NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

MEDIUM-TERM FORECAST

Q1
2012

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1 Summary

When Národná banka Slovenska produced its latest Medium-Term Forecast (MTF-2012Q1) in March 2012, the uncertainty in financial markets was no longer escalating and expectations in the euro area were gradually stabilising. At the same time, however, Slovakia's external demand recorded a further decline. As for the domestic part of the economy, it had contrasting effects on the forecast; on the one hand, there was the publication of favourable data on the Slovak economy for the last quarter of 2011, while, on the other hand, the situation in the labour market began to deteriorate.

These factors meant that, unlike in previous forecasts, it was not necessary to substantially revise developments in the economy and price level. Thus the projections for the basic macroeconomic indicators remain close to those given in the December forecast. The forecasts of other institutions are therefore also beginning to converge with the original and current estimates of NBS.

As in the December forecast (MTF-2011Q4), economic activity in both Slovakia and the euro area is expected to pick up over the projection horizon. This assumption was subject to a considerable degree of uncertainty in MTF-2011Q4, which has eased significantly in the light of recent developments.

The latest macroeconomic outlook for Slovakia is based on the ECB's technical assumptions[1], on the most recent national accounts data for the last quarter of 2011, and on updated monthly data and short-term indicators. The projection horizon for the medium-term forecast has been extended to 2014.

Slovakia's economic growth in the fourth quarter of 2011, according to the published data, was far higher than projected in the previous forecast. Export growth rose relatively sharply and net exports consequently made the largest contribution to GDP growth; however, this was not in line with the outlook for external demand. It may be supposed that in 2012 export performance will start to be affected by the lagging effect of lower demand from Slovakia's main trading partners, as implied by the ECB's revisions to projected growth in the euro area and global economy. A rise in import growth is assumed for this year on the basis of expected restocking. The rapid investment growth in the fourth quarter is not expected to carry on into 2012, due to a tightening of lending standards. Looking further ahead, investment activity is assumed to grow at a similar pace to the economy. Domestic consumption is expected to remain somewhat subdued in 2012 and then to pick up in the subsequent period. It is therefore assumed that economic growth will gradually be based more on domestic demand than on external demand. The labour market is expected to stabilise over the projection horizon, with conditions improving for the creation of jobs and reduction of unemployment. However, the downturn in the labour market in the fourth quarter of 2011 (in contrast to strong economic growth for that period) will affect the employment growth forecast for the whole of the current year. The unemployment rate is therefore expected to remain high throughout this year.

The inflation rate slowed in the first two months of 2012, reflecting to a large extent the fading of the effects of inflationary factors of the previous year, including tax hikes, the introduction of charges, and high prices of food and energy. Inflation is assumed to continue decelerating in 2012, owing to slower economic growth, declining agricultural commodity price inflation, and a reduction in administered gas prices. The marked slowdown in wage growth in the fourth quarter of 2011 (according to the published data) will affect the level and growth of wages in 2012. With the economy growing relatively quickly over the production horizon, it is assumed that labour productivity will rise and create scope for real wage growth. Inflation is likely to remain at low levels over the horizon, especially with energy and food prices making a lower contribution.

The sharp rise in GDP growth towards the end of 2011, at a time of declining external demand, is explained mainly by one-off factors. The forecast for economic growth throughout the projection horizon has been revised down slightly from the previous forecast. The labour market projections

1 *ECB Staff Macroeconomic Projections for the Euro Area, March 2012. The projections are available at www.ecb.int*

for 2012 have been revised down substantially in the wake of recent negative figures. In the medium-term horizon, employment is expected to pick up, but remain below the levels estimated in the previous forecast. Compared to the December forecast, the inflation projection for 2012 remained largely unchanged and the projection for the medium term horizon remained the same.

The risks to the GDP forecast continue to be on the downside over the projection horizon. The most significant risk is the anticipated implementation of fiscal consolidation measures in the euro area in general and in Slovakia in particular. Since there are still no specific consolidation measures for the years 2013 and 2014, the latest forecast does not reckon on fiscal deficit reduction in that period. A downside risk is that lending conditions are tightened both in Slovakia and abroad, with a negative impact on external demand and on investment in Slovakia. On the other hand, the current situation in external demand gives rise to the upside risk of a continuation of the supply-side shock and reduced import intensity. The risks to the price level forecast for 2012 are predominantly on the upside, the principal risk being higher external inflation and higher energy prices. In the medium-term horizon there is the risk that price inflation will be more pronounced due to the expected implementation of consolidation measures (through higher indirect taxes). The downside risks include weaker domestic demand and a deterioration in the labour market situation.

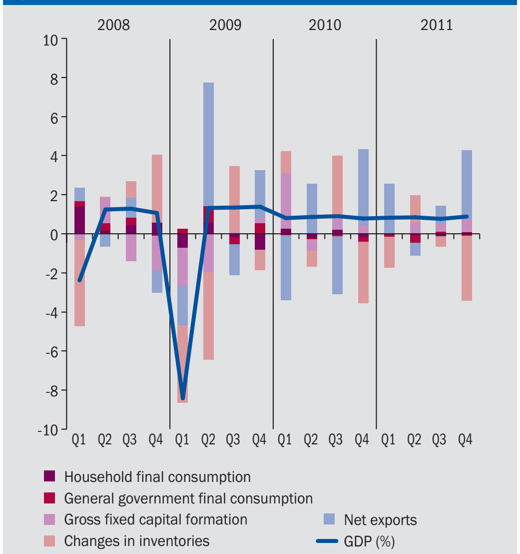
2 Current developments in the external environment and Slovakia

Global economic growth slowed in the fourth quarter of 2011 over the previous quarter. A combination of uncertainty surrounding the euro area sovereign debt crisis, the need for fiscal consolidation measures, and the weak financial situation of households acted as a brake on GDP growth in advanced economies, with some major economies even contracting during the fourth quarter (these included the euro area, Japan and the United Kingdom). Economic activity in emerging economies slowed moderately, but still outpaced growth in advanced economies.

In the euro area, the contraction of GDP stemmed from the deceleration of global economic growth, high commodity prices, and the negative impact of the bloc's sovereign debt crisis on both consumer and business confidence, as well as a deterioration in lending conditions and further tightening of fiscal policy in certain euro area countries. The contraction of the Japanese economy in the fourth quarter was attributable to the slowdown in world trade and to the disruption that floods in Thailand caused to supply chains. The US economy continued growing in the fourth quarter, driven by domestic investment and consumption. The ISM[2] manufacturing index for the last three months of 2011 rose slightly but remained below the contraction/expansion threshold. The US economy may therefore be showing signs of stabilising, although levels of uncertainty remain high. Although China's economy continues to record robust growth, it slowed further in the fourth quarter amid a slackening of global demand and the effects of previously implemented measures to dampen price growth.

The negative economic developments in euro area countries in the last quarter of 2011 did not affect the Slovak economy in that period. The pace of GDP growth in Slovakia remained at around its third-quarter level (0.9% year-on-year), substantially exceeding the previous forecast's projections. The composition of economic growth also diverged markedly from the assumptions.

Chart 1 Composition of GDP (contributions to quarter-on-quarter growth at constant prices)



Source: SO SR.

The far higher than expected GDP growth was driven mainly by export performance and the resulting positive contribution of net exports. The increase in exports in the fourth quarter outweighed their decline in the second and third quarters. The stagnation in imports did not accord with the expected slowdown in demand for Slovak products and services, the implication being that the Slovak economy experienced a positive supply-side shock. The resulting rise in Slovakia's market share was based on stronger growth in exports, not only to the euro area, but also to countries outside the euro area – the destination of an increasingly significant proportion of Slovak production. Import intensity declined due both to uncertainty surrounding future developments (reflecting in destocking) and to the continuing sluggishness of the domestic part of the economy. It is assumed, however, that the import stagnation in the fourth quarter was simply the result of a one-off factor and that import intensity will gradually return to higher levels. Preliminary data for nominal exports and imports in January indicate that exports are still rising and confirm

2 Institute for Supply Management – the index is a barometer of business sentiment in US industry. Although the survey collects data only from the industry sector, it is treated as a key indicator of sentiment in the economy as a whole.

the view about the one-off effect of imports. Another positive contribution to fourth-quarter GDP growth came from the investment component. Investment was boosted significantly by a one-off effect of expanding production capacity in the automotive industry. Without this effect, investment would have had a dampening effect on GDP growth. A key factor in the investment results was the deteriorating sentiment in financial markets. Credit standards for enterprises were tightened moderately in the fourth quarter and therefore dampened investment activity. A increasing proportion of corporate borrowing in the period was in the form of operating loans, due to a rise in demand for these products. Demand for loans for the purpose of investment financing decreased in the fourth quarter.

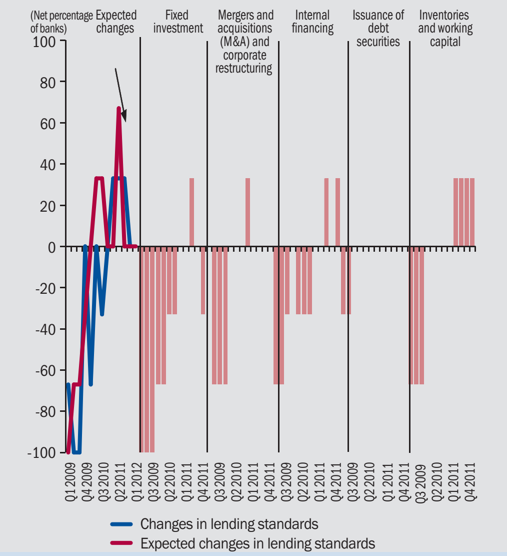
Household final consumption also declined year-on-year in the fourth quarter due to high uncertainty about the future situation and to a slump in real household income. Although this consumption increased in quarter-on-quarter terms (by 0.2%), it did so as a result of a fall in the savings rate. The main downward effects on real disposable income came from slower growth in nominal compensation per employee, a decline in social transfers, and inflation. Consumer sentiment reached the end of a declining trend in fourth quarter, with households not expecting a further deterioration in outlooks, particularly those for the expected financial situation and expect unemployment. Looking at the composition of consumption, the principal change was a rise in spending on consumer durables. Meanwhile the trend decline in spending on non-durables continued.

As for the government sector in the fourth quarter, fiscal consolidation efforts continued and government consumption fell by 0.6% in quarter-on-quarter terms, due in large part to restraint in compensation of government employees; intermediate government consumption expenditure increased.

Measured by output, economic growth was driven by the industry sector and by developments in net taxes. The marked rise in taxes on products was, however the result of a one-off VAT payment on a PPP project (construction of the R1 high-speed road). Industry also continued to be a key factor in export performance. The fourth-quarter data imply that industry was relatively effective in coping with negative expectations about a possible further crisis period.

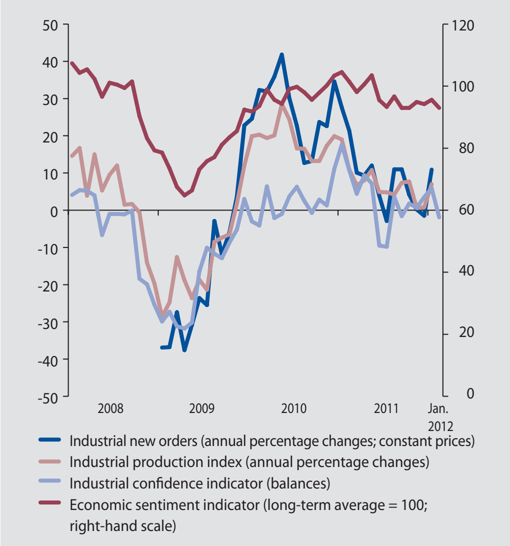
The most recent data on the economy do not give any clear pointer to how it will perform in the first quarter of 2012. Production and sales data for January indicated modest optimism, but the economic sentiment indicator for the first two

Chart 2 Changes in demand for loans to enterprises (contributing factors)



Source: NBS.

Chart 3 Changes in forward-looking indicators (%)



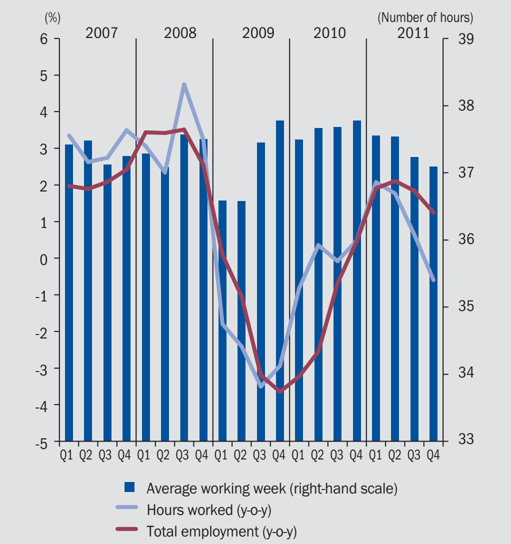
Source: SO SR, European Commission.

months suggests stagnation or a moderate deterioration. The outlook in industry was positive in January and then deteriorated slightly in February. Perceptions of future developments also deteriorated in services and construction sectors. On the other hand, expectations in the household and retail trade sectors improved somewhat.

The labour market situation failed to reflect the strength of economic growth in the fourth quarter of 2011. Employment figures were slightly worse than expected, due mainly to a drop in the total number of self-employed persons. The number of employees remained almost unchanged. The trend decline in the monthly employment data continued in January 2012. In a sign that this trend may have come to an end, expectations for employment stabilised in the first two months of the year in all sectors. The rate of unemployment increased in the fourth quarter, reflecting both the decline in employment and the fact that a proportion of economically-inactive people become unemployed (due to mainly to the ending of their health-induced incapacity for work). The unemployment rate was far higher than projected in the previous forecast. A decline in number of hours worked in the fourth quarter had a dampening effect on employees' compensation. With employment stagnating amid strong economic growth, there was a sharp rise in labour productivity per employee. Since this growth was not reflected in employee bonuses, unit labour costs improved and had an upward effect on firms' profits.

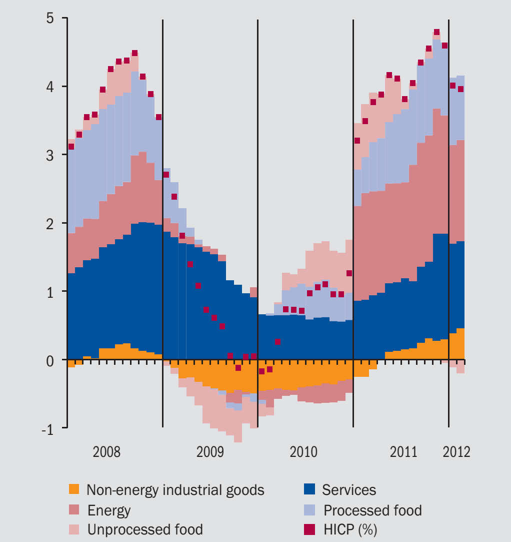
The annual inflation rate increased in the fourth quarter over the previous quarter, to stand at 4.7%. A moderate rise in price inflation was recorded by all items in the inflation basket, with the exception of unprocessed food. The energy price component included a rise in heat prices. Prices of non-energy industrial goods were pushed up by higher import prices and rising prices of health-care products. Cost factors and an increase in certain administered prices in the transport sector caused a rise in services price inflation. The inflation rate slowed in the first two months of 2012, reflecting to a large extent the fading of the effects of factors that had put the rate under upward pressure in the previous year, including tax hikes, the introduction of charges, and high prices of food and energy. At the beginning of 2012 the inflation rate was affected mainly by energy prices, probably owing to a marked rise in heat prices. Another factor was an increase in the weight of energy in the consumer basket. The rise in processed food price inflation may have been related to the absorption of pipeline cost pressures. The annual rate of change in prices of non-energy industrial goods increased on the back of rising administered prices in this core component of inflation.

Chart 4 Changes in labour market indicators



Source: SO SR.

Chart 5 Changes in the inflation rate (p.p.)

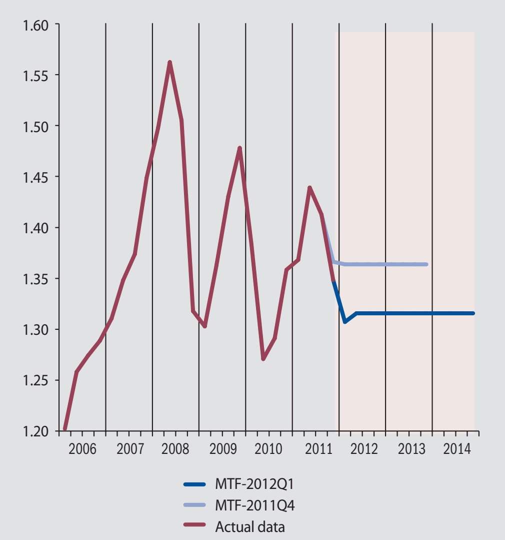


Source: SO SR; NBS forecast.

3 Technical assumptions[3]

Following the publication of the previous forecast in early December, the **exchange rate** of the euro against the US dollar showed volatility, owing to the effects of the euro area sovereign debt crisis as well as measures being adopted at various levels of European structures. The current forecast assumes that the exchange rate of USD per EUR[4] will be 1.31 in 2012 and 1.32 in 2012 and 2014.

Chart 6 USD/EUR exchange rate

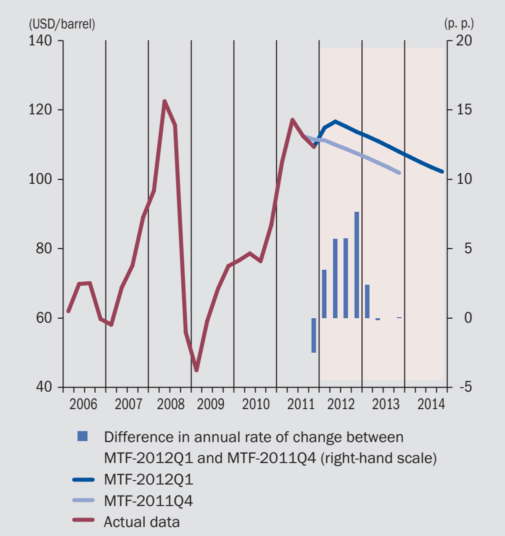


Source: NBS, ECB.

The volatility of the **oil price** in the last quarter of 2011 was the result of several counteracting factors. On the one hand, concerns about the global economic situation prevented oil prices from rising sharply, while, on the other hand, the repercussions of geopolitical tensions in oil-exporting countries put the prices under upward pressure. The price of a barrel of Brent crude oil averaged USD 109.3 in the fourth quarter, with the price oscillating between USD 103 and USD 115 during that period. The price per barrel rose sharply in the following period, and by the end of February 2012 it averaged USD 124. This forecast assumes that the price per barrel will average 115.1 in 2012, USD 110.2 in 2013 and USD 104.2 in 2014.

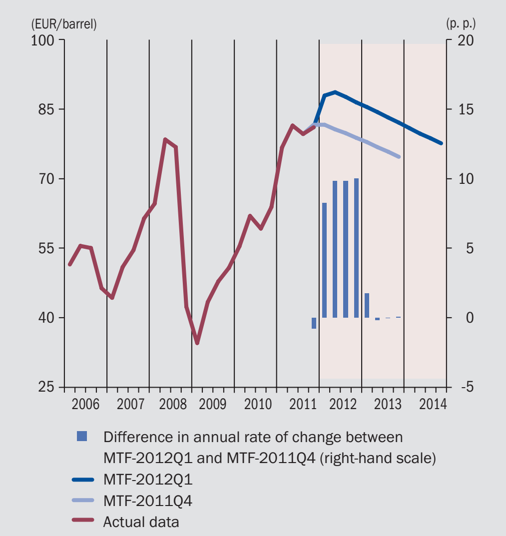
Prices of **non-energy commodities**, which in the first months of 2011 rose relatively sharply and exceeded their pre-crisis levels, declined moderately in the third and fourth quarters amid a deteriorating outlook for the global economy.

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



Source: NBS, ECB.

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

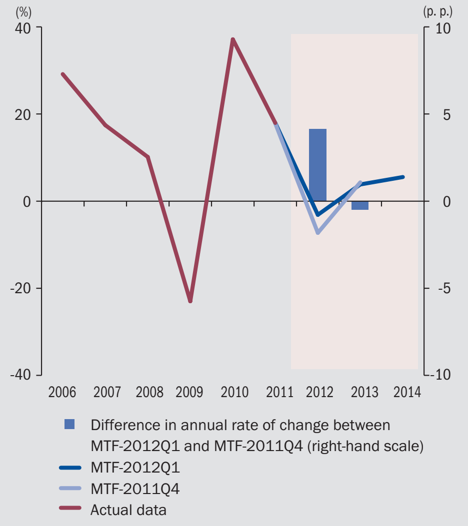


Source: NBS, ECB.

3 *The technical assumptions of the Medium-Term Forecast, as well as the assumption for developments in the international economy, are based on the „ECB Staff Macroeconomic Projections for the Euro Area" of March 2012, which are based on information available up to 23 February 2012.*

4 *The bilateral USD/EUR exchange rate is assumed to remain unchanged over the projection horizon at the average level prevailing in the ten-working day period ending on the cut-off date.*

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



Source: NBS, ECB.

Overall in 2011 non-energy commodity prices increased by 17.9%. Their prices are assumed to decline by 3.1% in 2012 before rising by 3.8% in 2013 and 5.5% in 2014.

The average level of **short-term interest rates**[5] (three-month EURIBOR) is expected to reach 0.9% in 2012, the same in 2013, and 1.2% in 2014.

5 *The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 16 February 2012. The assumption for short-term interest rates is of a purely technical nature.*

4 Forecast for the external environment

Global economic growth is projected at 3.3% in 2012, accelerating gradually to 3.8% in 2013 and 4.2% in 2014, at the end of the projection horizon. The main risk to the forecast for world GDP growth is the level of government debt and its sustainability in advanced economies. In emerging countries, growth is likely to decelerate over the projection horizon owing to the introduction of measures to alleviate overheating pressures. Nevertheless, these economies are expected to continue expanding at a much faster pace than the advanced economies.

Economic activity in the euro area in the first half of 2012 is expected to remain adversely affected by the tension and uncertainty surrounding the bloc's sovereign debt crisis, although this impacted is likely to be increasingly mitigated by strengthening foreign demand and the lower effective exchange rate. Net trade should be boosted by a gradual rise in foreign demand and a weaker exchange rate. Domestic demand is expected to recover on the back of a decline in energy and food price inflation (which should support real disposable incomes) as well as the favourable impact of very low short-term interest rates and of measures to support the functioning of the financial system. Assuming that the financial crisis does not intensify again, real GDP growth is expected to pick up modestly during the second half of 2012 and to improve further over the rest of the projection horizon. However, the recovery is expected to be dampened, as fiscal consolidation is continuing, adverse credit supply conditions are expected to ease only gradually, and balance sheet restructuring is still going in many sectors. Real GDP growth in the euro area is projected to exceed its potential rate at the end of 2013, leading to a narrowing of the negative output gap. Overall, the recovery is expected to be slow. In annual terms, real GDP is expected to grow by between -0.5% and 0.3% in 2012 and between 0.0% and 2.2% in 2013.

The overall HICP inflation rate in the euro area is expected to remain above 2% until the end of 2012 and then to decline in 2013. It is assumed that this moderation will largely be due to a decrease in the contribution from energy and food prices, since crude oil prices are expected to decline over the projection horizon and food prices should remain stable. The expected slower growth in unit labour costs should have a dampening effect on price inflation. On the other hand, upward pressure on inflation is expected to come from foreseen increases in indirect taxes and administered prices. Inflation is projected to be between 2.1% and 2.7% in 2012 and between 0.9% and 2.3% in 2013.

Global trade growth is expected to continue slowing, with its level in 2012 projected at 4.4%. Thereafter it should accelerate, to 6.5% in 2013 and 7.5% in 2014, at the end of the projection horizon. The expected slowdown of the global economy, including the euro area, will mean further downward pressure on growth in Slovakia's export markets[6], which is projected to be 2.9% in 2012. Growth in these markets should recover gradually, to 5.5% in 2013 and 6.5% in 2014.

6 *The export markets or the external demand indicator are calculated as the weighted average of the imports of Slovakia's trading partners; weights correspond to the destinations of Slovak exports.*

5 Macroeconomic forecast for Slovakia

5.1 Economic growth

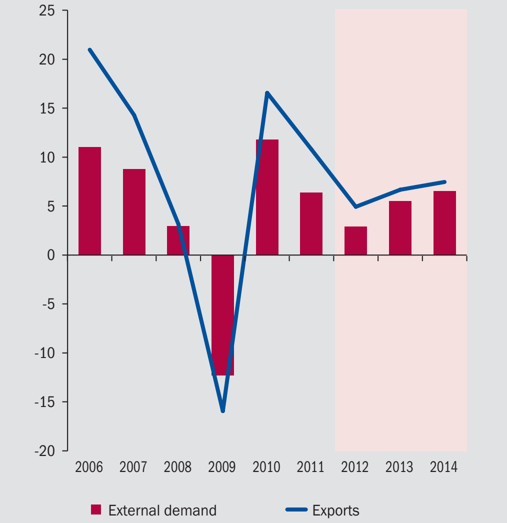
Slower growth in trading partners' economies in 2012 will affect exports …

Export performance in 2012 is expected to reflect a slowdown in global trade and declining growth in export markets for Slovak products. Forward-looking indicators suggest that export expectations will decline in the first quarter of 2012, possible related to a worsening perception of the competitive position within the EU. The favourable developments in the fourth quarter of 2011 are not expected to carry on into 2012. While an increase in production capacity in the automotive industry is assumed to have an upward effect on export performance, this effect is expected to be outweighed by lower growth in export markets. Their export growth is projected to be markedly lower than in 2011. In the years ahead, export growth should pick up in tandem with rising foreign demand for Slovak products and services.

Weak investment demand …

The latest forecast assumes that investment demand in the first half of 2012 will continue to reflect the persisting uncertainty among both investors and households. There is evidence of this in the decline in production capacity utilisation in early 2012. According to the Bank Lending Survey, credit standards for non-financial corporations were further tightened in the first three months. Banks, on the basis of their negative expectations, are restricting the provision of loan products, while at the same time they are reporting lower expected demand for loans. In the construction sector, the negative tendencies are assumed to continue with the most significant obstacle to growth being insufficient demand for construction work. The forecast projects a gradual improvement in the economic situation in the second half of 2012, which should be testified by rising investment. But despite an upturn in the second half of the year, investment growth in 2012 will be slower than in 2011, at 2.8%. Investment activity is not projected to increase until 2014, when growth in both foreign and domestic demand is expected to accelerate. Looking at the composition of investment growth, it is expected that investment activity will provide the major contribution over the projection horizon, as private residential investment will be dampened by the unfavourable

Chart 10 Forecast for external demand and for Slovak exports of goods and services at constant prices (annual percentage changes)



Source: ECB, NBS.

Chart 11 Composition of investment (annual contribution in p.p.)

Source: SO SR, NBS.

labour market situation. The forecast of low investment activity in residential real estate in the period ahead is supported by statistics on the number of newly started construction and number of building permits issued. These indicators have been falling continuously since 2008, indicating the adverse trend in residential construction. Government investment is not expected to show any significant growth, given the need for fiscal consolidation.

Household consumption to recover over the projection horizon ...

Household final consumption grew at 0.2% in the last quarter of 2011, and it is expected to continue growing throughout 2012 with a moderate acceleration in the second half of the year. The persisting adverse situation in the labour markets is having a marked effect on household consumption behaviour. The still subdued growth in household consumption is best evidenced by short-term indicators. Expectation for the financial situation of households are reaching all-time lows, and while expectations for unemployment have stabilised, they are at relatively low levels. These are indicators of household cautiousness, particularly in regard to the negative income effect. The real disposable income of households is assumed to fall moderately in 2011 and to rise marginally in 2012. The forecast for wage developments factors in an expected increase in salaries of doctors and nurses. Given the uncertainty about the future, this forecast does not envisage that last year's inflation rate will be a significant factor in wage bargaining in 2012. The rise in nominal wage settlements in the prospering export-oriented sectors is expected to be counterbalanced by negative developments in other sectors. Thus, overall, nominal wage growth is projected to be muted. With nominal income to be adjusted for what it is assumed will still be a high rate of inflation, real compensation per employee will decline. The rise in natural persons' income from business activities is expected to be in line with the profitability in the corporate sector. Labour productivity is assumed to increase over the projection horizon as a results of the economy recovering. This should create conditions for a rise in real income, while at the same time having a dampening effect on inflation. The combination of the positive income effect and renewed confidence in the household sector is expected to trigger consumption growth. Since households are not expected to abandon their cautious approach, the savings ratio is not projected to fall.

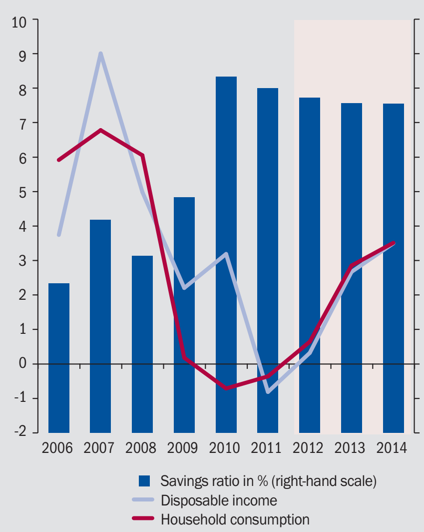
Fiscal consolidation efforts suspended ...

This forecast retain the previous assumption for the Government's fiscal consolidation efforts. The projections for 2012 and 2013 take into account two expenditure-limiting measures: one to freeze salaries of all public sector workers (except for teaching staff) and another to trim operating expenditure.[7] With the exception of these two measures, developments on expenditure side of the public finances are expected to be standard. The baseline scenario indicates that reducing the general government deficit to below 3% of GDP in 2013 will require the adoption of additional measures. Since no such measures have yet been specified, the current forecast does not make full provision for fiscal consolidation measures.

Import growth will not be significantly boosted by rising domestic demand until 2013 ...

After low levels of imports in second half of 2011, import growth is expected to pick up in 2012 as firms restock and import intensity increases. The rise in import growth over the projection hori-

Chart 12 Developments in the income, consumption (average percentage changes) and savings ratio of households



Source: SO SR, NBS.

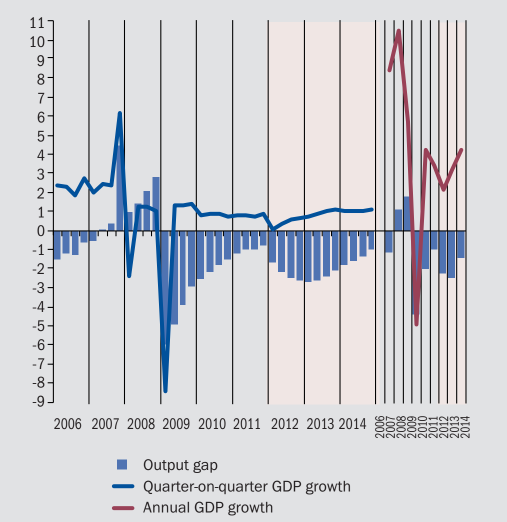
7 *These measures are also factored into the current general government budget.*

zon is expected to stem not only from stronger export performance but also from domestic demand. Export growth is expected to overtake import growth again from 2013, resulting in net trade exports making an increased contribution to economic growth. This will have a positive effect on nominal trade and on the balance of payments current account. The current account surplus is projected to rise relatively sharply over the projection horizon. Contributions to this improvement are assumed to come not only from the goods balance surplus but also from a declining deficit in the services balance. The terms of trade are assumed to weigh down on the current account surplus in 2012, and to improve gradually in subsequent years. Import prices are expected to rise marginally more slowly than export prices due to the assumption the converging economy.

Economic recovery from the second half of 2012

In line with both the projected development of foreign demand over the projection horizon and with current developments, economic growth is expected to slow to 2.1% in 2012, before rising to 3.1% in 2013 and 4.2% in 2014. Given the environment of low foreign demand and a subdued domestic economy, economic growth is expected fall below its potential in 2012 and 2013. Since the utilisation of production and human capacities will be weak, the output gap will widen in 2012 and at the beginning of 2013. It is not expected to narrow again until the domestic economy improves.

Chart 13 GDP growth and the output gap (%)



Source: SO SR, NBS.

5.2 LABOUR MARKET

Gradual rise in employment ...

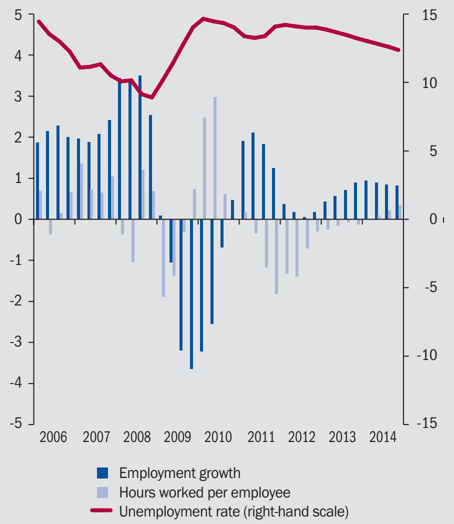
The labour market situation in the near term is expected to be determined to a large extent by a slowdown in economic activity during the first half of 2012. Expectations in individual sectors remained largely unchanged in the first two months of 2012. Expectations for employment in the industry and retail trade sectors remained prevailingly positive, albeit at moderately lower levels. Negative expectations worsened in the construction sector and stabilised in the services sector. No significant reduction in job numbers is expected, since the forecast assumes active implementation of the more flexible Labour Code and that skilled employees will be retained even in the case of a downturn. The economic recovery from the second half of 2012 will not be fully reflected in the employment figures until 2013, since the labour market reacts to upturns with a moderate lag. Employment is expected to rise by 0.7% in 2013 and by 0.9% in 2014. The unemployment rate is assumed to change in line with employment growth. Only a very gradual reduction in the unemployment rate is envisaged over the projection horizon, and by the end of 2014 it is expected to be around 12.5%.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

Modest rise in labour costs ...

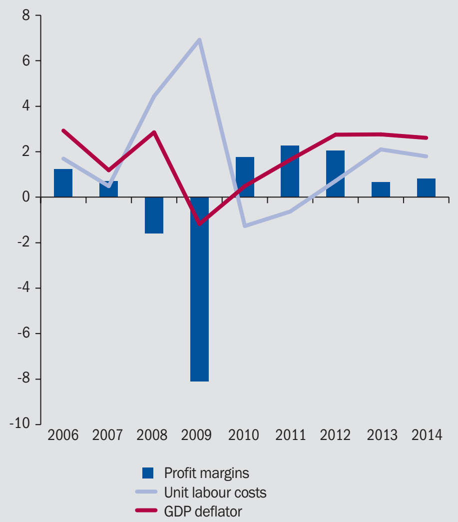
Labour costs are expected to increase at a moderately faster pace in 2012 and 2013, after declining in the previous two years. Their growth is then projected to slow slightly in 2014. Growth in nominal compensation is assumed to be moderately higher than growth in real labour productivity. This fact should not pose a significant cost problem to the economy, since there has been sufficient labour productivity growth in the previous two years. Given the higher price infla-

Chart 14 Employment, hours worked (annual percentage changes) and the unemployment rate



Source: SO SR, NBS.

Chart 15 Profit margins (annual percentage changes)



Source: SO SR, NBS.

tion, firms are expected to have sufficient scope to increase their profit margins and thereby to cover these costs without putting further upward pressure on price growth.

Labour costs having minimum effect on price development ... price inflation to slow ...

Price inflation in 2011 was the highest for five years. However, its trend over the projection horizon is expected to be downward. The inflation rate is expected to slow to 2.9% in 2012 and then to around 2% in 2013 and 2014. Negative contributions to the rate are expected from all the main components, except non-energy industrial goods. Prices of non-energy industrial goods are assumed to be affected by an expected acceleration in imported inflation. Nevertheless, the rise in industrial goods prices is projected to be partly dampened by low consumer demand.

The forecast for energy prices is based on the assumption that commodity price inflation will decelerate in 2012 and enter negative territory in the following two years; at the same time, it is assumed that prices of natural gas will decline by more than 5%, since the principal supplier of natural gas has signed a new contract on gas imports. A further decline in energy prices is expected from January 2013, due mainly to a drop in electricity prices based on developments at the European Energy Exchange in Leipzig; their effect is expected to outweigh the assumed moderate rise in prices of gas and heat. The effect of cost factors (especially energy prices) on services prices should gradually fade away, and, in the absence of demand impulses (dampened by consumer demand), the annual rate of services price inflation is projected to fall.

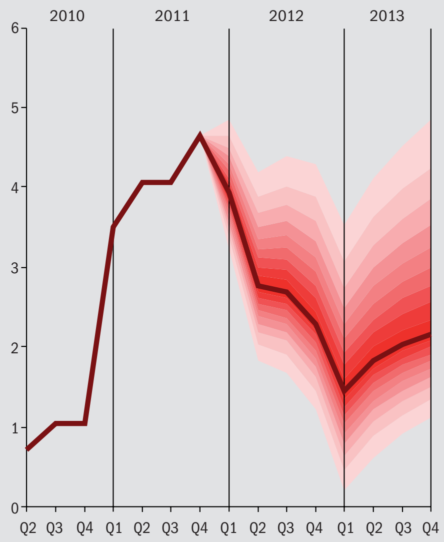
The forecast for food prices reflects the situation in the agricultural commodities market. Since there was a good harvest in 2011, the prices of these commodities are expected to remain unchanged. Food price inflation is therefore projected to be lower over the projection horizon, although processed food prices are expected to be affected by cost factors.

6 Risks to the forecast

The risks to the forecast for the real economy are predominantly on the downside, especially over the medium-term horizon. The largest risk is the fiscal consolidation measures that are expected to be taken, not only at home, but also in other European countries. Depending on the scope and structure of the measures adopted, the negative impact on GDP growth could be up to around 1.5 percentage point in 2012. An escalation in the euro area sovereign debt crisis (and associated developments in foreign demand) remains a downside risk, albeit to a lesser extent than in previous forecasts. Nevertheless, the current situation in foreign demand shows a potential upside risk in that the supply-side shock and low import intensity may prove not to be a one-off effect but may in fact continue. A further downside risk is that the household savings ratio continues to increase at the expense of consumption, owing to concerns about future economic developments and a possible deterioration in the labour market situation.

The risks to the inflation forecast are predominantly on the upside over the projection horizon. Upward pressure on the inflation rate may come from external inflation and higher energy prices. Another risk is that fiscal consolidation measures in 2013 and 2014 are more stringent and include an increase in indirect taxes, which could cause a rise in price inflation. On the downside, there are risks from other domestic indicators, particularly weaker domestic demand and a worsening of developments in the labour market.

Chart 16 HICP inflation forecast (%)



Source: SO SR, NBS.

Table 1 Risks to the forecast

	2012	2013	2014
GDP	↓ Sovereign debt crisis, foreign demand, increase in savings ratio ↑ Supply-side shock in exports, low import intensity	↓ Fiscal consolidation measures, sovereign debt crisis, foreign demand, increase in savings ratio	↓ Fiscal consolidation measures, sovereign debt crisis, foreign demand, increase in savings ratio
Inflation	↓ Domestic demand, labour market ↑ Import prices, energy prices	↑ Fiscal consolidation measures, import prices, energy	↑ Fiscal consolidation measures, energy

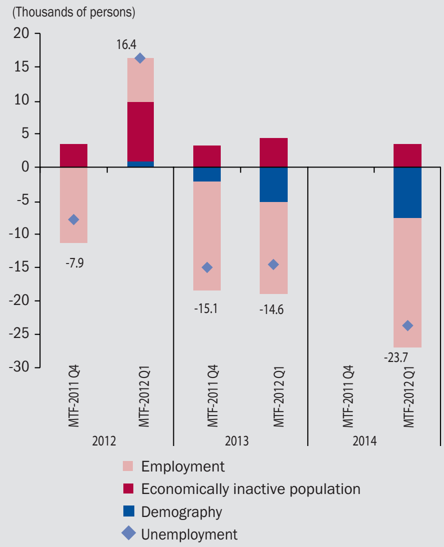
Source: NBS.

7 Comparison with the previous forecast

Comparing the technical assumptions of this forecast with those of the previous forecast (MTF-2011Q4), foreign demand is assumed to be lower over the projection horizon. The euro exchange rate is expected to be weaker, which together with higher commodity price inflation, has lead to oil prices being revised up over the projection horizon. Market interest rates are assumed to be lower over the whole period.

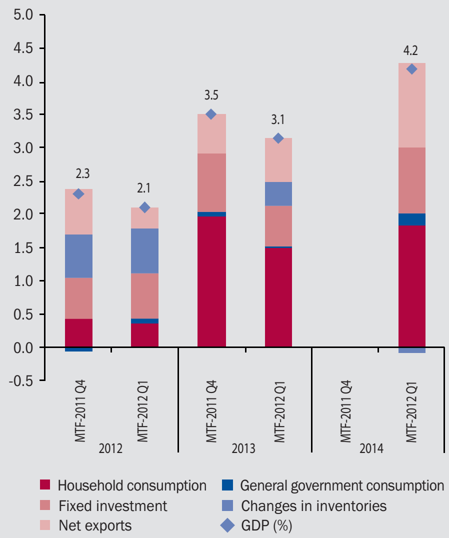
The most marked change in comparison with the previous forecast is in the economic growth forecast, which has been revised down to due to slower growth in export markets for Slovak products and services. This will have a dampening effect on Slovak export growth, particularly in 2013; export growth in 2012 has actually been revised up slightly from the previous forecast, due to the carry-over effect of developments in the last quarter of 2011. This forecast retains the assumption for 2012 that confidence will gradually stabilise and that there will be slow economic growth from the second half of the year; therefore growth in the domestic part of the economy has not been revised up. Household behaviour is expected to remain cautious. The revision of the export growth forecast in 2013 due to lower foreign demand is expected to affect the domestic economy, and therefore growth in domestic demand components has been revised down,

Chart 18 Comparison of labour market indicators (contributions to unemployment)



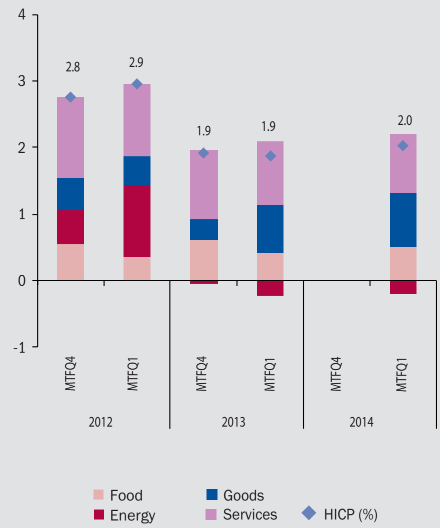
Source: NBS.

Chart 17 Comparison of forecasts for economic growth (contributions to GDP growth at constant prices)



Source: NBS.

Chart 19 Comparison of price level composition (%)



Source: NBS.

especially in 2013. The labour market experienced negative developments in the fourth quarter of 2011 and the situation remains unfavourable; consequently, labour market indicators for 2012 are more adverse than in the previous forecast, with employment growth being revised slightly down and the unemployment rate being revised markedly up. Disposable income growth has been revised down in both 2012 and 2013. The increase in labour costs in 2012 has been revised down, reflecting lower growth in both nominal compensation per employee and employment. Price inflation remained largely unchanged in comparison with the previous forecast.

Table 2 Medium-term forecast (MTF-2012Q1) – main macroeconomic indicators

Indicator (annual percentage change unless otherwise stated)	2011	2012	2013	2014	2012	2013	2014
	Actual data	Forecast			Difference versus MTF-2011Q4		
Prices							
HICP inflation (average)	4.1	2.9	1.9	2.0	0.1	0.0	-
CPI inflation (average)	3.9	2.9	1.9	2.0	0.2	0.0	-
ULC[1] (compensation per employee at current prices / labour productivity ESA 95 at constant prices)	-0.6	0.7	2.1	1.8	-0.5	0.2	-
Labour productivity ESA 95 (GDP at current prices/employment ESA 95)	1.5	1.9	2.5	3.3	0.1	-0.3	-
Compensation per employee	0.9	2.6	4.6	5.1	-0.4	-0.2	-
Economic activity							
Real GDP	3.3	2.1	3.1	4.2	-0.2	-0.4	-
Final consumption of households	-0.4	0.6	2.9	3.5	-0.2	-0.9	-
Final consumption of general government	-3.5	0.6	0.2	1.2	1.1	-0.3	-
Gross fixed capital formation	5.7	2.8	2.7	4.2	0.2	-1.0	-
Exports of goods and services	10.8	4.9	6.7	7.4	0.9	-1.4	-
Imports of goods and services	4.5	5.1	6.6	6.8	1.6	-1.5	-
Real gross disposable income of households	-0.8	0.3	2.7	3.5	-0.4	-0.4	-
Output gap (% of potential output)	-1.0	-2.2	-2.5	-1.5	0.3	-0.2	-
Labour market							
Employment (ESA 95)	1.8	0.2	0.7	0.9	-0.3	0.0	-
Unemployment rate (Labour Force Survey; percentage)	13.5	14.1	13.6	12.7	1.2	1.3	-
Balance of payments							
Economic openness (% of GDP)	174.1	180.9	186.2	190.9	6.7	5.0	-
Balance of trade (% of GDP)	3.5	2.9	3.0	3.7	0.4	0.5	-
Balance of services (% of GDP)	-0.5	-0.4	-0.3	-0.2	0.4	0.4	-
Current account (% of GDP)	0.1	0.4	0.7	1.5	0.8	1.0	-
Current and capital account (% of GDP)	1.3	2.2	2.5	3.2	0.7	0.9	-
External assumptions for the forecast							
External environment							
Real world GDP growth	3.7	3.3	3.8	4.2	-0.3	-0.3	-
Growth in Slovakia's export markets	6.3	2.9	5.5	6.5	-0.9	-0.8	-
Technical assumptions							
Exchange rate (USD/EUR) [2]	1.39	1.31	1.32	1.32	-3.7	-2.9	-
Price for a barrel of Brent crude oil (USD) [2]	111.0	115.1	110.2	104.2	5.2	6.0	-
Price for a barrel of Brent crude oil (EUR) [2]	79.7	87.7	83.7	79.2	9.4	9.7	-
Rise in oil prices (in USD)	39.3	3.8	-4.3	-5.4	5.7	0.6	-
Rise in oil prices (in EUR)	32.7	10.0	-4.5	-5.4	9.5	0.4	-
Non-energy commodity prices	17.9	-3.1	3.8	5.5	4.2	-0.5	-
3M EURIBOR (%)	1.4	0.9	0.9	1.2	-0.3	-0.5	-

Source: NBS, ECB, SO SR.
1) ULC – unit labour costs.
2) Change from previous forecast in percent.