NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

CHAPTER 1

MACROECONOMIC DEVELOPMENTS

1

1 Macroeconomic developments

1.1 The external economic environment

1.1.1 Global trends in output and prices

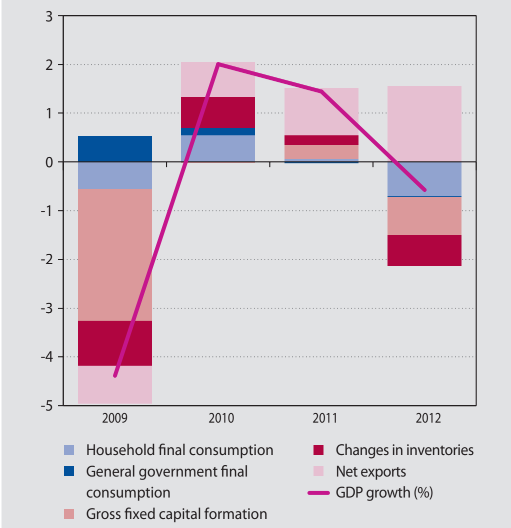
Global economic growth slowed to 3.2% in 2012, down from 3.9% in 2011.[1] Advanced economies saw a gradual softening of economic activity and several of them slid into recession. This reflected persisting concerns about the sovereign debt crisis in certain euro area countries and the effects of ongoing fiscal consolidation measures. The labour market remains depressed despite improving in a number of major economies. In emerging economies, growth continued to outpace growth in advanced economies, but it was also decelerating, amid fears about global economic developments and a decline in foreign trade. Global foreign demand growth slumped to 2.8% in 2012, from 5.9 % in the previous year.

The weakening of global activity had a moderating effect on price growth, with the average annual inflation rate in advanced economies falling to 2.0% in 2012, from 2.7% in the previous year. Inflationary pressures were contained by the slow pace of economic recovery, and inflation expectations were firmly anchored. In emerging economies, too, there was a decline in annual average inflation, from 7.2% in 2011 to 6.1% in 2012. Although commodity prices were relatively volatile over the year, they were not a significant source of inflationary pressure.

1.1.2 Economic developments in the euro area

Annual economic growth in the euro area slowed compared to 2011 (1.4%), as GDP declined by 0.6% in 2012. Domestic demand made a negative contribution to growth, as investment and private consumption declined amid weak business and consumer confidence, tight credit conditions, and ongoing tensions related to the debt crisis. Net exports contributed positively to growth, with exports rising moderately and imports falling. The economic downturn was reflected in the labour market, as the unemployment rate edged up over the year, from 10.7% in December 2011 to 11.8% in December 2012. The labour market situation weighed on private consumption. General government final consumption remained flat under the constraints of fiscal consolidation measures.

Chart 1 Contributions to annual GDP growth (p.p.)



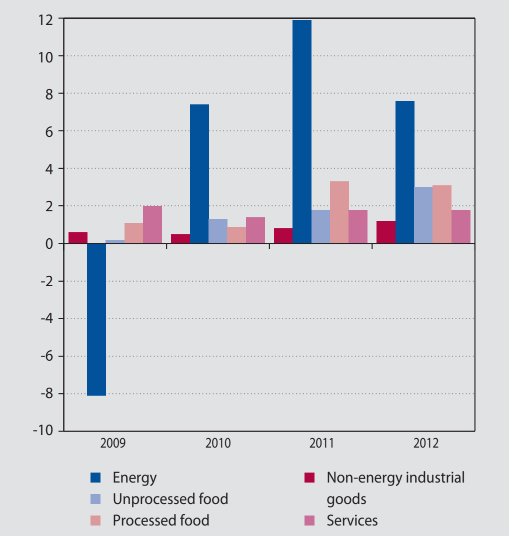
Source: Eurostat.

Annual average inflation as measured by the HICP was 2.5% in 2012, 0.2 percentage point lower than in the previous year. The inflation rate remained above 2% throughout the year. Indirect tax hikes in certain euro area countries put upward pressure on the headline rate, while a slowdown in commodity price inflation exerted downward pressure. Inflationary pressures from the labour market were subdued. Annual HICP inflation slowed to 2.2% in December 2012, from 2.7% in December of the previous year. Core inflation (i.e. the HICP rate excluding prices of energy and unprocessed food) remained largely unchanged in 2012. Its average level for the year was 1.8% (compared to 1.7% in 2011).

The exchange rate of the euro against the US dollar was marked by recurring volatility during 2012. This was largely a response to market expectations regarding economic developments in the euro area as well as to movements in credit risk premia stemming from the euro area sovereign debt crisis. The exchange rate was also

1 *Growth estimate from the IMF's World Economic Outlook Update (January 2013).*

Chart 2 Annual HICP inflation broken down by components (%)



Source: Eurostat.

affected by measures taken at various levels to mitigate the debt crisis. The euro's exchange rate against the dollar was 2.0% stronger at the end of 2012 than at the end of 2011.

The ECB's Governing Council adjusted the key ECB interest rates on only one occasion in 2012, deciding at its meeting on 5 July to lower the interest rate on the main refinancing operations of the Eurosystem by 25 basis points to 0.75% (starting from the operation to be settled on 11 July 2012) and to cut the interest rates on the marginal lending facility and the deposit facility by 25 basis points, leaving them at 1.50% and 0.00% respectively (with effect from 11 July 2012).

In 2012 the Governing Council continued to use non-standard measures in order to strengthen the transmission mechanism between the accommodative monetary policy stance and the real economy, in line with maintaining price stability over the medium-term horizon. Back in December 2011 the Governing Council decided to conduct two longer-term refinancing operations (LTROs) with a maturity of 36 months and the option of early repayment after one year; the first was conducted that December and the second in February 2012. These operations helped to improve the financial environment in the first months of 2012 and to ease tensions in financial markets. The Governing Council also decided to continue conducting its main refinancing operations as fixed rate tender procedures with full allotment at least until middle of 2013. Furthermore, in February and June, it expanded the scope of acceptable collateral for Eurosystem operations. In December the Governing Council decided to extend the existing foreign-currency swap arrangements with other central banks. Besides non-standard measures focused on refinancing operations, the Governing Council approved measures aimed at stabilising financial markets and supporting their functionality. In August 2012 it decided that the ECB may, as appropriate, support monetary policy transmission by conducting Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area. OMTs must be conducted in compliance with stipulated conditions and there will be full sterilisation of the liquidity created through them. The decision to proceed with OMTs was accompanied by the termination of the Securities Markets Programme (SMP); the liquidity injected through the SMP will continue to be absorbed as in the past and the existing securities in the SMP portfolio will be held to maturity.

1.2 MACROECONOMIC DEVELOPMENTS IN SLOVAKIA

Annual GDP growth in Slovakia slowed to 2.0% in 2012, from 3.2% in 2011, according to preliminary figures from the SO SR. External demand was the main driver of growth, although its rate of increase gradually decelerated. Domestic demand made a negative contribution to GDP growth, largely because investment declined amid a drop in company profits, and also due to lower private and government consumption. Growth according to the output measure of GDP was based mainly on industry and certain services. Net taxes on products contributed negatively to growth due to the base effect of a one-off VAT payment on a completed PPP project made at the end of 2011.

The balance of payments current account improved markedly in 2012, posting a surplus of 2.3% of GDP. The strongest-performing component was the trade balance, which reflected higher exports in the automotive industry as well as declines in import intensity and domestic demand.

In the labour market, the post-crisis recovery impulses began to fade in 2012. Employers managed to increase value added and total GDP even while employment remained virtually unchanged. As the number of job seekers entering the labour market exceeded the number of new job vacancies, the unemployment increased over the year. The situation became particularly adverse in the last quarter, when there was a relatively large drop in employment. The number of hours worked declined amid subdued demand for labour, whereas in the previous year they had increased. The annual growth rate of nominal wages accelerated slightly, but insufficiently for an increase in real wages. Labour productivity growth increased in both nominal and real terms and again outpaced real wage growth. Consequently, the annual growth rate of unit labour costs remained virtually unchanged.

Average annual HICP inflation slowed to 3.7% in 2012, from 4.1% in the previous year, and the average inflation rate in December 2012 was 3.4% (1.2 percentage points lower than in December 2011). December's lower than average inflation rate was attributable to services prices, which in the last two months were affected by the base effect of rail price increases at the end of 2011.

1.2.1 Price developments

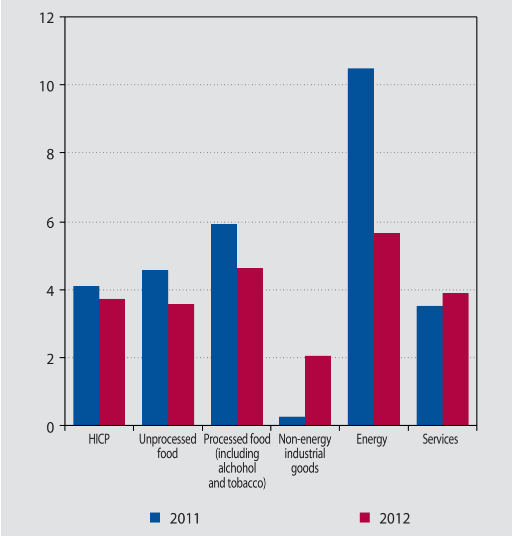
Consumer prices

Inflation as measured by the Harmonised Index of Consumer Prices (HICP)

The average inflation rate decelerated to 3.7% in 2012, from 4.1% in the previous year, owing mainly to external factors and in particular to a lower increase in administered prices of food and energy. Increases in excise taxes on cigarettes, introduced as part of the fiscal consolidation effort, added approximately 0.1 percentage point to the inflation rate.

As for prices of non-energy industrial goods, their annual rate of change increased moderately, in line with developments in the euro area. Pharmaceutical product prices accounted for most of the increase in this component, while motor vehicle prices, which fell year-on-year, had a slightly decelerating effect.

Chart 3 Inflation components (average annual percentage changes)



Source: SO SR, NBS calculations.

Services price inflation was moderately higher in 2012 than in 2011. A marked rise in rail prices at the end of 2011 caused the annual rate of change of the services component to increase in 2012. This effect faded in November 2012, and the growth rate of service price inflation slowed noticeably. Services prices stripped of the effect of administered price changes increased only moderately in year-on-year terms, as domestic demand remained muted. The inflation in services prices was attributable to increases in prices of food and energy (food service prices) and probably also to wage growth in the health-care and social services sectors and to price convergence in personal care services.

Producer prices

Looking at how producer prices changed in 2012 in comparison with the previous year, industrial producer price inflation increased significantly while construction prices (work and material) and agricultural prices recorded lower increases.

The annual growth rate of industrial producer prices (3.9%) in 2012 was driven mainly by energy price inflation, although the pipeline pressures in this case were probably mitigated by softening demand and increasing competition. That also explains why the increase in

Table 1 HICP inflation (average for the period; annual percentage changes)

	2011		2012					
	Dec.	Q1-Q4	Q1	Q2	Q3	Q4	Dec.	Q1-Q4
Headline rate	4.6	4.1	4.0	3.6	3.8	3.6	3.4	3.7
Goods	4.4	4.3	3.8	3.5	3.6	3.7	3.6	3.7
Industrial goods	4.5	3.7	4.0	3.7	3.2	2.8	2.7	3.4
Non-energy industrial goods	1.0	0.3	1.5	2.2	2.1	2.3	2.3	2.0
Energy	11.2	10.5	7.9	6.2	5.0	3.6	3.3	5.7
Food	4.3	5.5	3.6	3.1	4.5	5.5	5.4	4.2
Food – processed (including alcohol and tobocco)	6.8	5.9	6.4	5.0	3.5	3.7	3.3	4.6
Food – unprocessed	-0.6	4.5	-1.4	-0.1	6.9	9.5	10.1	3.6
Services	5.0	3.5	4.2	3.9	4.1	3.3	2.9	3.9
Core inflation (headline rate excluding energy and unprocesssed food prices)	3.8	2.7	3.6	3.5	3.2	3.0	2.7	3.3
Headline rate excluding energy prices	3.4	2.9	3.1	3.1	3.5	3.6	3.4	3.3

Source: NBS calculations based on SO SR data.

industrial producer prices in 2012 was only one-third as high as in the previous year; inflation declined in all segments of manufacturing producer prices.

As for agricultural prices, their annual rate of change in 2012 was affected mainly by rising crop product prices in the second half of the year, which to some extent was caused by the base effect of a decline in these prices at the end of 2011.

1.2.2 Gross domestic product

Slovakia's gross domestic product (GDP) at constant prices grew year-on-year by 2.0% in 2012, compared to 3.2% in 2011, according to preliminary figures from the SO SR.

Table 2 Average annual producer price inflation (%)

	2011	2012				
	Q1–Q4	Q1	Q2	Q3	Q4	Q1–Q4
Industrial producer prices	2.7	3.6	4.0	4.0	4.0	3.9
Mining and quarrying	5.0	5.1	7.1	5.3	3.0	5.1
Manufacturing	4.1	1.3	1.2	0.9	2.0	1.3
Energy	0.8	6.7	7.7	8.1	6.4	7.3
Water supply and sewage disposal	5.2	2.9	4.9	5.8	5.8	4.9
Construction work prices	1.2	0.3	0.6	0.8	0.8	0.6
Building material prices	1.8	1.7	2.1	1.0	1.3	1.5
Agricultural producer prices	16.7	-0.8	-0.1	4.7	16.8	6.9
Crop products	22.0	-14.0	-10.5	6.8	23.9	9.3
Livestock products	10.8	7.5	4.1	0.4	4.4	4.0

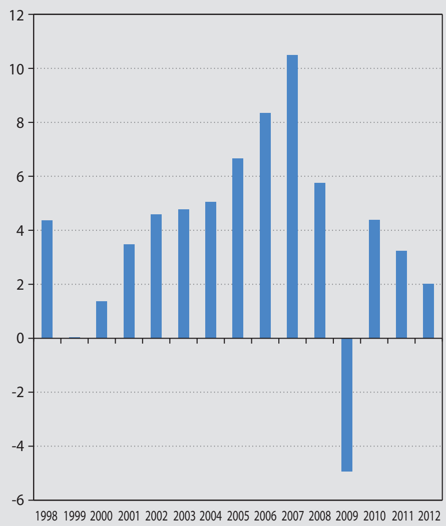
Source: SO SR.

Looking at the expenditure measure of GDP, most of the growth was accounted for by foreign demand, which nevertheless decelerated gradually. Domestic demand declined due to a fall in investment as well as to declines in both private and general government consumption. Growth in the output measure of GDP was largely attributable to industry and certain services. Nominal GDP in 2012 amounted to €71,463 million, which was 3.4% higher year-on-year.

Supply side of GDP

The GDP figure for 2012 included an increase in the annual growth rate of value added at constant prices, to 3.2% (from 2.7% in 2011). There was, however, a negative contribution to GDP growth from net taxes on products (value added tax, excise tax, and import tax, less subsidies), which decreased by 9.2% mainly due to the base effect of a one-off VAT payment on a completed PPP project made at the end of 2011.

Chart 4 Real GDP (annual percentage changes)



Source: SO SR.

The most marked increases in value added were in the sectors of industry, information and telecommunication services, real estate services, and other specialised services. By contrast, value added declined in agriculture, construction, and financial services.

Demand side of GDP

As regards the expenditure measure of GDP, net exports accounted for most of the growth in 2012, while domestic demand made a negative contribution with a further annual decline (including a running down of inventories).

Domestic demand contributed negatively to GDP due mainly to a fall in investment as well as to declines in household consumption and general government consumption. Household final consumption maintained a downward trend amid high unemployment and low consumer confidence, despite an increase in household disposable income that reflected higher social benefits. Consumers continued to prefer saving over consumption, as the high level of the saving ratio confirmed. The decline in general government consumption stemmed from a cautious fiscal policy. Further downward pressure on household and general government consumption in 2012 came from gross fixed capital formation, which fell due to a downturn in firms' profits. The most pronounced declines in investment were reported by firms in the sectors of manufacturing, real estate activities, and administrative services.

In 2012 export growth increased gradually and then slowed in the second half of the year. The amount of exports and services increased by

Table 3 GDP and its components (index: same period a year earlier = 100; constant prices)

	2011	2012				
	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4
Gross output	105.6	104.9	102.7	102.0	100.0	102.4
Intermediate consumption	107.5	105.8	102.2	101.6	98.3	101.8
Value added	102.7	103.5	103.6	102.8	103.0	103.2
Net taxes on products [1)]	109.0	96.8	93.1	94.8	81.0	90.8

Source: SO SR.
1) Value added tax, excise tax, and import tax, less subsidies.

Table 4 Expenditure measure of GDP (index: same period a year earlier = 100; constant prices)

	2011	2012				
	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4
Gross domestic product	103.2	102.9	102.6	102.1	100.7	102.0
Domestic demand	101.2	99.2	94.6	96.7	98.1	97.1
Final consumption	98.5	100.1	99.3	99.5	99.0	99.4
Household final consumption	99.5	99.9	99.7	99.4	98.8	99.4
General government final consumption	95.7	100.5	97.9	99.6	99.7	99.4
Non-profit institutions serving households	100.2	98.9	99.1	99.7	100.0	99.4
Gross fixed capital formation	114.2	96.7	97.5	96.3	95.0	96.3
Exports of products and services	112.7	105.0	110.8	111.6	107.1	108.6
Imports of products and services	110.1	99.8	101.6	105.7	104.2	102.8

Source: SO SR.

10.2% at current prices, while imports of goods and services grew at a far slower pace (5.2% at current prices), due mainly to declining import intensity, low domestic demand, and uncertainty about future developments. As a consequence, nominal net exports in 2012 reached an all-time high of €3,553.6 million. As regards price developments, the import deflator increased more sharply than the export deflator, resulting in a slight deterioration in the terms of trade. Import prices, however, were affected by an increase in commodity prices.

Both the export performance and import intensity of the Slovak economy increased year-on-year in 2012, by around 5.9 p.p. and 1.5 p.p. respectively. The openness of the Slovak economy, as measured by the ratio of exports and imports of goods and services to nominal GDP, increased by 7.4 percentage points to 186.3%.

1.2.3 The labour market

The labour market situation began to deteriorate in 2012 as uncertainty increased. Employers were taking a cautious approach to hiring and were not under pressure to increase wages. Consequently, employment remained flat and the unemployment rate increased, while wage growth rose only slightly in nominal terms and fell in real terms.

Employment

Employment (according to ESA 95 methodology) increased year-on-year by only 0.1% in 2012, compared to a rise of 1.8% in 2011. Its annual rate of change declined in each quarter, and entered negative territory in the second half of the year. The number of hours worked fell by 0.4% in comparison with the previous year. The sectors that accounted for most of the slowdown in annual employment growth were industry (where employment fell 0.8% year-on-year), and trade and transportation (with a drop of 0.7%). There were smaller negative contributions to employment growth from agriculture and from information and communication. By contrast, professional, scientific, technical and administrative activities contributed positively to employment growth, as did public administration, defence, education, and human health activities. According to the Labour Force Survey, the number of people working abroad in 2012 increased year-on-year by 4.8% (or by 5,500 people), and the number working in the domestic economy rose by 0.4%. On the other hand, the number of self-employed people fell by 2.4%.

Unemployment

According to the Labour Force Survey, the number of unemployed increased year-on-year by 3.5% in 2012 amid a deteriorating labour market situation; consequently, the unemployment rate rose by 0.5 percentage point, to 14.0%. The registered unemployment rate based on data from Labour, Social Affairs and Family Offices averaged 13.6% in 2012, which was 0.4 percentage point higher than in the previous year.

Table 5 Labour market indicators

	2011	2012				
	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4
Nominal wage (index)	102.2	103.2	101.5	102.0	103.2	102.4
Real wage (index)	98.4	99.4	98.1	98.4	99.4	98.8
Nominal compensation per employee – ESA 95 (index)	101.1	101.5	102.1	101.4	103.2	102.0
Labour productivity based on GDP (index, current prices)	103.1	103.7	103.4	103.8	102.6	103.4
Labour productivity based on GDP (index, constant prices)	101.4	102.2	102.3	102.2	101.2	102.0
Employment – ESA 95 (index)	101.8	100.6	100.2	99.9	99.4	100.1
Unemployment rate – LFS[1)] (%)	13.5	14.1	13.6	13.7	14.4	14.0
Nominal unit labour costs (ULC)[2)]	99.6	99.2	99.8	99.2	102.0	100.1

Source: SO SR, NBS calculations.
1) Labour Force Survey.
2) Ratio of compensation per employee growth at current prices to labour productivity growth (ESA 95) at constant prices.

Wages and labour productivity

The average monthly nominal wage in 2012 increased to €805, and its annual rate of growth accelerated by 0.2 percentage point, to 2.4%. The sectors that recorded the highest nominal wage growth were financial and insurance activities (7.3%), human health and social work activities (6.6%), industry (4%), and information and communication (3.9%). By contrast, average nominal wages in the sectors of real estate activities and administrative services were lower compared to the previous year. With inflation continuing to exceed wage growth, real wages declined by 1.2% in 2012 (after falling by 1.6% in 2011). Since GDP growth was accompanied by only a modest rise in the number of employed people, 2012 saw an increase in the annual growth rate of labour productivity (measured by GDP per employed person). The annual growth rate of real labour productivity exceeded that of real wages by 3.2 percentage points, similar to the margin of difference in the 2011. This situation is favourable in view of the potential weak inflationary pressures and elevated competitiveness in the economy; on the other hand, it is weighing on final consumption. The gap between labour productivity growth and wage growth was reflected in the annual rate of change in unit labour costs, which remained subdued at 0.1% (0.5 percentage point higher than their annual rate of change in 2011).

1.2.4 Financial results

In 2012, according to preliminary data from the SO SR, profits of non-financial and financial corporations in Slovakia amounted to €10,471.8 million, down by 2.7% from 2011 (when the aggregate profit increased by 17.7% year-on-year). Non-financial corporations accounted for most of the decline, as their profitability fell year-on-year by 8.1% (after rising by 12.2% in 2011). With domestic demand softening and input prices rising, not even the fact of labour productivity growth being higher than wage growth could prevent a slump in firms' profits. As for the aggregate profit of the financial sector (not including NBS), it increased by 17.7% in 2012 (compared to a rise of 12.4% in 2011).

Non-financial corporations made an aggregate profit of €8,857.4 million in 2012, which was €784.9 million lower compared to 2011. This decline was due largely to the aggregate loss in the health-care sector (in 2011 this sector made a profit based on the write-down of hospital debts at the year end). Looking at non-financial corporations outside the health-care sector, the annual decline in their aggregate profit was €420.6 million or 4.5%, (instead of the officially recorded annual decline of 8.1% in the profitability of non-financial corporations). Profits fell substantially in the sectors of construction, real estate activities and trade. Industrial firms made a slightly negative contribution, as a decline in profitability in the energy sector was largely offset by profit growth in the manufacturing sector, with most of that increase accounted for by the manufacturing segment of coke and refined petroleum products. Profits in the manufacture of transport equipment maintained their upward trend in 2012.

The profitability of the financial sector (not including NBS) in 2012 increased by €212.9 million year-on-year, to €1,415.0 million. At the same time, however, the composition of the aggregate profit in 2012 was markedly different from the previous year. Most of the profitability growth was attributable to other financial intermediaries (which include, for example, leasing companies, private health insurers, stock exchanges, and pension fund management companies), as their aggregate profit increased by 633.2% in 2012, after falling by 65.2% in 2011. This result offset the adverse trend in the banking sector, where the profitability of monetary financial institutions (not including NBS) fell by 30.4%. The drop in banks' profits stemmed mainly from a decline in interest income and from the imposition of a special levy on selected financial institutions. As for insurance corporations and pension funds, the annual growth rate of their aggregate profit slumped to 3.3%, from 400% in 2011.

1.2.5 Balance of payments

Current account

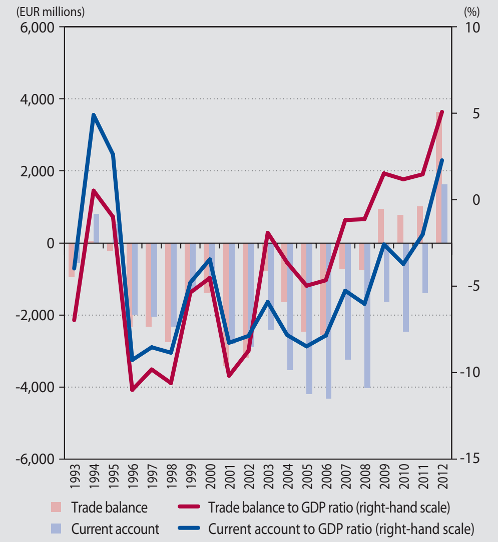
The balance of payments current account for 2012 recorded a surplus of €1.6 billion, which was substantially higher than the surplus for 2011 and reflected mainly an improvement in the trade balance. The ratio of the current account surplus to GDP (at current prices) stood at 2.3% in 2012, representing a year-on-year increase of 4.3 percentage points.

Table 6 Balance of payments current account (EUR billions)

	2012	2011
Trade balance	3.6	1.0
Exports	62.8	56.8
Imports	59.2	55.8
Services balance	0.3	-0.4
Income balance	-1.7	-1.7
of which: investment income	-3.0	-2.9
of which: reinvested earnings	-0.6	-1.2
Current transfers balance	-0.6	-0.3
Current account in total	1.6	-1.4
Current account to GDP ratio (%)	2.3	-2.0

Source: NBS and SO SR.

Chart 5 Current account and trade balance developments between 1993 and 2012



Source: NBS and SO SR.

The trade surplus growth was driven by an increase in automotive exports, as the production launch of new car models allowed domestic car makers to increase their share of existing markets and also to expand into new markets. Further contributing to the higher trade surplus was a decline in import intensity, which was reflected in the gap between export growth (10.7%) and import growth (6.2%).

The services balance went from a deficit in 2011 to a surplus in 2012 due to results in the categories of *other services in total* and, to a lesser extent, *transportation*. The *travel* category, by contrast, saw a moderate decrease in its surplus, as expenditure grew more sharply than receipts. In the case of *other services in total*, most of the increase in receipts stemmed from growth in external demand.

The income balance remained unchanged from 2011, as an increase in interest payments was offset by higher remittances from Slovak residents working abroad.

The current transfers balance deteriorated year-on-year due mainly to an adverse result in the *other transfers* category (caused by a combination of lower receipts and higher expenditures).

Capital and financial account of the balance of payments

The capital and financial account of the balance of payments generated a surplus of €1.0 billion in 2012 (compared with a surplus of €3.4 billion in 2011).

In the category of *direct investment*, the inflow increased year-on-year owing mainly to the inflow of other capital, which reflected a decline in claims on direct investors as well as on foreign direct enterprises.

The category of *portfolio investment* saw a shift from the previous year's moderate outflow to an inflow, based on activities of the government (issuance of government bonds) and NBS.

In the category of *other investment*, the inflow was higher in 2012 than in 2011 due largely to developments in the Government and NBS sector, where the outflow of deposits from accounts with NBS was only partly counterbalanced by the inflow from the drawing of loans.

Table 7 Capital and financial account of the balance of payments (EUR billions)

	2012	2011
Capital account	1.4	0.9
Direct investment	2.2	1.1
abroad	0.1	-0.4
of which: equity capital	0.0	-0.1
reinvested earnings	0.0	0.4
in Slovakia	2.1	1.5
of which: equity capital	0.3	0.8
of which: non-privatisation FDI[1)]	0.3	0.8
reinvested earnings	0.7	0.8
Portfolio investment and financial derivatives	8.2	-0.5
Other long-term investment	0.3	1.1
Other short-term investment	-11.1	0.8
Capital and financial account in total	1.0	3.4

Source: NBS.
1) FDI – foreign direct investment.

External debt of Slovakia

As a result of developments in the balance of payments, the external debt of Slovakia increased by €0.8 billion (USD 2.4 billion) to €53.8 billion (USD 70.9 billion), mainly due to heightened demand for government bonds and to a reduction in the short-term foreign liabilities of the Slovak Government and NBS in cash and deposit items, along with an increase in the central bank's stock of short-term borrowings. According to preliminary data, Slovakia's ratio of total gross external debt to GDP at current prices was 77.8% as at 31 December 2012, compared to 76.7% at the end of 2011. The country's net debtor position increased by €4.4 billion between end-2011 and end-2012, to stand at €18.9 billion. Over the same period, the ratio of short-term external debt to total gross external debt fell by 13.8 percentage points, to 39.7%.

Nominal and real effective exchange rates[2]

On average in 2012 the nominal effective exchange rate (NEER) depreciated year-on-year by 0.8%, after appreciating by 0.1% in the previous year. Of that depreciation, weakening against the Chinese yuan contributed 0.7 percentage point. Also contributing negatively were exchange rates against the currencies of key non-euro area trading partners, including the Korean Republic, the United Kingdom, the United States, and Russia. By contrast, the exchange rates against the currencies of the other V4 countries had a mitigating effect on the NEER's depreciation.

The combination of a weakening NEER and a negative inflation differential vis-à-vis Slovakia's most important trading partners caused the real effective exchange rate (REER) based on manufacturing prices to depreciate by 1.5%. The rate of the REER's depreciation was 0.6 percentage points slower in comparison with the previous year. Since higher domestic labour productivity growth in comparison with partner countries created some scope for possible REER appreciation without jeopardising the economy's balance, the price competitiveness of domestic firms increased. A further sign of growth in Slovakia's competitiveness was provided by the trade balance, which improved with support from the depreciating REER and despite a downturn in external demand (caused by the sovereign debt crisis).

2 *The methodology of the effective exchange rate calculation is published on the NBS website at: http://www.nbs.sk/_img/Documents/_Statistika/VybrMakroUkaz/EER/NEER_REER_Methodology.pdf*

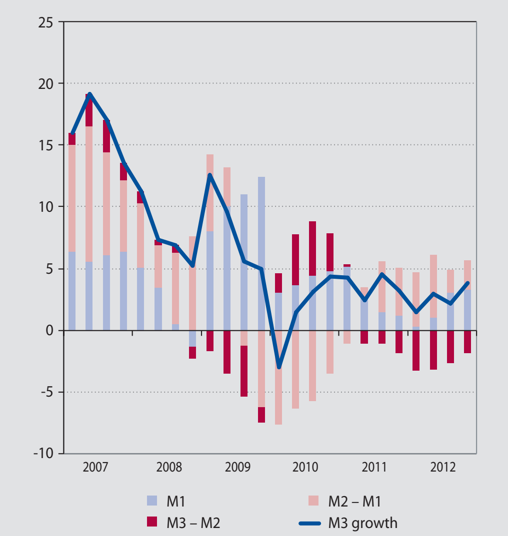
1.2.6 Monetary developments

Monetary aggregates and retail interest rates

In 2012 monetary indicators reflected trends in the real economy. Households' propensity to save increased amid negative consumer sentiment, deterioration in the labour market situation, and decelerating economic growth. Meanwhile, the deposit and lending activities of non-financial corporations were affected by uncertainty in the corporate sector. All these factors were at play in M3 movements in 2012. Interest rate changes contributed significantly to a shift in preference for short-term time deposits over long-term deposits outside M3, as evidenced by the contributions to M3 growth from different components. The largest increase was in the contribution of M1 deposits, and there was also a positive contribution to M3 growth from the less liquid M2-M1 component. Marketable instruments, which have been declining for a long time, contributed negatively to M3 growth. Their downward trend reflects falling investment in money market funds (due partly to the certain MMFs being reclassified into other fund categories, in line with changes in ECB methodology) and a decrease in the issuance of two-year debt securities.

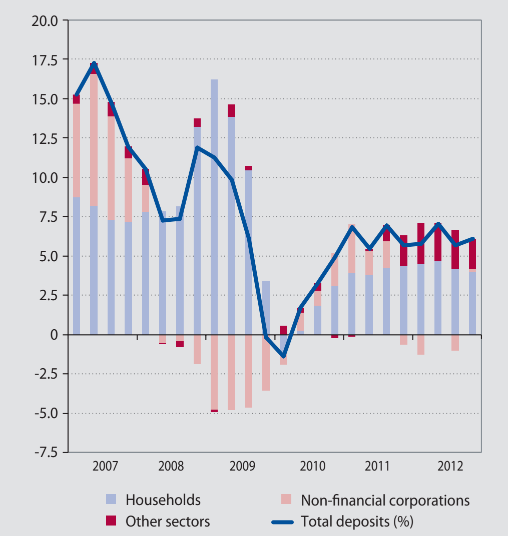
Sectorally, M3 growth was driven mainly by households, which shifted funds into short-term time deposits in response to the narrowing gap between interest rates on long-term and short-term deposits. Although shorter-term deposits attracted lower interest rates, their main advantage was greater liquidity. Households were therefore largely cautious in their saving behaviour. Although deposits from non-financial corporations increased moderately towards the end of 2012, they contributed negatively to private sector deposit growth over the year as a whole. This stemmed from the deteriorating economic situation, as slumps in both consumption and investment weighed on sales growth. A significant positive contribution to M3 growth came from deposits of other sectors (other financial intermediaries, insurance corporations and pension funds). Investments funds in particular increased their bank deposits, probably in preference to other investment products.

Chart 6 M3 growth by contribution of components (p.p.; annual percentage changes)



Source: NBS.

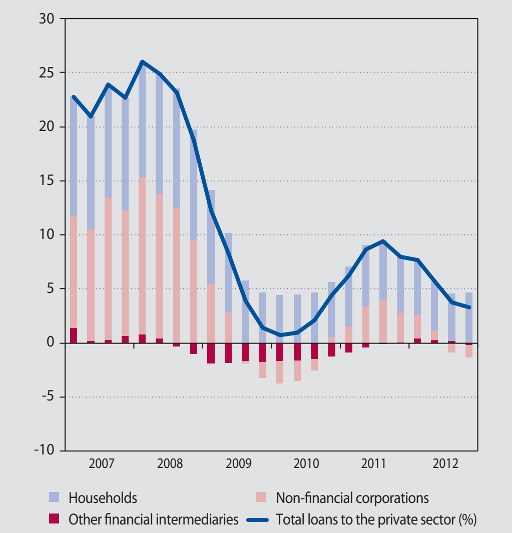
Chart 7 Private sector deposits – contributions to their annual rate of change (quarterly average; p.p.; annual percentage changes)



Source: NBS.

Turning to the counterparts of M3, bank lending activity increased, but the pace of lending growth decelerated over the year. Loans to households, seen as lower risk, showed the largest increase, and households' demand for loans held up throughout the year. Most of their new borrowing was in the form of housing loans, demand for which was boosted by a slight decline in lending rates and falling property prices. The

Chart 8 Loans to the private sector – contributions to their annual rate of change (p.p.; annual percentage changes)



Source: NBS.

stock of consumer credit increased in the second half of the year. The stimulus that low market rates gave to demand for loans among non-financial corporations lasted only until mid-year. Up to that point, economic activity was increasing at a relatively respectable pace and expectations were not pessimistic. In the second half, however, sentiment deteriorated and lending to non-financial corporations declined sharply, which reflected also a moderate tightening of credit standards. Lending to non-financial corporations was squeezed from both the supply and demand sides since, on the one hand, banks began demanding repayment of loans and, on the other hand, firms facing uncertain times were seeking to reduce their debt burden.