NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

MEDIUM-TERM FORECAST

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1 Summary

In producing its latest Medium-Term Forecast (MTF-2013Q2), Národná banka Slovenska took into account the flash GDP and employment estimate for the first quarter of 2013[1] and the most recently published monthly statistics and forward-looking indicators. The forecast is predicated on the situation in the euro area improving gradually from the second half of 2013 and on technical assumptions taken from the ECB.[2]

The flash estimate for economic growth in the first quarter of 2013 was in line with projections. Monthly data indicate that the first-quarter growth was driven solely by external trade and that the domestic part of the economy probably contracted again, with the most pronounced decline expected to have been in investment activity.

The euro area economy remained in its longest-ever recession, according to Eurostat's flash estimate. The persisting headwinds from the euro area as well as from significant trading partners are affecting Slovakia through declining foreign demand for Slovak products and services. Foreign demand is assumed to have bottomed out in the first quarter of 2013 and to be gradually beginning to rise, with its recovery expected to pick up pace towards the end of 2013.

The whole of GDP growth in 2013 is expected to be accounted for by exports, but since the economic situation of Slovakia's main trading partners is deteriorating, GDP growth in 2013 will be lower than in 2012. Other factors weighing on the Slovak economy in 2013, in addition to weaker external demand, should be the persisting climate of uncertainty and fiscal consolidation measures. In 2014, external demand boosted by a projected recovery of Slovakia's trading partners is assumed to be the main driver of economic growth. **Over the medium-term horizon, the revival of external demand is expected to put upward pressure on domestic demand, too, with the labour market situation assumed to improve as a result.**

In contrast to the previous projection, the macroeconomic outlook is moderately worse in this forecast due to the expected further contraction of domestic demand, especially so for the years 2014 and 2015. **Economic growth is expected to slow to 0.6% in 2013[3] and then increase to 2.3% in 2014 and 3.3% in 2015**. In the absence of demand-pull factors, the inflation rate is assumed to fluctuate below 2% over the whole projection horizon. **Inflation is expected to fall to 1.7% in 2013 (compared to 1.9% in the previous forecast) and to 1.6% in 2014 (unchanged). Subsequently, as domestic demand picks up, inflation is projected to increase towards 2%.**

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

Source: SO SR, NBS calculations.

1 *Since the full composition of GDP had not been published by the cut-off date for this forecast, only the SO SR's flash estimate for GDP and employment was used.*
2 *The cut-off date for the data used in this forecast was 22 May 2013.*
3 *Economic growth for the full year is projected to be 0.64%, virtually unchanged from the previous forecast (0.7%).*

2 Current developments in the external environment and Slovakia

Global economic growth remained subdued

Global economic growth remained subdued in the first quarter of 2013, owing mainly to the contraction of activity in the euro area. The improvement in economic sentiment that several indicators pointed to at the end of 2012 and beginning of 2013 did not fully materialise in subsequent months and the pace of growth in the most advanced world economic fell short of projections. Nevertheless, growth rates either accelerated slightly or declined more slowly compared with the fourth quarter of 2012. The euro area sovereign debt crisis continues to represent a major risk to global economic growth, as do weak labour markets and the ongoing repair of balance sheets in the banking and corporate sectors. Economic activity is also weighed down by the fragile financial situation of households, which indicates that consumer demand will remain muted, and by tight credit standards. High public debt levels and the associated need for fiscal consolidation are also constraining economic recovery. On the other hand, global economic growth is expected to receive a boost from accommodative monetary policies. The main driver of global growth is assumed to be the recovery of economic activity in emerging economies. Although several regional indicators deteriorated in the first quarter of 2013, the OECD's composite leading indicator (CLI)[4] continued to improve moderately, indicating a firming-up of global growth towards the end of 2013 and at the beginning of 2014.

Lower contraction of the euro area economy in the first quarter of 2013

The euro area economy contracted for a fifth successive quarter in the first quarter of 2013, by 0.2% quarter-on-quarter. This decline was lower than that in the last quarter of 2012 (-0.6%). The largest economy in the euro area – Germany – grew modestly after contracting in the last quarter of 2012. Economic activity in the euro area continues to be affected by the sovereign debt crisis and related events in Cyprus, as well as by a further deterioration of sentiment among economic entities. According to several indicators, the euro area's slump could continue in the next quarter, too.

Economic activity remains heterogeneous across countries

Although economic activity in the OECD area accelerated slightly in the first quarter of 2013, it masked considerable heterogeneity across countries. While the euro area economy continued to contract, the UK economy emerged from recession and the Japanese and US economies saw an increase in growth. The US economy was buoyed by growth in household consumption as well as by restocking. Fixed investment growth decelerated. Economic activity came under downward pressure from the continuing decline in government spending and also from net exports, as export growth was lower than import growth. Despite the acceleration of US economic activity in the first quarter, economic sentiment indicators[5] declined in March and April, pointing to a slowdown in growth.

China's economic growth continued to cool in the first quarter, reflecting mainly a decline in investment demand. On the other hand, consumer demand remains relatively robust and export growth is also quite strong. The first-quarter developments confirm that the Chinese economy has avoided a "hard landing", although growth remains below its historical average. This situation was also confirmed by the PMI[6] manufacturing output index, which declined at the beginning of the quarter, firmed slightly in March and fell again in April, while remaining just above the contraction/expansion threshold of 50.

In the Czech Republic, Slovakia's second-largest trading partner, the economic contraction in the first quarter was surprisingly greater than projected, largely due to heavier than expected destocking. Forecasts of a decline in exports did not materialise, and certain economic activity indicators in industry are already pointing to stabilisation.

4 CLI indicators are published by the OECD on a monthly basis – the latest available data, published in May 2013, are for March 2013.

5 Economic sentiment indicators compiled by regional Federal Reserve banks for the Federal Reserve survey of business conditions.

6 The China Manufacturing PMI: an indicator of economic sentiment in Chinese industry published by the Chinese National Bureau of Statistics.

Slovak economy grew modestly, in line with expectations

The Slovak economy in the first quarter of 2013 was significantly affected by the continuing recession in the euro area as a whole, but nevertheless managed to grow by a modest 0.3% quarter-on-quarter, consistent with projections in the previous forecast. As indicated by monthly figures for industrial production and nominal external trade, the growth was entirely attributable to external demand. The moderate first-quarter growth in industrial production was driven mainly by the automotive industry, which therefore supported moderate export growth while other sectors saw their exports decline. This effect was exacerbated by the fact that the automotive industry itself had reported a drop in production in the previous quarter. The adverse tendencies observed in the domestic part of the economy last year continued in the first quarter, according to monthly data.

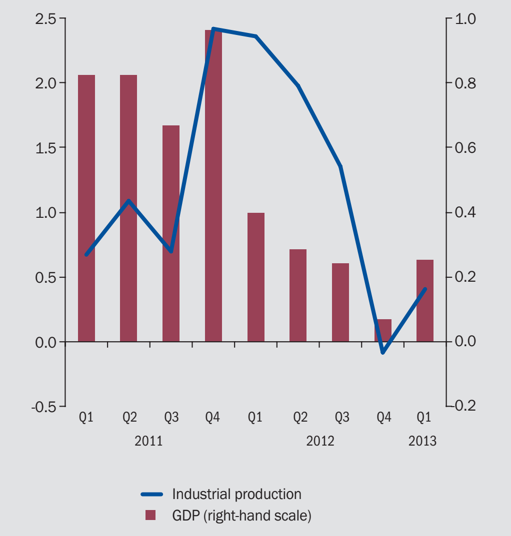
Chart 3 Investment and long-term loans (annual percentage changes)

Source: SO SR.
Note: The figure for the first quarter of 2013 is a projection.

Investment activity declined again

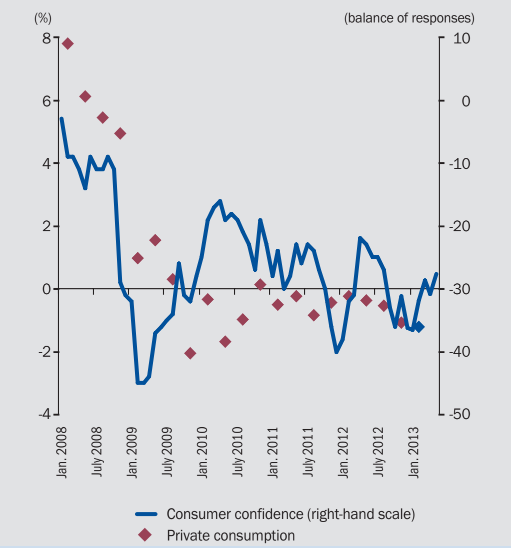
The continuing slump in investment activity reflected persisting uncertainty among firms, expressed in sentiment surveys conducted in the first months of 2013. A similarly pessimistic picture was found by the bank lending survey, according to which firms' demand for investment financing declined in the first quarter of 2013. At the same time, banks moderately tightened certain credit conditions. Squeezed by supply and, even more so, demand factors, the stock of corporate loans continued to decline and at a faster pace. The slump in investment activity was probably higher than projected, reflecting in particular investment by key economic sectors and the government.

Chart 2 GDP and industrial production (annual percentage changes)



Source: SO SR.

Chart 4 Consumer sentiment and private consumption (balance of responses; annual percentage changes in real terms)

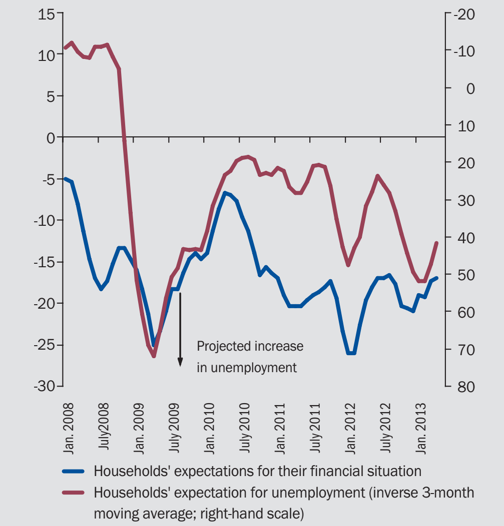


Source: SO SR.
Note: The figure for the first quarter of 2013 is a projection.

Chart 5 Retail trade sales and private consumption (annual percentage changes in real terms; 3-month moving average)

Source: SO SR.
Note: The figure for the first quarter of 2013 is a projection.

Chart 6 Household expectations (balance of responses)



Source: SO SR and the European Commission.

Private consumption continued to decline

Monthly figures indicate that the decline in private consumption probably continued in the first quarter of 2013. Retail trade sales stabilised, while consumer confidence, although slightly stronger that it was at the end of 2012, remained subdued. Amid modest wage growth and a decline in employment, household real income declined and therefore private consumption growth was muted. Households' expectations for employment and their financial situation in coming months improved moderately, possibly indicating a recovery of private consumption growth in the near-term horizon.

The government continues to implement its fiscal consolidation objectives, particularly in intermediate consumption

Even though general government final consumption declined year-on-year in the first quarter, possibly indicating that the government is meet-

Table 1 Potential risks to the general government budget for 2013 (EUR millions)

1	**Budget revenue**	**-267**
2	Shortfall in tax and contribution revenues[1)]	-572
3	One-off revenue from opening of Pillar II of the pension system	236
4	Increase in dividend revenue for the state budget	69
5	**Budget expenditure**	**212**
6	Lower expenditure on unemployment benefits and pensions	17
7	Lower expenditure on debt management	21
8	Underestimation of expenditure on public health insurance[2)]	-100
9	Overestimation of local government savings[2)]	-125
10	Potential savings on expenditure related to the EU budget	350
11	Public health insurance expenditure (additional measures)	39
12	Other savings on expenditure (additional measures)	10
13	**GDP denominator effect**	**-42**
14	**Potential risks to the general government budget**	**-96**

Source: NBS and the Fiscal Reponsibility Board (FRB).
Note: + denotes an improving deficit, - denotes a deteriorating deficit.
1) €543 million according to the Institute of Financial Policy calculator vs. budgeted €575 million (l. 2+l. 6+l. 7+l. 13).
2) Source: CBR.

ing its fiscal consolidation objectives, government consumption made a moderately positive contribution to GDP growth. Implementation of the state budget (cash-basis) indicates that compensation is falling below budget assumptions, while consolidation measures in spending on goods and services exceeded budget assumptions in the first quarter.

In the latest update of the macroeconomic scenario, the projected shortfall in tax and contribution revenues for 2013 has been revised up by €30 million from the MTF-2013Q1 forecast. On the other hand, potentially recurring savings from non-utilisation of EU funds could substantially reduce the need for additional measures this year. Taking these assumptions into account, the potential risk to the budget objectives would amount to 0.1% of GDP (€96 million).

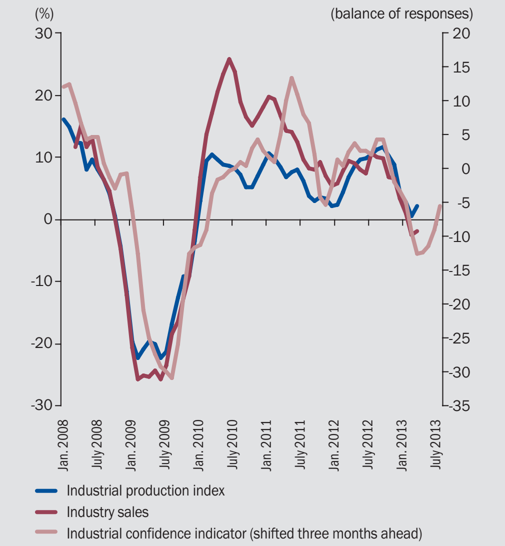
Expectations improving moderately

Economic sentiment improved moderately in April owing mainly to higher confidence in the industry and services sectors. In industry, somewhat surprisingly, expectations increased for production and exports over coming months. For a third successive quarter, however, industrial firms are negatively assessing current order books. Other sectors in which current order books are negatively assessed include services and, to a greater extent, construction. The utilisation of production capacities in the first quarter of 2013 was relatively high (marginally above the long-run average), according to firms' assessments. This could signal investment growth, assuming that uncertainty eases.

The labour market situation worsened again

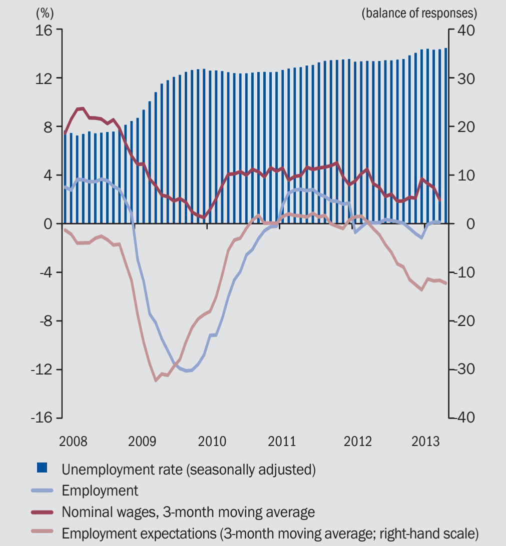
The effects of the economic slowdown at the end of last year continued to be felt in the labour market in the first quarter of 2013, togethter with the effects of legislative amendments that entered into force from January. In line with the previous forecast, employment fell in the first quarter by 0.3% quarter-on-quarter, according to the SO SR's flash estimate. In response to legislative amendments in force from January 2013, which, for example, increased the contributions payable by people who are self-employed or employed on limited work contracts, many people employed on limited work contracts were re-employed as regular workers (thereby distorting the monthly figures for employees). Employment still declined slightly in the first quarter (according to the flash estimate), in part because of the re-calculation on a full-time equivalent basis in accordance with ESA 95 methodology. Nevertheless, firms' expectations pointed to stabilisation in employment. The unemployment rate remained high, accord-

Chart 7 Forward-looking indicators (3-month moving average; annual percentage changes; balance of responses)



Source: SO SR and the European Commission.

Chart 8 Current labour market indicators (annual percentage changes; balance of responses)



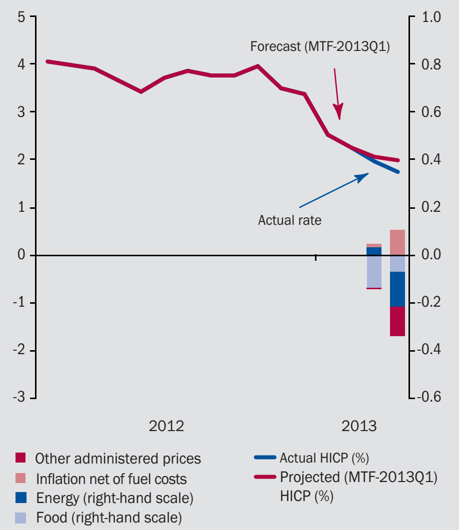
Source: SO SR and the European Commission.

ing to monthly figures, but it was positively affected (with downward pressure on the quarterly rate) by a higher outflow of workers to foreign countries and by increasing utilisation of welfare-to-work schemes. Nominal wage growth decelerated in the first quarter of 2013 by around 2% year-on-year (according to monthly figures), amid the continuing slowdown in economic activity.

Disinflationary trend continues

The actual inflation rate in the last two months (March and April) was slightly lower than projected. In April the headline rate fell to 1.7%, reflecting lower energy prices (especially electricity prices) and lower administered price inflation (in pharmaceutical products). Inflation net of fuel costs has been at around 1% for a long period, reflecting the absence of demand-pull pressures. The increase in goods and services prices is entirely attributable to cost-push factors.

Chart 9 Inflation (annual percentage changes and difference from forecast; contributions in p.p.)



Source: SO SR and NBS forecast.

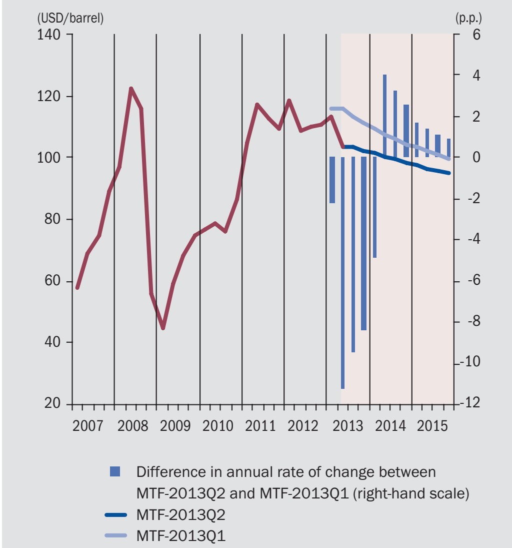
3 Technical assumptions[7]

In the period after the previous forecast was published, the **exchange rate** of the euro against the US dollar remained at around 1.3 USD per EUR with no significant fluctuations. This development largely reflected sentiment in financial markets as well as the latest economic results in the euro area and the United States. The current forecast assumes that the exchange rate will be 1.31 USD/EUR[8] over the projection horizon.

The **oil price** increased at the beginning of the first quarter of 2013, but then declined in both March and April. Early in the year oil prices were boosted mainly by improving expectations for the global economy as well as by concerns about geopolitical tensions. Later in the quarter, however, projections for oil demand declined and estimates for oil production in North America and the North Sea increased. These factors caused a gradual decline in oil prices despite ongoing geopolitical tensions. This forecast assumes that the average barrel price will be USD 105.5 in 2013, falling to USD 100.0 in 2014 and USD 96.2 in 2015, and that the price in euro will be €80.5 in 2013, €76.4 in 2014 and €73.5 in 2015.

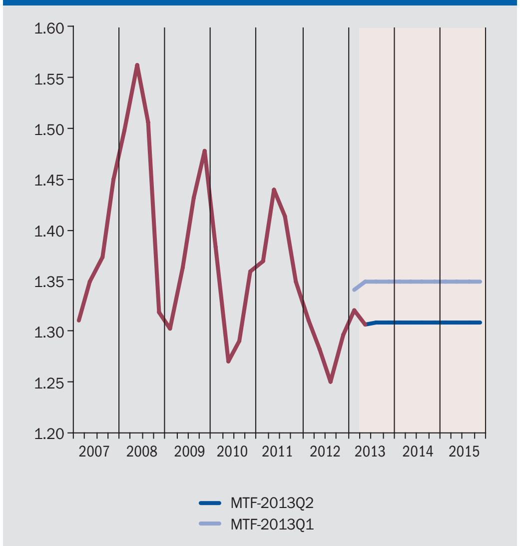
Prices of **non-energy commodities** behaved similarly to oil prices in the first quarter of 2013, rising moderately at the beginning of the year and then declining in March and April. Metals prices contributed significantly to the early

Chart 11 Price per barrel of Brent crude oil (USD)



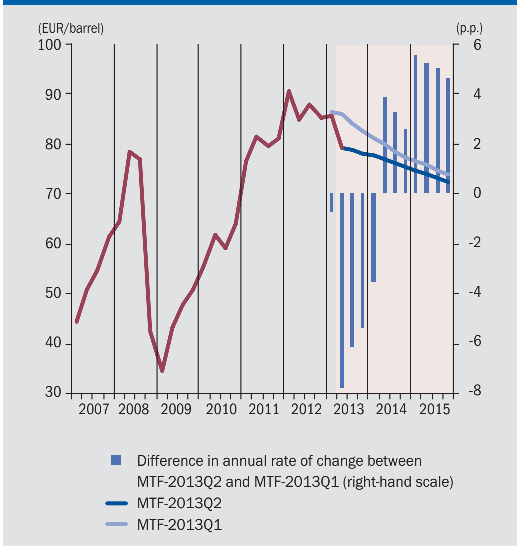
Source: NBS and ECB.

Chart 10 USD/EUR exchange rate



Source: NBS and ECB.

Chart 12 Price per barrel of Brent crude oil (EUR)



Source: NBS and ECB.

7 The technical assumptions of the Medium-Term Forecast are based on the „Eurosystem Staff Macroeconomic Projections for the Euro Area" of June 2013, with a cut-off date of 14 May 2013.

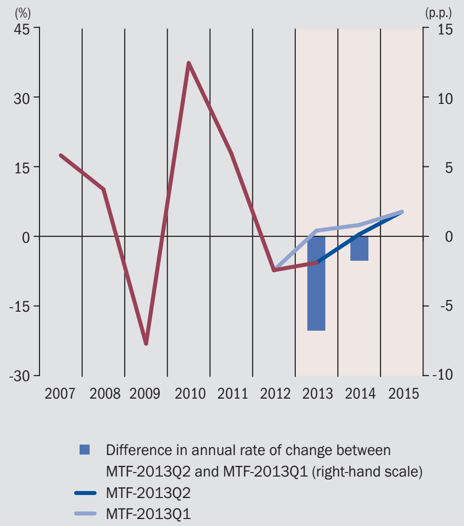
8 The bilateral USD/EUR exchange rate is assumed to remain unchanged over the projection horizon at the average level prevailing in the ten-working day period ending on the cut-off date.

growth, rising on elevated demand that lasted until mid-quarter. Agricultural commodity prices fell gradually during the first quarter and then increased moderately in April. This forecast assumes that non-energy commodity prices will decline by 5.6% in 2013, and then increase by 0.5% in 2014 and by 5.2% in 2015.

For the purpose of this forecast, the average level of **short-term interest rates**[9] (three-month EURIBOR) is expected to be 0.2% in 2013, 0.3% in 2014, and 0.5% in 2015.

This forecast takes into account additional fiscal tightening equivalent to 0.2% of GDP in 2014 and 0.5% of GDP in 2015.

Chart 13 Non-energy commodity prices (annual percentage changes)



Source: NBS and ECB.

9 *The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 14 May 2013. The assumption for short-term interest rates is of a purely technical nature.*

4 Forecast for the external environment

The **world economy** grew by 3.0% in 2012 and is expected to grow by the same rate in 2013, then accelerating to 3.8% in 2014 and 4.0% in 2015. Risks to the forecast for the global economy include weaker than expected foreign demand and slow implementation of structural reforms in euro area countries. Another risk is the process of fiscal consolidation in the United States, which could act as a significant drag on economic activity. At the same time, geopolitical tensions in certain regions of the world could pose a risk to global growth, e. g. through commodity markets.

Euro area GDP fell by 0.2% in the first quarter of 2013, declining for the sixth consecutive quarter. The decline in economic activity was mainly due to a large fall in investment, reflecting low confidence and the adverse impact of cold winter weather, mainly on construction activity, particularly in Germany. Private consumption rose slightly, while public consumption declined. Exports fell in the first quarter, albeit less than imports, resulting in a positive net trade contribution.

Looking ahead, real GDP is expected to increase in the course of 2013 and to gain momentum in 2014. The recovery is expected to be supported by the favourable impact on exports of gradually rising external demand. Domestic demand should also pick up over time, initially bolstered by the unwinding of the effects of adverse winter weather on activity. Domestic demand should also initially benefit notably from a fall in commodity price inflation supporting real incomes and from the accommodative monetary policy stance. In 2014 it should also be supported by the progress made in fiscal consolidation. However, economic activity will continue to face headwinds from still low levels of consumer and business sentiment, weak labour market developments and remaining private sector deleveraging needs in some countries, as well as from difficult funding conditions in certain euro area countries. The recovery is therefore expected to remain subdued. GDP is expected to decline by 0.6% in 2013, largely reflecting a negative carry-over effect stemming from the declines in GDP in late 2012 and in early 2013. In 2014 economic activity is projected to increase by 1.1%.[10]

The economic crisis is expected to have adversely affected potential growth, although the exact magnitude of the impact remains highly uncertain. Notably, the continued weakness in employment and investment is weighing on the outlook for potential output growth. The output gap is projected to remain negative, although it is difficult to estimate its size with precision.

Overall **HICP inflation in the euro area** is projected to decline from an average rate of 2.5% in 2012 to 1.4% in 2013 and 1.3% in 2014.[11] HICP inflation is expected to decrease markedly in the course of 2013 owing to the projected strong decline in energy price inflation and, to a lesser extent, food price inflation. The drop in energy price inflation partly reflects downward base effects owing to the expected fading away of the impact of past increases in oil prices and the assumed gradual decline in oil prices over the projection horizon. Similarly, the pattern of food price inflation reflects initial downward base effects, as the impact of past increases is expected to fade away, followed by upward pressures related to the assumed increase in food commodity prices. HICP inflation excluding food and energy is projected to ease in 2013, reflecting weak developments in economic activity. In 2014 it is expected to edge up slightly, amid the assumed recovery in activity. External price pressures have eased in recent months owing partly to the appreciation of the euro in 2013.

Turning to domestic price pressures, the annual growth rate of compensation per employee is expected to be broadly stable over the projection horizon. Taking into account projected inflation, real compensation per employee is expected to rise moderately over the projection horizon. Unit labour cost growth is projected to remain relatively high in 2013, before declining in 2014 owing to a cyclical rise in productivity growth. Profit margins are expected to fall slightly in 2013, reflecting the weakness of domestic activity and the relatively strong increase in unit labour costs. Thereafter, lower

10 These figures are at the middle of the Eurosystem's projection ranges for GDP growth, which are -1.0% – 0.2% in 2013 and 0.0% – 2.2% in 2014.

11 These figures are at the middle of the Eurosystem's projection ranges for HICP inflation, which are 1.3% – 1.5% in 2013 and 0.7% – 1.9 % in 2014.

unit labour cost growth and gradually improving economic conditions are expected to support a recovery in profit margins. Increases in administered prices and indirect taxes that are included in fiscal consolidation plans are expected to make significant contributions to HICP inflation in 2013 and 2014, albeit less than in 2012.

The **annual growth rate of global trade**, after slowing to 2.9 % in 2012, is expected to increase slightly to 3.1% in 2013 and then accelerate to 5.9% in 2014 and 6.8% in 2015. The average growth in **Slovakia's export markets** contracted to 1.0% in 2012 (from 6.2% in 2011), and it is projected to increase modestly in 2013 (to 1.3%), and then to accelerate in 2014 (4.7%) and 2015 (5.7%).

5 Macroeconomic forecast for Slovakia

5.1 Economic growth

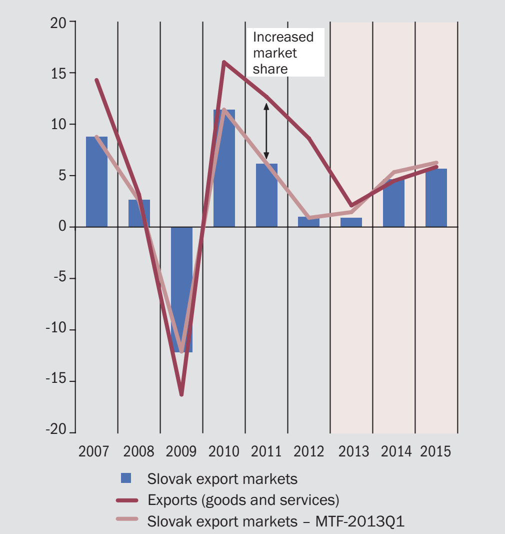
Growth in export markets to decelerate in 2013 and then accelerate over the medium-term horizon

The euro area's ongoing recession caused external demand for Slovak goods and services to decline further in the first quarter of 2013. This effect was evident in monthly figures for nominal exports, particularly in March. However, external demand is expected to increase slightly in the second quarter and then to accelerate over the medium-term horizon. Export performance is expected to improve in 2013, as the combination of a sound export structure and strong competitiveness (notably in the automotive industry) should support the acquisition of market share. In subsequent years exports are projected to grow in tandem with increasing external demand. Compared with the previous forecast (MTF-2013Q1), external demand for Slovak products is expected to be lower.

Investment demand to decline further in 2013 and then pick up slightly over the projection horizon

After falling sharply in 2012, investment demand is expected to have fallen again in the first quarter of 2013 owing to persisting uncertainty among both investors and consumers; it may also reflect the possible postponement of an investment project in the automotive industry (which has not yet been reported this year). Bank credit standards for firms were tightened slightly and further tightening of these standards is expected. Negative trends were also observable on

Chart 14 Forecasts for external demand and for Slovak exports of goods and services (annual percentage changes; constant prices)



Source: NBS.

Chart 15 Investment forecast (annual percentage changes; constant prices)

Source: SO SR and NBS.

Table 2 Forecast for gross fixed capital formation (annual percentage changes)

	2013	2014	2015
Gross fixed capital formation			
– Total gross fixed capital formation (GFCF)	-2.0	0.3	2.9
– GFCF adjusted to exclude one-off investment in the automotive industry	-1.7	3.0	3.2

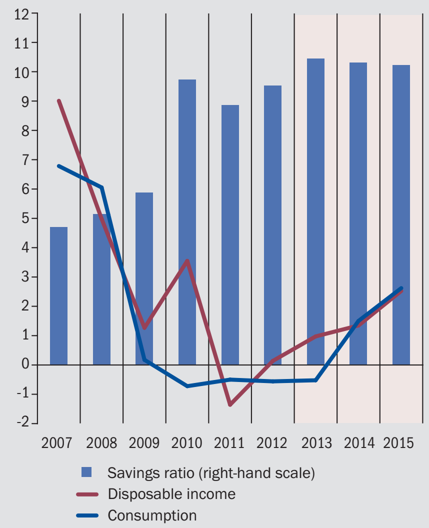
Source: SO SR and NBS.

the demand side and these are expected to carry over into the next quarter. Although corporate lending rates are at all-time low levels, concerns about future developments are stifling a recovery in investment. Thus the accommodative monetary policy stance has not yet been enough to stimulate investment growth. Construction activity, a key indicator of investment and a forward-looking indicator for future economic growth is not showing any signs of rebounding. Not only is private investment at a standstill, so is government investment owing to the fiscal consolidation effort. The decline in investment has been revised up from the previous forecast (MTF-2013Q1).

Private investment to continue falling in 2013 and to pick up moderately in subsequent years

The moderate decline projected for household final consumption in 2013 is largely a statistical result stemming from weak consumption in late 2012. As households' expectations rise slightly and consumer sentiment improves, private consumption growth is expected to increase marginally in the second half of 2013 and then accelerate over the medium-term horizon. This recovery in domestic demand is based on an assumed improvement in the labour market and on an increase in real wage growth, reflecting mainly

Chart 16 Household income and consumption (annual percentage changes) and the household savings ratio (%)



Source: SO SR and NBS.

a decline in inflation. Nominal income growth is expected to decline slightly in 2013 owing to a substantial slowdown in public sector wage growth and to low wage growth in the private sector (stemming from falling profits and uncertainty about future developments). It is assumed that firms will have regard to labour productivity growth in collective bargaining and wage growth will increase very moderately as a result. With economic growth and labour productivity expected to pick up, wage growth should accelerate over the medium-term horizon. Doctors' salaries are also expected to be raised in 2014 and 2015. Public sector wages are not expected to be raised until 2015, ahead of the scheduled parliamentary elections. As private consumption accelerates, the savings ratio is expected to fall gradually.

General government spending to decline in 2013

The forecast for 2013 assumes that Slovakia will correct its excessive deficit by reducing the general government deficit to below 3% of GDP. It should be helped in this regard by consolidation measures adopted in 2012 and incorporated in the Medium-Term Forecast. The forecast also factors in a wage freeze for public sector workers other than teachers and a decline in intermediate consumption. Projected general government consumption in 2014 and 2015 reflects assumed savings in employee compensation and in intermediate consumption, supported by cuts in health care spending.

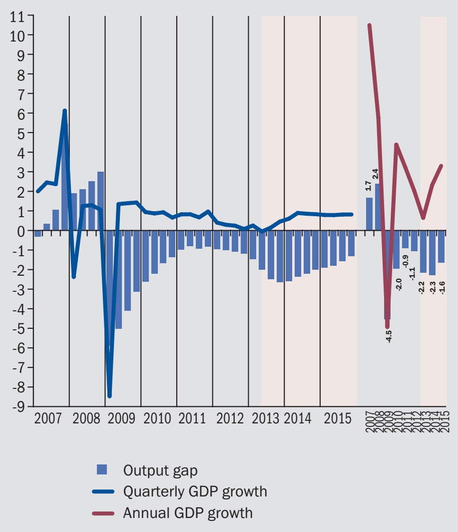
Imports expected to grow as economy recovers

According to monthly data, imports continued to fall in the first quarter of 2013, probably reflecting declines in both consumption and investment demand. Import growth in the following period is expected to increase moderately, boosted by technology imports for an investment project in the automotive industry, a partial turnaround in import intensity (back up towards its historic average), a modest recovery in domestic demand, and restocking. The effect of these factors over the medium-term horizon is expected to increase, as both external and domestic demand accelerate. For 2014 this forecast, like the previous one, explicitly assumes a moderate decline in import intensity in the automotive industry as a new investment project enters the production phase. Over the projection horizon foreign prices are expected to further support the trade balance surplus (in nominal terms), which is assumed to be the main determinant of the balance of payments current account surplus.

Growth to slow markedly in 2013 and thereafter to pick up only gradually

After falling again in the first quarter of 2013, domestic demand is expected to recover only very gradually and not sufficiently so as to make a positive contribution to annual GDP growth. External demand is therefore expected to continue being the main driver of Slovak economic growth in 2013; however, since export growth is projected to increase only moderately, most of the improvement in external trade should be accounted for by lower import growth. As the external demand projection for 2013 was revised down in previous forecast, it remains virtually unchanged in this forecast. **Based on the latest data for the real economy, forward-looking indicators, and assumptions for external demand, economic growth in Slovakia is expected to slow to 0.6% in 2013**. The domestic part of the economy is not projected to recover significantly until 2014 and 2015, when domestic demand should make a gradually increasing contribution to substantially accelerating economic growth. An underlying assumption of this forecast is that the situation in the euro area will gradually improve and that the sovereign debt crisis will be resolved. **Looking ahead, economic growth is expected to increase from 2.3% in 2014 to 3.3% in 2015**. The estimated cyclical position of the economy suggests that the output gap will widen significantly in 2013 amid pronounced slowdowns in both external and domestic demand (stemming partly from the effect of fiscal consolidation measures). Assuming a decline in investment in 2013 and a sluggish revival of domestic demand, the output gap is not expected to begin narrowing until 2015 and therefore the economy should still be growing below potential in that year.

Chart 17 GDP growth and the output gap (%)



Source: SO SR and NBS.

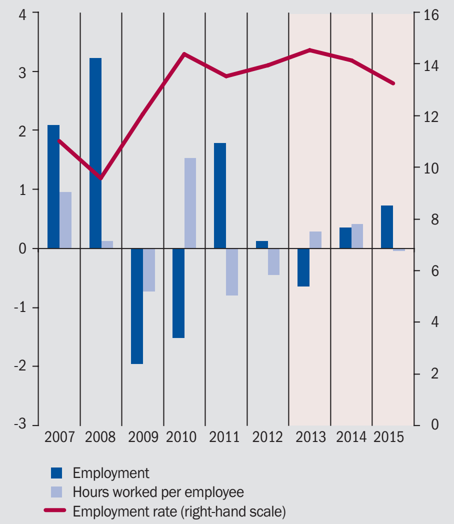
5.2 THE LABOUR MARKET

LABOUR MARKET SITUATION TO REMAIN ADVERSE IN 2013, RECOVERING SLOWLY OVER THE MEDIUM-TERM HORIZON

Employment continued to decline in the first quarter of 2013. Based on the monthly figures, we assume that employment fell moderately owing to a decline in the number of people employed on a limited work contract (notwithstanding that some of these people were re-employed as regular employees) as well as to the effects of decelerating economic activity. Looking ahead, employment is expected to continue falling moderately, since although firms' expectations for employment have stabilised, they remain in negative territory. No revival in job creation is expected until 2014 and 2015, when domestic and external demand are projected to recover significantly.

Unemployment was affected not only by the usual creation of jobs (according to ESA 95 methodology), but also by additional positive effects, including an expansion of welfare-to-work schemes and an increased outflow of workers abroad. These factors explain the (positive) difference in trends between unemployment and employment. The unemployment rate is expected to increase in 2013 and then gradually decline until 2015. Apart from supporting welfare-to-work schemes (consisting of temporary paid work organised at the regional level), the government has announced the creation of temporary jobs for young people. The effect of this subsidised stimulus has not yet been incorporated into the medium-term forecast and therefore represents a downside risk to the unemployment forecast. In response to increasing labour productivity in 2013, firms are expected to increase the number of hours worked while at the same time laying off staff; hence employment is not projected to increase until the economic recovery gains significant momentum.

Chart 18 Employment, hours worked (annual percentage changes) and the unemployment rate (%)



Source: SO SR and NBS.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

LABOUR COSTS TO RISE SLOWLY

Labour cost growth is expected to rise moderately in 2013 owing mainly to an increase in compensation per employee. This increase stems from legislative changes in force since January 2013, which increased the tax and contribution burden, and hence firms' labour costs to the extent that they could not be covered by labour productivity growth. Given, however, the previous cumulative labour productivity increases that exceeded labour cost growth, the higher labour costs are not yet expected to impair the competitiveness of firms, in other words they do not yet have to be passed on to prices. Unit labour cost growth over the projection horizon is expected to be around 1%.

Table 3 Compensation per employee (annual percentage changes)

	Economy as a whole	Economy as a whole, real terms	Public sector	Public sector, real terms	Private sector	Private sector, real terms
2012	2.0	-1.6	1.6	-2.0	2.1	-1.5
2013	2.8	1.0	1.0	-0.8	3.3	1.4
2014	3.1	1.2	0.8	-1.1	3.7	1.8
2015	4.0	2.0	3.1	1.1	4.2	2.2

Source: SO SR, Eurostat, NBS calculations.
Note: Deflated by the private consumption deflator.

Table 4 Wages (annual percentage changes)

	Economy as a whole	Economy as a whole, real terms	Public sector	Public sector, real terms	Private sector	Private sector, real terms
2012	2.5	-1.1	3.7	0.1	2.2	-1.4
2013	1.5	-0.2	-0.2	-1.9	2.0	0.3
2014	3.1	1.5	1.1	-0.5	3.7	2.1
2015	4.0	2.0	3.4	1.3	4.3	2.2

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

With lower inflation this year, the decline in real wages may be moderated, with the most marked drop expected to be in the public sector.

Inflation to be further below 2% in 2013 and 2014, then to rise towards 2%

Looking at price developments in the first four months of 2013, the inflation rate is expected to continue declining at a greater pace until the end of the year, falling as low as 1.4% in the last quarter. This trend is assumed to be driven by falling energy prices, stabilising prices of agricultural commodities, and subdued consumer demand. The real economy is expected to further constrain an inflation rate that still remains subdued; pipeline pressures from manufacturing producer prices and import prices are dampening non-energy industrial goods inflation, with this trend assumed to continue in coming quarters. In the absence of consumer demand, services price inflation is expected to be accounted for entirely by cost-push factors. The inflation rate in 2014 is projected to be relatively low, reflecting the effect of declining energy prices. These assumptions are based on commodities futures prices. Other inflation components are expected to maintain a stable, low rising trend. As the economic recovery gathers momentum, the inflation rate is projected to increase towards 2%.

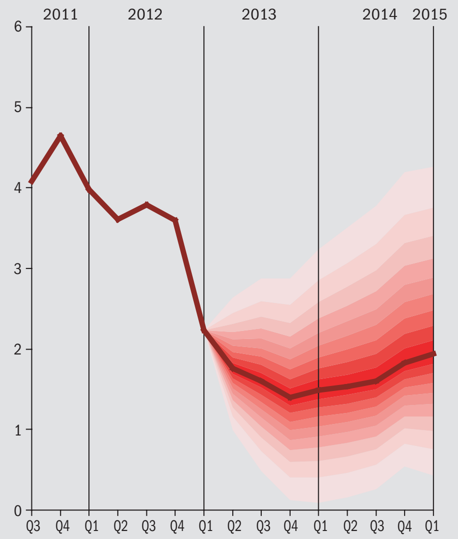
6 Risks to the forecast

In this medium-term forecast, the risks to the real economy forecast are predominantly on the downside over the projection horizon. External demand remains the principal risk, as it could be affected by deteriorating sentiment in financial markets and by the situation in the euro area banking sector. A downward risk to the outlook for the domestic part of the economy is that household consumption behaviour remains cautious and the savings ratio stays high.

The risks to the labour market forecast appear to be balanced, according to the latest data. Negative trends have stabilised and the unemployment rate could be lower than projected as suggested by data on the outflow of workers abroad.

The risks to the inflation forecast over the medium-term horizon projection are on the upside. The risks to the 2013 inflation forecast are balanced, while the risks to the 2014 and 2015 forecasts are on the upside due to the scope for actual developments to differ from technical assumptions, notably if oil prices and external inflation are higher than projected. Moderate downward risks include lower than projected foreign demand and/or compensation per employee, while an upward risk is the VAT rate being cut back to 19%.

Chart 19 HICP inflation forecast (%)



Source: SO SR and NBS.

Table 5 Risks to the forecast

	2013	2014	2015
GDP	↓ Sovereign debt crisis, fiscal consolidation measures, high savings ratio	↓ Fiscal consolidation measures, sovereign debt crisis, external demand, high savings ratio	↓ External demand
Inflation	↓ Domestic demand, labour market ↑ Technical assumptions	↑ Technical assumptions ↓Domestic and external demand	↑ Technical assumptions ↓ VAT reduction, domestic and external demand

Source: NBS.

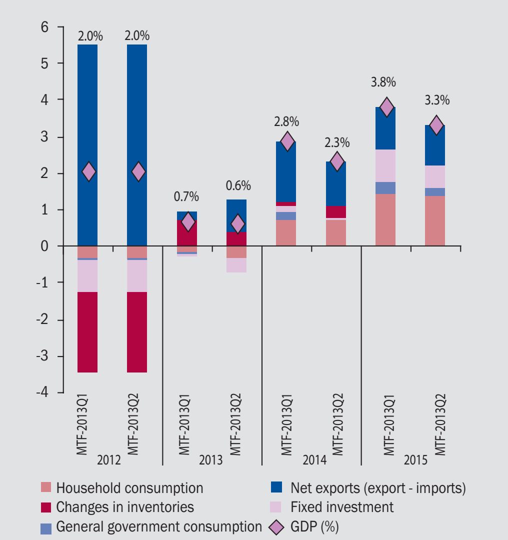
7 Comparison with the previous forecast

In this forecast, compared with the previous forecast (MTF-2013Q1), the projection for external demand growth has been revised down, while revisions to the technical assumptions include slightly lower oil prices, a weaker exchange rate of the euro, and lower short-term interest rates.

Revisions of projections for both domestic and external demand

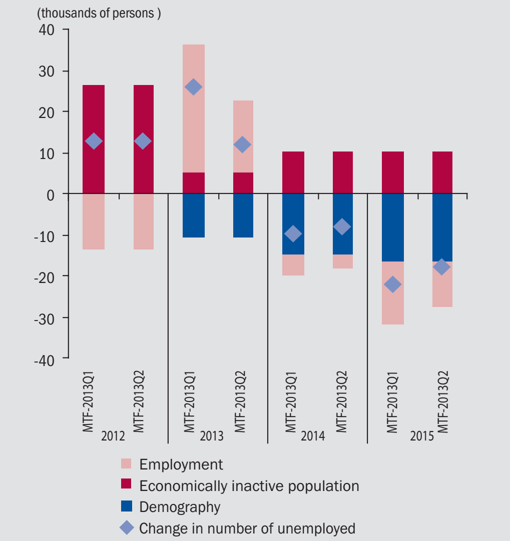
This forecast includes revised projections for both the domestic part of the economy and external demand, the result being that the economic growth forecast for 2013 is virtually unchanged from the previous forecast. Lower external demand growth than that projected in the previous forecast is reflected in downward revisions of projections for export performance and GDP growth. On the other hand, domestic demand developments were worse than projected and the consequent upward revision of the decline in imports for domestic consumption had a positive effect on the GDP growth forecast. The result of these factors is that the GDP growth projection for 2013 is largely unchanged from the previous forecast.

Chart 20 Composition of GDP growth (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

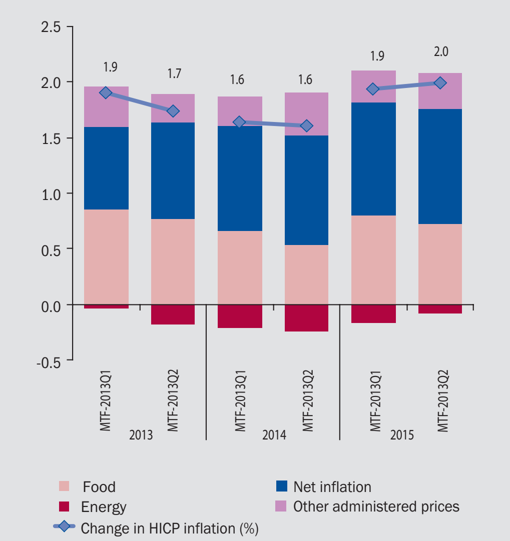
Chart 21 Comparison of labour market indicators (contributions to unemployment)



Source: SO SR (Labour Force Survey) and NBS.

Having regard to weaker than expected external demand growth and less favourable developments in the domestic part of the economy, the projections for economic growth over the medi-

Chart 22 Comparison of inflation projections broken down by component (annual percentage changes; contributions in p.p.)



Source: SO SR and NBS.

um-term horizon have been revised down from the previous forecast.

The downward revision of the growth forecast was reflected in projections for other real economy indicators as well. The forecast for labour productivity growth and the resulting nominal growth in compensation per employee have been revised down. As regards the labour market, the forecasts for employment growth towards the end of the projection horizon have been adjusted down to reflect lower economic growth. The unemployment rate projection has been lowered, mainly on assumed increases in the number of people leaving for work abroad and in the utilisation of welfare-to-work schemes. These two factors were the main cause of the revision of the unemployment projection; employment is expected to rise more moderately than stated in the previous forecast.

The inflation forecast for 2013 has been revised slightly down, since the inflation rate has recently been lower than expected and since energy price projections have been lowered. Looking ahead, no significant changes are expected and the inflation rate projection is unchanged from the previous forecast.

Table 6 Medium-Term Forecast (MTF-2013Q2) – main macroeconomic indicators (year-on-year changes)

Indicator (annual percentage changes unless otherwise indicated)	2012	2013	2014	2015	2013	2014	2015
	Actual	Forecast P2Q-2013			Difference with MTF-2013Q1		
Prices							
HICP inflation (average)	3.7	1.7	1.6	2.0	-0.2	0.0	0.1
CPI inflation (average)	3.6	1.7	1.6	2.0	-0.3	0.0	0.0
ULC[1] (Compensation per employee at current prices / labour productivity at constant prices according to ESA 95)	0.1	1.4	1.0	1.2	0.2	0.3	0.1
Labour productivity (ESA 95)	2.0	1.4	2.1	2.8	-0.1	-0.5	-0.3
Compensation per employee (ESA 95)	2.0	2.8	3.1	4.0	0.0	-0.3	-0.3
Nominal wages[2]	2.5	1.5	3.1	4.0	0.1	-0.3	-0.3
Real wages[3]	-1.1	-0.2	1.5	2.0	0.4	-0.2	-0.3
Economic activity							
Real GDP	2.0	0.6	2.3	3.3	-0.1	-0.5	-0.5
Final consumption of households	-0.6	-0.5	1.5	2.6	-0.2	0.1	-0.3
Final consumption of general government	-0.6	-0.3	0.1	1.6	0.1	-1.5	-0.3
Gross fixed capital formation	-3.7	-2.0	0.3	2.9	-1.6	-0.3	-1.1
Exports of goods and services	8.6	2.1	4.5	5.8	-0.6	-0.7	-0.5
Imports of goods and services	2.8	1.3	3.8	5.5	-1.5	-0.3	-0.5
Real gross disposable household income	0.1	1.0	1.3	2.5	0.1	0.2	-0.2
Output gap (% of potential output)	-1.1	-2.2	-2.3	-1.6	-0.3	-0.8	-1.2
Labour market							
Employment (ESA 95)	0.1	-0.8	0.2	0.5	0.0	0.0	-0.2
Employment in persons (thousands, ESA 95)	2 209.4	2 191.9	2 195.6	2 207.1	1.0	-0.5	-4.7
Unemployment rate (LFS[4]; percentage)	13.9	14.4	14.1	13.5	-0.5	-0.5	-0.3
Number of unemployed people (LFS[4]; thousands)	377.5	389.2	381.4	363.7	-14.4	-12.2	-8.0
Balance of payments							
Economic openess (% of GDP)	186.0	185.7	188.3	192.3	-1.2	-1.4	-1.2
Balance of trade (% of GDP)	5.1	5.8	6.3	6.8	0.9	0.6	0.5
Balance of services (% of GDP)	0.4	0.3	0.4	0.5	-0.1	0.0	0.0
Current account (% of GDP)	2.3	3.6	4.4	5.1	0.7	0.6	0.5
Current and capital account (% of GDP)	4.2	5.3	6.1	6.9	0.6	0.6	0.6
External assumptions for the forecast							
External environment							
Slovak foreign demand growth	1.0	0.9	4.7	5.7	-0.4	-0.3	-0.4
Technical assumptions							
Exchange rate (USD/EUR)[5]	1.28	1.31	1.31	1.31	-3.0	-3.0	-3.0
Brent crude oil (USD per barrel)[5]	112.0	105.5	100.0	96.2	-7.5	-6.4	-5.0
Brent crude oil (EUR per barrel)[5]	87.1	80.5	76.4	73.5	-5.1	-3.5	-2.3
Oil price inflation (in USD)	0.9	-5.7	-5.2	-3.8	-7.7	1.2	1.3
Oil price inflation (in EUR)	9.3	-7.6	-5.1	-3.8	-4.9	1.4	1.3
Non-energy commodity price inflation (in USD)	-7.2	-5.6	0.5	5.2	-6.8	-1.8	0.0
3M EURIBOR (%)	0.6	0.2	0.3	0.5	-0.1	-0.2	-0.4

Source: NBS, ECB, SO SR.
1) ULC – unit labour costs.
2) Average monthly wages based on SO SR statistical reporting.
3) Wages based on statistical reporting and deflated by CPI inflation.
4) Labour force survey.
5) Changes from previous forecast (%).

Table 7 Medium-Term Forecast (MTF-2013Q2) – main macroeconomic indicators (quarter-on-quarter changes)

Indicator (quarterly percentage changes unless otherwise indicated)	2012				2013				2014				2015			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	Actual				Forecast											
Prices																
HICP inflation (average)	2.0	0.7	0.3	0.6	0.7	0.2	0.1	0.4	0.7	0.2	0.2	0.6	0.9	0.3	0.2	0.7
ULC[1] (Compensation per employee at current prices / labour productivity at constant prices according to ESA 95)	0.0	1.3	0.0	0.2	0.1	0.3	0.7	0.1	0.2	0.1	0.2	0.2	0.3	0.4	0.4	0.5
Labour productivity (ESA 95)	0.3	0.4	0.4	0.4	0.5	0.1	0.2	0.4	0.5	0.8	0.8	0.8	0.6	0.6	0.6	0.7
Compensation per employee	0.5	1.8	0.5	0.8	0.6	0.4	0.9	0.6	0.6	0.9	1.0	1.0	0.9	1.1	1.1	1.2
Economic activity																
Real GDP	0.4	0.3	0.2	0.1	0.3	-0.1	0.1	0.5	0.6	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Final consumption of households	-0.0	-0.3	-0.4	-0.4	-0.2	0.1	0.2	0.2	0.4	0.5	0.6	0.6	0.6	0.7	0.7	0.8
Final consumption of general government	2.0	-2.4	0.9	-0.6	1.0	-0.8	-0.3	-0.0	0.1	0.1	0.3	0.5	0.3	0.4	0.7	0.6
Gross fixed capital formation	-5.1	-1.7	-0.4	0.8	-2.2	1.6	-2.2	0.7	-1.0	1.0	0.9	0.9	0.7	0.6	0.5	0.5
Exports of goods and services	4.1	2.9	0.2	1.1	0.0	0.0	0.4	1.1	1.2	1.4	1.5	1.5	1.4	1.4	1.5	1.5
Imports of goods and services	1.6	3.0	1.9	-2.1	-0.1	1.0	0.6	0.9	0.5	1.2	1.4	1.4	1.4	1.3	1.4	1.4
Real gross disposable household income	0.6	0.0	0.2	0.5	0.2	0.2	0.2	0.1	0.2	0.5	0.6	0.6	0.6	0.7	0.7	0.7
Output gap (% of potential output)	-1.0	-1.0	-1.1	-1.2	-1.5	-2.0	-2.5	-2.6	-2.6	-2.4	-2.2	-2.0	-1.9	-1.8	-1.6	-1.3
Labour market																
Employment (ESA 95)	0.1	-0.1	-0.1	-0.4	-0.3	-0.2	-0.1	0.0	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.1
Unemployment rate (LFS[2]; percentage)	13.7	13.8	14.0	14.4	14.3	14.4	14.5	14.4	14.3	14.2	14.1	14.0	13.8	13.6	13.4	13.2

Source: NBS, ECB, SO SR.
1) ULC – unit labour costs.
2) LFS – labour force survey.

Abbreviations

CBR	Council for Budgetary Responsibility
CPI	Consumer Price Index
EA	euro area
EC	European Commission
ECB	European Central Bank
EMU	Economic and Monetary Union
EONIA	Euro OverNight Index Average
ESA 95	European System of Accounts 1995
EU	European Union
EURIBOR	Euro Interbank Offered Rate
Fed	Federal Reserve System
FNM	National Property Fund
GDP	gross domestic product
GNI	Gross National Income
HICP	Harmonised Index of Consumer Prices
GNDI	Gross National Disposable Income
IFP	Institute for Financial Policy
IMF	International Monetary Fund
IPI	Industrial Producer Index
MF SR	Ministry of Finance of the SR
NBS	Národná banka Slovenska (Slovak central bank)
p. a.	per annum
p. p.	percentage points
PPI	Producer Price Index
q-q	quarter-on-quarter
SO SR	Statistical Office of the SR
ULC	Unit Labour Costs
y-y	year-on-year

Symbols used in the tables

. – Data are not yet available.

- – Data do not exist / data are not applicable.

(p) – Preliminary data