NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Medium-term forecast

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1 Summary

The latest Medium-Term Forecast of Národná banka Slovenska (NBS), MTF-2012Q2, was produced at a time when expectations in the euro area were stabilising. It assumes that the slump in euro area economic activity bottomed out at the end of 2011 and beginning of 2012 and that this activity has subsequently been rising. As in the previous forecast (MTF-2012Q1), this assumption is predicated on the financial crisis not escalating any further and on a recovery of growth in global trade and external demand, as well as on a gradual strengthening of domestic demand over the projection horizon.

The latest macroeconomic outlook for Slovakia takes into account the Eurosystem's technical assumptions,[1] the published flash estimate for economic and employment growth in the first quarter of 2012, and the most recent monthly data and short-term leading indicators.[2]

Given that the technical assumptions changed minimally, the forecasts for key macroeconomic indicators over the projection horizon did not need to be revised significantly and therefore remained similar to those given in the previous forecast. The forecasts for the economy and employment in Slovakia for the whole of 2012 were revised up slightly after both indicators performed better than expected in the first quarter of the year. There was also an upward revision of the full-year inflation forecast, since the latest price inflation figures were higher than projected.

The flash estimate for economic and employment growth in the first quarter of 2012 implied that the supply-side shock of the previous quarter was not simply a one-off effect but could be boosting the economy. The largest contribution to economic growth came from net exports, with exports rising and imports plummeting. However, a catching-up of import intensity over the course of 2012 is expected. Economic growth in 2012 is assumed to be driven mainly by export performance and, in the domestic part of the economy, household consumption and general government consumption. On the other hand, investment demand is expected to show a more marked slowdown. This, together with the projected decline in external demand, should lead to a deceleration in economic activity in 2012 when compared with the previous year.

External demand is expected to accelerate over the projection horizon, contributing to an increase in Slovakia's economic growth. There should also be a contribution to this growth from domestic demand, boosted by positive income effects and low interest rates.

Turning to the labour market situation in 2012, employment growth is expected to be lower than it was in 2011 owing to the economic situation. Later this year, employment growth is assumed to rebound amid a marked recovery in the economy. In line with these developments, the unemployment rate is expected to decline gradually over the projection horizon.

Inflation at the beginning of 2012 was higher than expected, reflecting price increases in unprocessed food and non-energy industrial goods (unexpected rises in pharmaceutical and egg prices). As a result, the inflation forecast for the whole of 2012 has been revised upwards, although the inflation rate over the projection horizon is expected to follow a downward trend. Throughout the projection horizon, a negative output gap, high unemployment rate, and lower energy price inflation are assumed to put downward pressure on the headline inflation rate in 2013 and 2014.

The most pronounced difference between this forecast and the previous forecast is in the projection for economic growth in 2012. Growth in the first quarter of 2012 was far higher than expected and outweighed the negative effect of lower external demand in 2012. Similarly, the employment growth forecast for 2012 was revised up moderately owing to the better than expected employment figures for the first quarter of 2012. The employment forecast over the medium-term horizon remains unchanged from MTF-2012Q1. The estimated inflation rate for 2012 has been revised up from the previous forecast, largely due to the higher than expected

1 *Eurosystem Staff Macroeconomic Projections for the Euro Area, June 2012. The projections are available at www.ecb.int.*
2 *Since the cut-off date for the forecast's assumptions was 15 May 2012, only the flash estimate for GDP was available.*

inflation in the first quarter of the year. The assumptions for price developments over the projection remain at around the same level.

In this forecast, the risks to the projections for the real economy over the projection horizon remain predominantly on the downside. The uncertainty surrounding developments in certain euro area countries could spread to other countries and hence cause a marked reduction in demand for Slovak goods and services, with adverse repercussions on the performance of the Slovak economy. External demand could be further dampened by the expected continuation of fiscal consolidation measures abroad. Since no figures for fiscal consolidation measures in Slovakia were available at the cut-off date of this forecast, none of these measures were incorporated in the baseline scenario. Nevertheless, they represent a downward risk to the growth forecast. Looking at the preliminary information, it can be assumed that the measures will be mostly on the income side and will not have a significant effect on GDP in the short term. It remains to be seen, however, what effect they will have on public finance sustainability and economic growth over the longer term. Looking at the forecast for Slovakia's foreign trade there is an upside risk that the supply-side shock and low import intensity turn out not to be merely a one-off effect and continue for a longer time.

The risks to the inflation forecast for 2012 are balanced, while risks to the forecasts for subsequent years are predominantly on the upside, including mainly risks of imported inflation, higher oil prices and exchange rate developments. The upward risks in the domestic side of the economy lie in the planned consolidation of public finances, which may be implemented through hikes in indirect taxes. Overall, the effect of these risks may be partially mitigated by lower than expected foreign demand.

2 Current developments in the external environment and Slovakia

Developments in different countries vary considerably ...

Global economic growth accelerated moderately in the first quarter of 2012. In advanced countries, the main obstacle to stronger growth continues to be the weak labour market, the financial situation of households, and the need for fiscal consolidation. Economic activity in several euro area countries has been further slowed by uncertainty surrounding the sovereign debt crisis. In most emerging economies economic activity has decelerated, but it remains stronger than in advanced economies and is therefore playing a key role in the recovery of the global economy. According to the OECD composite leading indicator (CLI),[3] economic confidence in the OECD is maintaining a slightly upward trend. This gradual increase indicates that the global economy is continuing to recover.

GDP in the euro area stagnated in the first quarter of 2012 after contracting by 0.3% in the fourth quarter of 2011. The fragility of economic growth in the first three months was a consequence of subdued domestic demand, which in turn reflected several factors: the adverse effect of the sovereign debt crisis on consumer and business confidence; high oil prices; stricter credit conditions; and further tightening of fiscal policy in certain euro area countries. Economic activity in OECD countries accelerated moderately in the first quarter of 2012, although growth rates varied between countries. GDP in the United Kingdom contracted, whereas in the euro area it stagnated and in Japan and the United States it increased. In the United States, GDP growth in the first quarter was lower than in the previous quarter due to weaker growth in private investment as well as the fact that government spending declined (albeit not so sharply as in the last three months of 2012). Household consumption made a positive contribution to GDP growth, as did export growth. The ISM[4] manufacturing index for the first quarter of 2012 increased slightly owing to an upturn in new orders that implies an improvement in business sentiment in the Untied States. The US economy may therefore grow moderately, although the level of uncertainty remains high. In China, economic growth again slowed moderately in the first quarter of 2012, owing to the lingering effects of restrictive economic measures, a decline in exports and stagnation in the Chinese real estate market. The Chinese economy has been decelerating since the second half of 2011, although its growth rate is still relatively high in comparison with advanced economies. In other emerging economies, too, economic activity slowed but still showed relatively strong growth. The assumption remains that these economies will slow only slightly, despite slackening demand both at home and abroad.

Stronger economic growth due to rising exports and, in particular, low imports ...

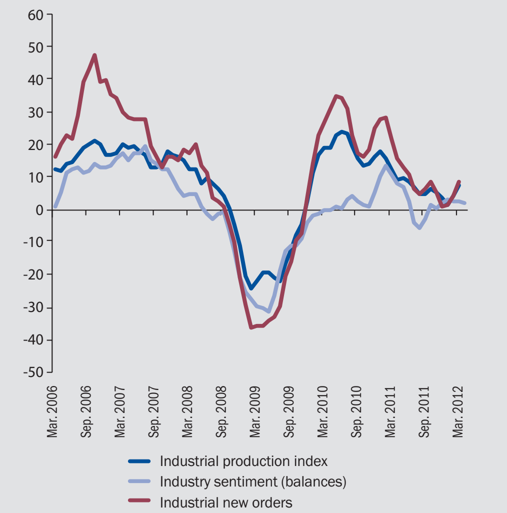
Euro area GDP remained flat in the first quarter of 2012, although there were considerable disparities between GDP growth in different euro area countries. According to the flash estimate of the Statistical Office of the Slovak Republic (SO SR), the Slovak economy grew by 0.8% in comparison with the previous quarter, therefore far exceeding the growth projected in the previous forecast. This improvement stemmed from stronger growth rates in Germany and in non-euro area countries. It is clear from the monthly data that the main driver of growth was external trade, with export destinations also including non-EU countries. The high trade surplus reflected not only rising exports, but also the fact that imports remain low. Import intensity fell[5] for a second successive quarter. The trade balance developments may confirm the positive supply-side shock identified in the December forecast. This is related to an expansion of automotive production, which in the first three months resulted in rising production and sales in the automotive industry. There was even a year-on-year increase in new orders in the first quarter. Overall, according to the sentiment indicator for April, sentiment in industry remains positive. On the production side, the improved situation was largely attributable to industry output, specifically in the auto-

3 The CLI indicators are published by the OECD on a monthly basis.

4 The ISM (Institute for Supply Management) Purchasing Managers Index – 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.

5 In this forecast a change in import intensity is understood to mean a temporary change in the ratio of imports to exports.

Chart 1 Short-term indicator (annual percentage growth; 3-month moving averages)



Source: SO SR.

motive industry and related segments. The Slovak economy gained market share and increased its competitiveness.

In the first two quarters of 2012 firms' production was affected by restrictions on their internal financing, probably stemming from a deterioration in their economic performance. This was indicated in the last quarter of 2011 by a decline in industry sector profitability. Banks did not report any tightening in credit standards for non-financial corporations, nor any change in the level of demand for credit products, which remains subdued. On the whole, interest rates for non-financial corporations are still relatively low. It should be noted, however, that the annual rate of growth in lending to non-financial corporations slowed in the first quarter of 2012 and reflects relatively diverse developments in different segments of the economy.

Not only did net exports make a positive contribution to economic growth, probably so too did a moderate increase in domestic demand. The monthly retail sales figures indicate a modest recovery in household consumption. The real disposable income of households reflected slightly higher growth in household nominal income and lower price inflation, which together provided a basis for consumption growth. At the turn of the year the consumer confidence indicator stopped declining and began to improve, although it remains deep in negative territory. Household expectations about future unemployment and the financial situation stabilised in the first two months of this year and showed a moderately positive trend in March and April. The improved sentiment of households was reflected in household borrowing, as households began to take out more consumer loans. On the other hand, demand for housing loans declined slightly. Banks kept their credit standards unchanged in the first quarter of 2012, but, as a result of market rate movements, retail lending rates on housing loans declined moderately. Slower growth in the stock of housing loans was reflected in slightly lower growth in the overall stock of loans. This stemmed mainly from households' cautious approach to investment and probably also to the fact that property prices remain relatively high.

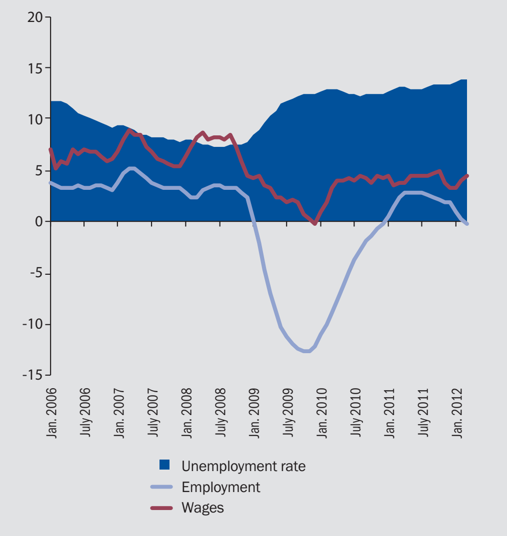
General government consumption is also expected to have contributed positively to economic growth in the first quarter. According to budget implementation figures, public spending on goods and services was higher than in the same period of the previous year (probably due in part to the holding of an early general election in March this year).

As regards investment growth, which in the fourth quarter of 2011 was marked by one-off effects, in the first quarter of 2012 it was affected to a large extent by the persisting uncertainty in financial markets. It may be assumed that the slowdown in lending to the corporate sector caused investment activity to stagnate.

Modest upturn in the labour market ...

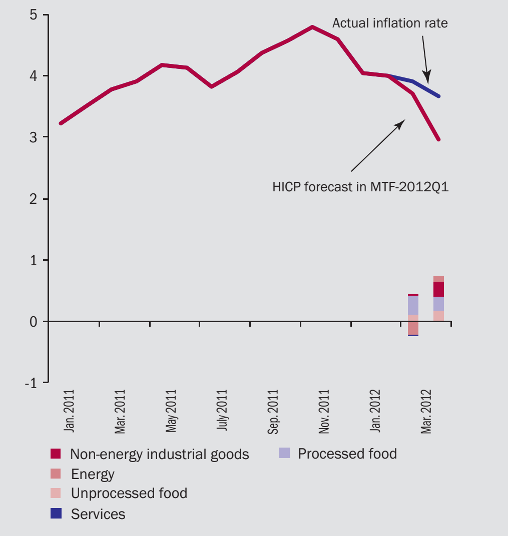
According to the SO SR flash estimate, the labour market situation in the first quarter of 2012 was better than expected. Employment increased by 0.2% in comparison with the fourth quarter of 2011. The flash estimate did not bear out monthly figures for selected sectors which had implied stagnating or declining employment. The improvement was probably explained by job creation at small and medium-sized enterprises, since these figures are not included in the monthly reports. The employment growth reflected better than expected developments in the real economy. At the same time, however,

Chart 2 Labour market situations (annual percentage growth; 3-month moving averages)



Source: SO SR.

Chart 3 Inflation rate changes (contributions in percentage points; growth in %)



Source: NBS, SO SR.

the unemployment rate remained unchanged from the last quarter of 2011, at just under 14%, according to the monthly figures. Labour productivity was moderately higher than expected, but, owing to the rise in employment, its growth in the first quarter was lower than in the previous quarter. The rise in labour productivity created scope for income growth. It is assumed on the basis of monthly figures that compensation per employee increased in the first quarter of 2012, after declining quarter-on-quarter in the last three months of 2011.

Higher than expected price inflation reflected cost factors, administrative interventions, and a supply-side shock ...

Inflation slowed moderately in the first four months of 2012, due to the fading of tax hike effects, the introduction of certain fees, and the high prices of food and energy in the previous year. Nevertheless, price growth has remained at a relatively elevated level. Price inflation in the first four months was higher than projected in the previous forecast, reflecting the higher than expected inflation in prices of non-energy industrial goods and food. Prices of non-energy industrial goods were affected by unexpected increases in prescription medicine prices (following a new categorisation of medicines), while food prices came under upward pressure from egg prices (due to a supply-side shock resulting from an EU Directive). Prices of industrial goods reflected developments in other euro area countries affected by cost factors and exchange rate developments. Services prices in particular reflected cost factors. As for energy price inflation, since the beginning of the year it has been driven up by rising fuel prices and higher energy prices.

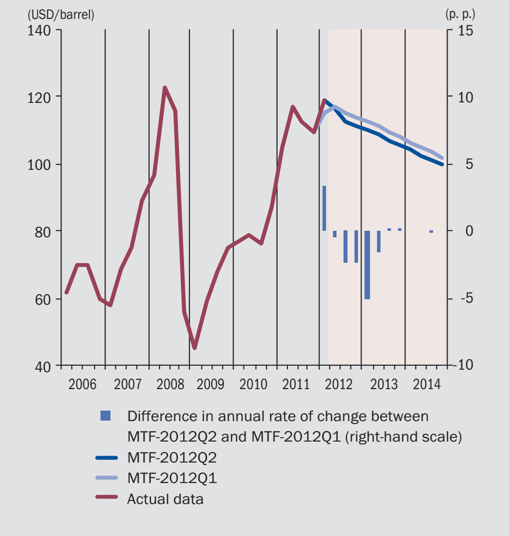
3 TECHNICAL ASSUMPTIONS[6]

Following the publication of the previous forecast in early March, the **exchange rate** of the euro against the US dollar continued to show volatility and, affected by the euro area sovereign debt crisis, it depreciated sharply from the end of April. The current forecast assumes that the exchange rate of USD per EUR[7] will be 1.30 in 2012, 2013 and 2014.

The price of oil rose markedly in the first quarter of 2012, driven up by expectations for a stronger economic recovery, by extremely cold weather in Europe, and by fears related to the geopolitical tensions in oil-exporting countries. The price of a barrel of Brent crude oil averaged USD 118.5 in the first quarter. The price per barrel declined in the following period, and by the end of May it was around USD 110. The downward pressure on the oil price came mainly from increased oil production in both OPEC and non-OPEC countries as well as from the expected weak demand for oil. This forecast assumes that the average price per barrel will be USD 114.6 in 2012, USD 107.9 in 2013 and USD 102.0 in 2014.

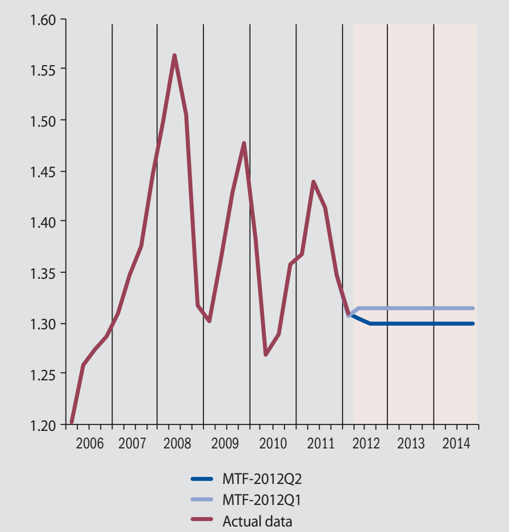
Prices of **non-energy commodities** (in USD) increased moderately in the first quarter of 2012 after declining quite sharply towards the end of 2011. This turnaround was largely due to improving outlooks for global economic activity. In the case of agricultural commodities, prices were also pushed up by unfavourable climatic condi-

Chart 5 Price per barrel of Brent crude oil (USD)



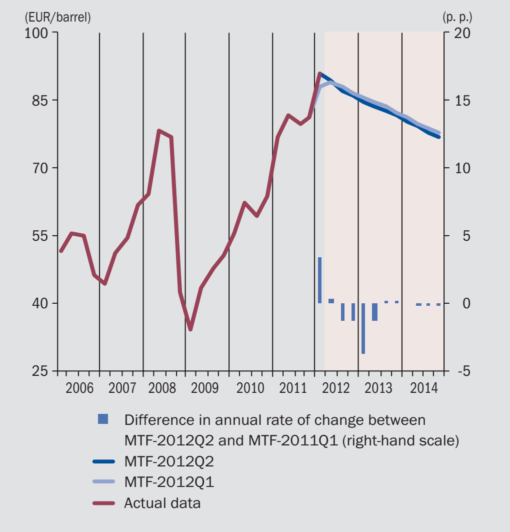
Source: NBS, ECB.

Chart 4 USD/EUR exchange rate



Source: NBS, ECB.

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

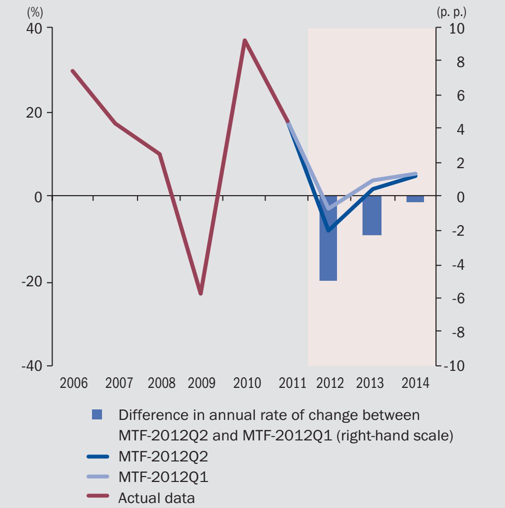


Source: NBS, ECB.

6 *The technical assumptions of the Medium-Term Forecast, as well as the assumptions for developments in the international economy, are based on the „Eurosystem Staff Macroeconomic Projections for the Euro Area" of June 2012, which are based on information available up to 15 May 2012.*

7 *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 7 Non-energy commodity prices (annual percentage changes)



Source: NBS, ECB.

tions. The increase in metal prices was caused by stronger demand for metal from emerging economies. This forecast assumes that non-energy commodity prices will decline by 8.0% in 2012, before rising by 1.6% in 2013 and by a further 5.1% in 2014.

The average level of **short-term interest rates**[8] (three-month EURIBOR) is expected to reach 0.8% in 2012, 0.7% in 2013 and 0.9% in 2014.

8 *The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 15 May 2012. The assumption for short-term interest rates is of a purely technical nature.*

4 Forecast for the external environment

Global growth to accelerate over the projection horizon ...

Global economic growth is expected to be 3.2% in 2012, accelerating gradually to 3.8% in 2013 and 4.2% in 2014. The main risks to these developments are the uncertainty surrounding the euro area sovereign debt crisis, the escalation of financial market tensions, and any further rise in commodity prices.

Very modest recovery in the euro area due to need for balance sheet restructuring ...

Assuming no further escalation of the financial crisis, euro area GDP growth is expected to accelerate gradually over the projection horizon owing to a recovery in global trade and external demand as well as to a gradual strengthening of domestic demand. The latter is expected to be boosted by very low short-term interest rates and by a decline in energy and food prices, which would have an upward effect on households' real disposable income. GDP growth should also be supported by measures taken to restore the functioning of the financial system. Overall, however, the recovery will be moderate given the continuing need for restructuring of both public and private sector balance sheets in several euro area countries. GDP growth is expected to be in range -0.5% – 0.3% in 2012 and 0.0 % – 2.0% in 2013.

Above-target inflation due to high oil prices, exchange rate depreciation, and tax hikes ...

The average HICP inflation rate in 2012 is expected to be between 2.3% and 2.5%. The relatively high level reflects the effect of oil price inflation, depreciation of the euro exchange rate, and hikes in indirect taxes. Inflation in 2013 is expected to slow markedly, to between 1.0% and 2.2%. The downward pressure on inflation is assumed to come mainly from energy prices (with the oil price declining and the effect of its past high growth fading away) and to a lesser extent from food prices. Excluding the food and energy components, the HICP rate is expected to be more or less stable over the projection horizon, as the projected rises in indirect taxes and administrative prices will be counterbalanced by weaker domestic demand and restrained growth in labour costs.

Global trade to accelerate over the projection horizon ...

After decelerating sharply in 2011, global trade growth is expected to continue slowing in 2012, to 4.4%, before accelerating to 6.4% in 2013 and 7.2% in 2014. The slowdown in global economic activity in 2011 was reflected in lower growth in Slovakia's export markets; this growth is expected to continue declining in 2012, to 2,1%, and then to recover gradually, to 5.8% in 2013 and 6.6% in 2014.

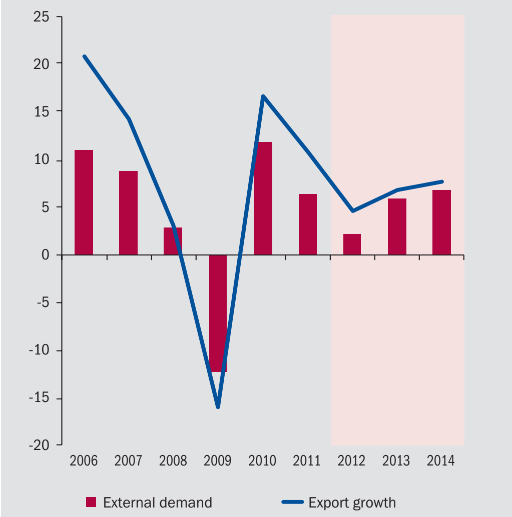
5 Macroeconomic forecast for Slovakia

5.1 ECONOMIC GROWTH

External demand to recover gradually with a positive effect on exports ...

According to external assumptions, growth in foreign demand for Slovak goods and services is expected to have bottomed out at the end of 2011 and beginning of 2012 and to have its largest impact in 2012. This situation is reflected in Slovak export growth, although the positive supply-side shock of production expansion in the domestic automotive industry is also expected to push up the market share of Slovak exports in 2012. The improved sentiment in export-oriented sectors of industry is evident from the marked rise in export expectations during the course of this year, which corresponds to the gradual rise in foreign demand and is expected to have a moderate upward effect on export growth in 2012. Slovak industry is seeing its competitive position improve not only in the EU but also in non-EU countries. This may be the main factor in the forecasted improvement in export performance this year. In the medium-term horizon, export growth is expected to be in line with a moderate acceleration in foreign demand growth.

Chart 8 Forecast for external demand for Slovak exports of goods and services at constant prices (annual percentage changes)



Source: ECB, NBS.

Box 1

PRICE COMPETITIVENESS AS REPRESENTED BY THE EFFECTIVE EXCHANGE RATE

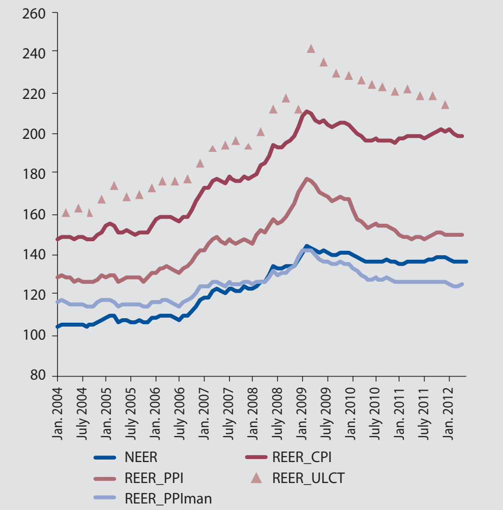
From 2004 there was an appreciating trend in both nominal effective exchange rate (NEER) indices and real effective exchange rate (REER) indices. This changed in 2009, since when both the NEER and REER have been mainly depreciating due to part of the NEER being partially pegged after the euro adoption as well as to the economic crisis, which has had a dampening effect on domestic price inflation. The resulting negative inflation differential against Slovakia's most significant trading partners is leading to a more marked weakening of the REER in comparison with the NEER. Depreciation of the NEER and REER therefore represents an increase in the price competitiveness of domestic producers.

According to estimates of the equilibrium real effective exchange rate (EREER),[9] a prevailing correspondence to the appreciating trend of the PPI manufacturing-based REER was observed until 2009. This trend reflected the long-term correspondence between nominal convergence (price convergence) and the gradual real convergence of the Slovak economy to advanced EU countries, as measured by developments in macroeconomic fundamentals. The adverse effect of the crisis on the Slovak economy was seen in equilibrium real appreciation, as it slowed and has continued to do so. The weakening of the REER after 2009 has led to it being undervalued.

9 Alternative approaches to estimating the equilibrium real effective exchange rate for the Slovak economy, the results of which were used to define the equilibrium band,are described in a document available on the NBS website at: http://www.nbs.sk/_img/Documents/_Publikacie/MU/2012/EREER_032012.pdf

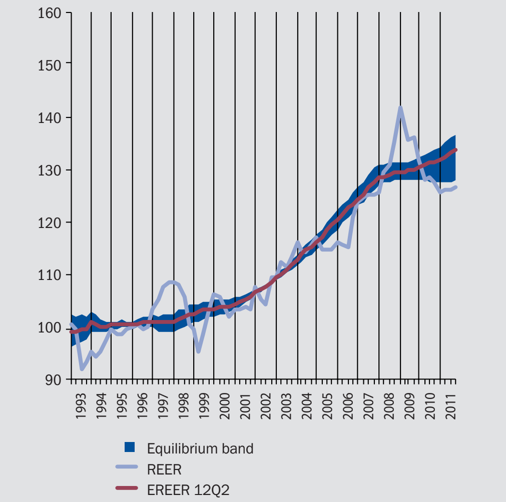
The price competitiveness of Slovakia has increased, and its positive effect on export performance may help to explain why export growth has been relatively favourable despite reduced external demand. At the same time, the undervalued real exchange rate may also be boosting net exports by dampening imports.

Chart A NEER and REER indices (15 trading partners) (1993M1/Q1=100)



Source: NBS.
Note: + appreciation / - depreciation of the indices.

Chart B Equilibrium real effective exchange rate



Source: NBS.
Note: PFI manufacturing REER, EREER 12q2 - the corresponding equilibrium exchange rate from the NBS Medium-Term Forecast MTF-2012Q2; + appreciation / - depreciation of the indices.

Investment activity subdued ...

The current negative trend in investment growth will affect the outlook for the whole year. As economic activity slows, the deceleration in investment growth is expected to continue. Investment activity this year should be dampened not only by the persisting uncertainty related to the sovereign debt crisis, but also by a reduction in bank lending activity amid a drop in both the supply of and demand for credit products. Banks are not expecting to tighten credit standards further, but given their need to meet new capital adequacy requirements, the forecast assumes a slight decline on the supply side. Although the utilisation of production capacities has increased moderately, it remains below the long-term average. Investment growth in coming quarters is therefore not assumed to increase significantly. Investment growth in 2012 is expected to come entirely from private investment, as government investment may be curbed by the implementation of fiscal consolidation measures. Investment in residential real estate is expected to be affected by a high supply of property, reduced demand from households, and low rental yields. In the new construction segment there are negative tendencies in the falling numbers of building permits issued and construction projects started. Investment growth is expected to pick up moderately in subsequent years amid an upturn in economic activity. The main increase should be in private investment, with only very slight growth in government investment and residential investment. Residential investment is expected to reflect the state of a market in which supply exceeds demand, real income growth is subdued, and property speculation declines due to the low returns that property investments offer in comparison with other types of investment. This forecast does not explicitly reckon on further large investments such as the expansion of production in the automotive sector in 2011.

Chart 9 Composition of investment (annual contribution in p.p.)

Source: SO SR, NBS.

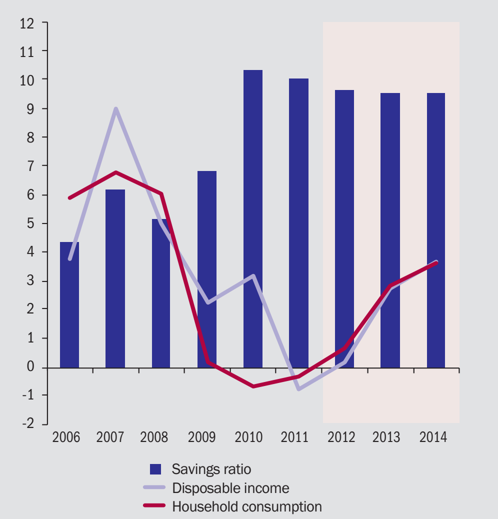
Revival of household consumption ...

The monthly data for retail trade sales in the first quarter of 2012 indicate that household final consumption will continue to rise moderately, as it did in the last quarter of 2011. This trend is assumed to last throughout 2012 and therefore final consumption for the year as a whole is projected to increase by 0.6%. In 2012 consumption growth is expected to slightly exceed disposable income growth, with higher consumption expected to be financed by savings. Incomes should reflect the fact that public sector wages remain flat and that private sector wage growth is relatively low due to a climate of uncertainty and declining profitability. Wage growth in 2012 is affected by an assumed increase in salaries in the health care sector (salaries of doctors and nurses). We do not, however, expect that wage rises recently laid down by law will be transmitted in full to overall wage growth, given that health care facilities are unlikely to be able to meet the increased salaries. The overall disposable income of households is expected to be positively affected by business income. On the basis of moderately more optimistic consumer sentiment, it is assumed that consumption growth will exceed income growth. Signs of rising confidence have been observed in recent months, especially April. Households expect that their financial situation will improve and that the labour market situation will not worsen. Considering the relatively long slump in consumption and the need to consolidate public finances (which could cause household sentiment to deteriorate again), the upturn in household consumption is expected to be gradual. Consumption growth over the projection horizon should accelerate and be in line with income developments. The savings rate is expected to remain the same as in 2012. Under conditions of low price inflation and gradually increasing economic activity, income growth is expected to accelerate. This growth will be seen first in corporate profits and later in negotiated wages in the private sector. Public sector wages should remain subdued over the projection horizon.

Suspension of expenditure-based consolidation efforts ...

Looking at the implementation of the state budget in 2012 there appears to have been an increase in general government consumption in the first quarter of 2012. This consumption is not, however, expected to have continued rising in the second quarter. The forecast does not factor in any revised or additional consolidation measures, since details of the intended fiscal consolidation measures had not been published by the cut-off date for this forecast. Thus, like the previous forecast, MTF-2012Q2 considers only the two modest expenditure-limiting measures specified in the general government medium-

Chart 10 Developments in the income, consumption (annual percentage changes) and savings ratio of households (%)



Source: SO SR, NBS.

term budget for 2012–2014, namely: to freeze salaries of central government workers (except for teaching staff) and to trim central government operating expenditure. Since these measures concern only central government, their impact on general government final consumption in 2012 and 2013 is assumed to be minimal. The largest contributor to growth in general government final consumption is expected to be health care spending, which will include expenditure on new higher pay awards for doctors and nurses.

Imports to increase from 2013 ...

Based on developments in the first quarter of 2012, when import intensity was at a very low level, import growth in 2012 is expected to remain relatively low. Import intensity should return to former levels during coming quarters, although this would not make up for the slump in imports over the last six months and the substantial destocking that accompanied it. The rebounding of import intensity this year will be reflected in high quarterly rates of growth, which will carry on in 2013. As for domestic demand, it should increase from the second half of 2012 until the end of the projection horizon, and therefore should contribute to import growth. The contribution of net exports is expected to turn negative in 2013. The situation should be the same in both real and nominal terms, since the same increase is assumed for both export deflators and import deflators. Thus the terms of trade are not expected to affect the balance of payments current account over the projection horizon. The current account surplus is assumed to rise quite sharply in 2012, to temporarily stop increasing in 2013, and to rise again towards the end of the projection horizon. This pattern follows mainly changes in the trade balance, the largest contributor to the current account surplus. Looking at the effect of the current transfers balance on the current account, the component of receipts from EU funds is expected to make a positive contribution over the projection horizon.

Economic growth to slow moderately from the second quarter of 2012 and to accelerate again from 2013

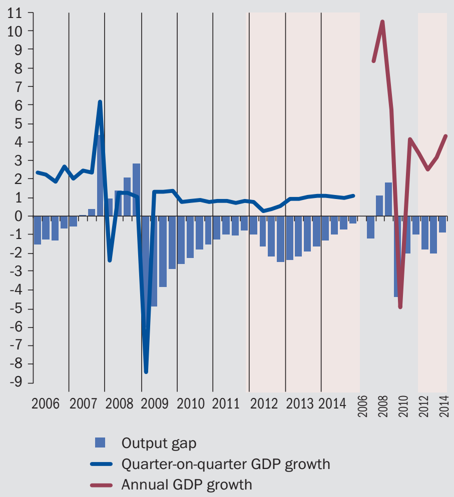
Economic growth over the projection horizon is assumed to mirror movements in external demand and an expected increase in the share of imports in exports. Growth is therefore projected to slow over the next three quarters and to stand at 2,5% for 2012 as a whole, rising to 3.1% in 2013 and 4.3% in 2014. Economic growth in 2012 should be driven largely by export performance. In subsequent years growth is expected to be more balanced, with an increased contribution from the domestic part of the economy. The economy should remain below its potential, and in 2012 the output gap is assumed to widen further due to a slowdown in external demand, resulting in lower utilisation of production and human capacities. As external demand picks up and domestic demand recovers, the output gap is expected to begin narrowing from 2013.

5.2 LABOUR MARKET

Employment growth to be weak in 2012 and then accelerate in the next two years ...

With economic activity projected to decelerate in 2012, employment growth is expected to be markedly slower in this year than in 2011. Expectations in the economy did not change significantly. Since the domestic part of the economy remained subdued there continued to be negative sentiment in the construction and services sectors regarding job creation. In industry and retail trade the situation was unchanged from the previous period in that there were positive expectations for job creation. Given the mixed

Chart 11 GDP growth and the output gap (%)



Source: SO SR, NBS.

signals about future recruitment levels in different sectors of the economy, job creation is expected to slow in the short-term under downward pressure from the climate of uncertainty and low external demand. Amid the reduced demand, it is assumed that the workforce will be utilised more flexibly and that skilled employees will be retained. As a consequence, the number of hours worked per employee is expected to decline. Employment growth should pick up from 2013, when economic growth is expected to accelerate. The unemployment rate is assumed to rise moderately in 2012 as the increase in the number of economically active people exceeds employment growth. Over the following two years the unemployment rate should fall to 12.4%, in line with employment growth.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

Restrained rise in labour costs ...

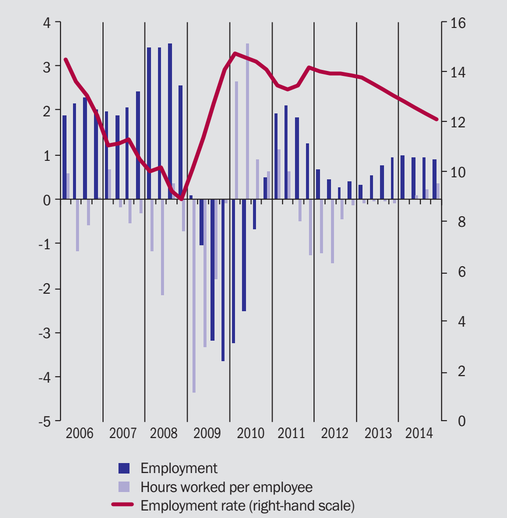
Labour costs are expected to grow at a gradually rising pace, after having declined in 2010 and 2011 when labour productivity growth was far higher than the rise in nominal compensation per employee. The increased labour productivity should be reflected in nominal wages, although it is still assumed that there will be a lead in labour productivity growth over the projection horizon. Price rises in the economy are expected to support an increase in firms' profitability.

Lower inflation ...

The inflation rate is expected to decline over the projection horizon, to 3.5% in 2012, 1,7% in 2013 and 1.9% in 2014. The main influences on the rate are expected to be autonomous factors. No inflationary pressures are anticipated from the real economy, whether from the demand side or through increases in labour costs. Throughout the projection horizon, consumer demand should be dampened by a negative output gap, high unemployment rate, and relatively low wage growth.

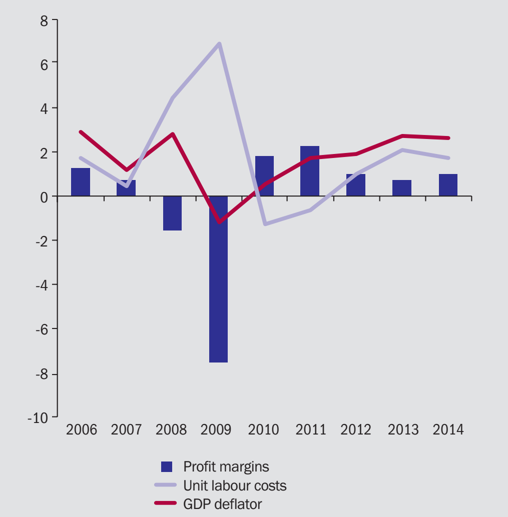
Negative contributions to the inflation rate in 2012 are expected from all the main components, except non-energy industrial goods and unprocessed food. In the summer, prices of unprocessed food should reflect the base effect of last year's surge in vegetable prices. Annual inflation in processed food prices is assumed to continue slowing in line with commodity price developments. The expected acceleration in imported inflation and increase in administered prices of pharmaceuticals should put upward pressure on

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



Source: SO SR, NBS.

Chart 13 Profit margins (annual percentage changes)



Source: SO SR, NBS.

prices of non-energy industrial goods. The forecast for energy price inflation assumes a gradual slowdown in commodity price inflation in 2012. Services price inflation is expected to decelerate during the course of 2012 owing to an absence of cost and demand impulses, as well as to the base effect of a marked rise in rail transport prices at the end of 2011.

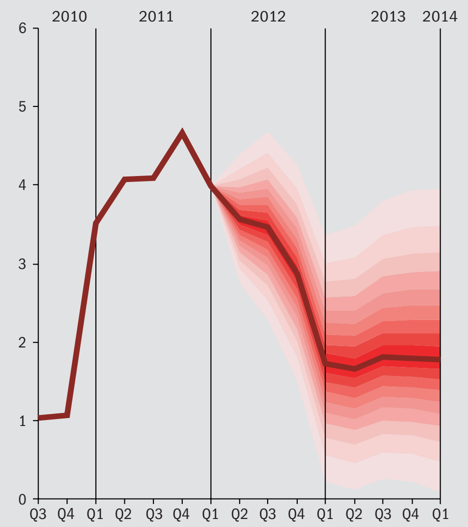
Food prices are assumed to rise moderately in 2013 in accordance with developments in the technical assumptions. This increase may be counterbalanced to some extent by a slower annual rate of change in prices of non-energy industrial goods (as the effect of hikes in administered prices of pharmaceuticals fades). In line with technical assumptions (a drop in oil prices) administered energy prices are assumed to decline more moderately in 2014 than in 2013. Services price inflation is expected to accelerate towards the end of the projection horizon, since there is assumed to be an increase in economic activity and recovery in the domestic part of the economy.

6 Risks to the forecast

Risks in both the real economy and price developments are predominantly on the downside ...

The risks to the medium-term forecast for the real economy are predominantly on the downside. The uncertainty surrounding developments in certain euro area countries could spread to other countries and hence cause a marked reduction in demand for Slovak goods and services, with adverse repercussions on the performance of the Slovak economy. External demand could be further dampened by the expected continuation of fiscal consolidation measures abroad. Since no figures for fiscal consolidation measures in Slovakia were available at the cut-off date of this forecast, it is difficult to estimate their risk to the forecast. Looking at the preliminary information, it can be assumed that the measures adopted will be mostly on the income side and will not have a significant effect on GDP in the short term. It remains to be seen, however, what effect they will have on public finance sustainability and economic growth in the longer therm, especially given the planned changes in the second pillar of the pension saving system and in direct taxes. As regards the forecast for Slovakia's foreign trade there is an upside risk that the supply-side shock and low import intensity are not merely one-off effects and will continue for a longer time.
The risks to the inflation forecast for 2012 are balanced, while risks to the forecasts for subsequent years are predominantly on the upside, including mainly risks of imported inflation, higher oil prices and exchange rate developments.The upward risks in the domestic side of the economy lie in the planned consolidation of public finances, which may be implemented through hikes in indirect taxes. Overall, the effect of these risks may be partially mitigated by lower than expected foreign demand.

Chart 14 HICP inflation forecast (%)



Source: SO SR, NBS.

Table 1 Risks to the forecast

	2012	2013	2014
GDP	↓ Debt crisis, foreign demand ↑ Supply-side shock in exports, low import intensity	↓Fiscal consolidation measures, sovereign debt crisis, foreign demand	↓ Fiscal consolidation measures, sovereign debt crisis, foreign demand
Inflation	Balanced	↑ Fiscal consolidation measures, import prices, oil prices, exchange rate ↓ Foreign demand	↑ Consolidation measures, import prices, oil prices, exchange rate ↓ Foreign demand

Source: NBS.

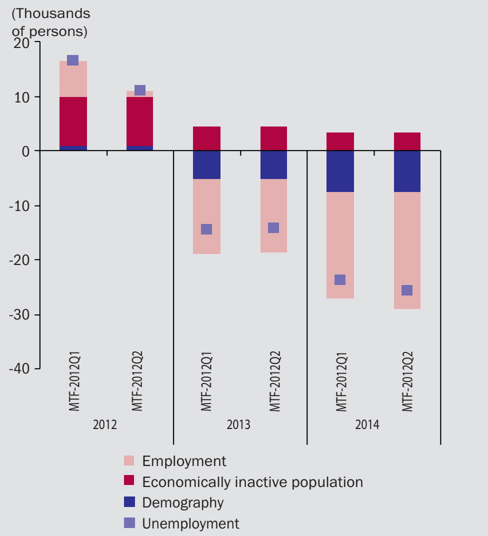
7 Comparison with the previous forecast

Looking at the technical assumptions of this forecast in comparison with those of the previous forecast (MTF-2012Q1), foreign demand for Slovak goods and services has been revised down in 2012, but revised up slightly in 2013 and 2014. Furthermore, this forecast assumes a weaker exchange rate and a moderately lower oil price in 2012 and 2013. The forecasts for short-term interest throughout the projection horizon have been revised down slightly from the March forecast.

No significant changes in macroeconomic indicators …

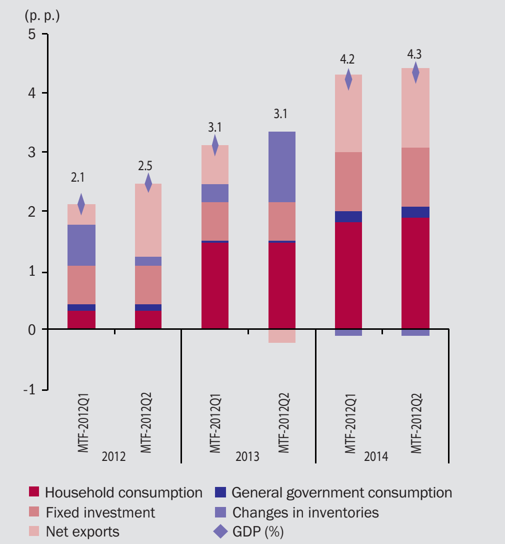
The main changes in forecasts for the real economy were based on the latest published figures. With the flash estimate for economic growth in the first quarter of 2012 being higher than expected, the growth forecast for the whole of 2012 has been revised up. Although foreign demand in 2012 caused a slowdown in export growth, the contribution of net exports to economic has been revised up from the previous forecast due to a short-term decline in import intensity. The forecast for economic growth towards the end of the projection horizon is marginally higher owing to an increase in foreign demand. Turning to the labour market, the flash estimate for first-quarter employment growth was higher than projected in the previous forecast, and therefore the fore-

Chart 16 Comparison of labour market indicators (contributions to unemployment)



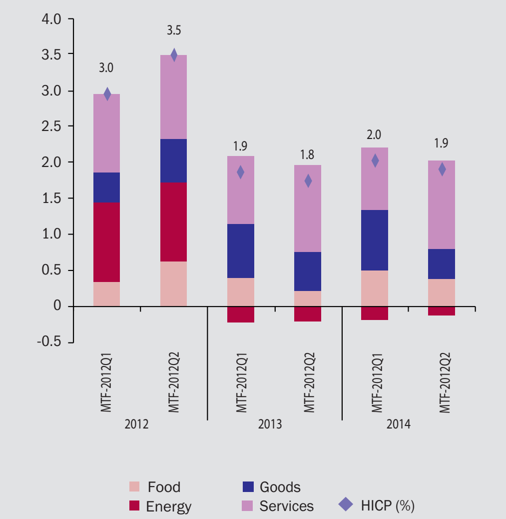
Source: NBS.

Chart 15 Comparison of forecasts for economic growth (contributions to GDP growth at constant prices)



Source: NBS.

Chart 17 Comparison of price level composition (p. p.)



Source: NBS.

cast for employment growth in 2012 has been revised up moderately. Given the slightly higher economic growth, employment is expected to be marginally higher and, in line with these developments, there should be a moderately faster decline in the unemployment rate. As regards incomes, the forecast for nominal compensation growth in 2012 has been revised up on the basis of current developments, with the result that unit labour costs are slightly higher. In real terms, however, incomes are assumed to be lower than projected in the previous forecast due to marked downward pressure from higher than expected inflation. The inflation rate in 2012 is expected to be significantly higher than previously projected, largely because prices of energy and other items in the consumer basket have been revised up in response to current developments. As for non-energy industrial goods, administered prices of pharmaceuticals have risen relatively sharply and seasonal prices of footwear and clothing were significantly higher than projected. The forecast for consumer prices in 2013 and 2014 remains largely unchanged.

Table 2 Medium-term forecast (MTF-2012Q2) – main macroeconomic indicators

Indicator (annual percentage changes unless otherwise stated)	2011	2012	2013	2014	2012	2013	2014
	Actual	Forecast			Difference with MTF-2012Q1		
Prices							
HICP inflation (average)	4.1	3.5	1.7	1.9	0.6	-0.2	-0.1
CPI inflation (average)	3.9	3.4	1.8	1.9	0.5	-0.1	-0.1
ULC[1] (compensation per employee at current prices / labour productivity ESA 95 at constant prices)	-0.6	0.9	2.1	1.7	0.2	0.0	-0.1
Labour productivity ESA 95 (GDP at current prices/employment ESA 95)	1.5	2.0	2.5	3.3	0.1	0.0	0.0
Compensation per employee	0.9	3.0	4.6	5.0	0.4	0.0	-0.1
Economic activity							
Real GDP	3.3	2.5	3.1	4.3	0.4	0.0	0.1
Final consumption of households	-0.4	0.6	2.8	3.6	0.0	-0.1	0.1
Final consumption of general government	-3.5	0.6	0.2	1.2	0.0	0.0	0.0
Gross fixed capital formation	5.7	2.8	2.8	4.4	0.0	0.1	0.2
Exports of goods and services	10.8	4.6	6.7	7.8	-0.3	0.0	0.4
Imports of goods and services	4.5	3.6	7.7	7.1	-1.5	1.1	0.3
Real gross disposable income of households	-0.8	0.2	2.7	3.7	-0.1	0.0	0.2
Output gap (% of potential output)	-1.0	-1.8	-2.0	-0.9	0.4	0.5	0.6
Labour market							
Employment (ESA 95)	1.8	0.4	0.6	1.0	0.2	-0.1	0.1
Unemployment rate (Labour Force Sample Survey; percentage)	13.5	13.9	13.4	12.4	-0.2	-0.2	-0.3
Balance of payments							
Economic openness (% of GDP)	174.1	179.8	185.8	190.7	-1.1	-0.4	-0.2
Balance of trade (% of GDP)	3.5	3.8	3.1	3.9	0.9	0.1	0.2
Balance of services (% of GDP)	-0.5	-0.1	-0.1	0.0	0.3	0.2	0.2
Current account (% of GDP)	0.1	1.6	1.0	1.9	1.2	0.3	0.4
Current and capital account (% of GDP)	1.3	3.4	2.8	3.5	1.2	0.3	0.3
External assumptions for the forecast							
External environment							
Real world GDP growth	3.7	3.2	3.8	4.2	-0.1	0.0	0.0
Growth in Slovakia's export markets	6.2	2.1	5.8	6.6	-0.8	0.3	0.1
Technical assumptions							
Exchange rate (USD/EUR) [2]	1.39	1.30	1.30	1.30	-0.8	-1.5	-1.5
Price for a barrel of Brent crude oil (USD) [2]	111.0	114.6	107.9	102.0	-0.4	-2.1	-2.1
Price for a barrel of Brent crude oil (EUR) [2]	79.7	87.9	83.0	78.5	0.2	-0.8	-0.9
Rise in oil prices (in USD)	39.4	3.3	-5.9	-5.4	-0.5	-1.6	0.0
Rise in oil prices (in EUR)	32.7	10.3	-5.6	-5.4	0.3	-1.1	0.0
Non-energy commodity prices	17.9	-8.0	1.6	5.1	-4.9	-2.2	-0.4
3M EURIBOR (%)	1.4	0.8	0.7	0.9	-0.1	-0.2	-0.3

Source: NBS, ECB, SO SR.
1) ULC – unit labour costs.
2) Changes against the previous forecast in %.