*

The time series of selected macroeconomic indicators can be found at
http://www.nbs.sk/_img/Documents/_Publikacie/PREDIK/2014/MTF-2014Q4_a.xls