NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Medium-term forecast

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1 Summary

The latest NBS forecast is based on recently published details of the composition of GDP growth for the second quarter of 2013, short-term hard and soft indicators from July and August, and technical assumptions used in the most recent ECB forecast. The NBS forecast assumes that the euro area economy, including the economies of Slovakia's main trading partners, will continue to recover.

After a long recession, euro area GDP grew by 0.3% in the second quarter of 2013. Its fragile recovery is expected to continue in the second half of the year and then to accelerate over the medium-term horizon, albeit more moderately than projected in the previous forecast.

The earlier than expected upturn in the euro area fed through to the Slovak economy in the second quarter, as its growth of 0.3% was moderately higher than projected and exports increased substantially. Benefiting from an undervalued exchange rate, exports made the largest contribution to growth. Domestic demand also put upward pressure on growth, with increases in private consumption and investment. In response to this favourable development, **the projection for Slovakia's economic growth in 2013 has been revised up to 0.9%**. The outlook for 2014 remains unchanged, even after taking into account the negative impact of fiscal consolidation efforts, with **growth expected to accelerate to 2.1%**. **In 2015, growth is projected to increase further to 3.2%.** In 2014 and 2015, the acceleration of external demand is expected to boost domestic demand, which should begin contributing positively to economic growth and hence make it more balanced. The largest risk to the growth outlook is additional fiscal adjustment measures and possible activation of the debt brake. External risks to the forecast have moderated slightly.

The inflation rate is expected to remain low over the forecast period, **falling to 1.7% in 2013 and 1.5% in 2014** (with downward pressure from low, albeit accelerating, consumer demand, and in particular from declining energy prices), before increasing again to **1.8% in 2015**.

2 Current developments in the external environment and Slovakia

Global economic growth picked up moderately

The global economy continued its slow and uneven recovery in the second quarter of 2013. While the economic situation in advanced economies gradually strengthened, emerging economies decelerated owing to weaker domestic demand and to low external demand weighing on export activity. The main drag on the emerging world was the Chinese economy's slowdown. By contrast, OECD economic activity increased modestly in the second quarter, as the euro area economy returned to growth and both the US and UK economies expanded at an increased pace. In the United States, the activation of automatic government spending cuts in March (the "sequester") had a downward effect on activity, but it did not significantly affect private demand and there was relatively strong growth in investment and consumption. Although Japan's growth slowed, it maintained a relatively robust pace, with the economy stimulated by expansive monetary and fiscal policies.

Global growth recovery expected to be gradual

Global economic growth is expected to remain moderate over the medium-term horizon, with advanced economies affected by subdued labour markets and the consequent restraining effect on private consumption growth. Growth will also come under downward pressure from deleveraging in the private sector and from fiscal consolidation efforts. The effect of these factors is assumed to ease gradually, and the global economy is expected to be stimulated as monetary policy stances remain accommodative and financial markets rally, supporting a further improvement in private sector confidence and subsequently in domestic demand. As advanced economies gather momentum, emerging economies should pick up, too, albeit more moderately than they did in the past given the constraints of structural factors (particularly in China). For a majority of the OECD's largest economies, the composite leading indicator (CLI) showed a further moderate increase in the second quarter, but for some large emerging economies it pointed to flattening or moderating growth.

The euro area economy grew in the second quarter after six quarters in recession.

The euro area economy expanded in the second quarter after contracting in the previous six quarters. GDP increased by 0.3% following a decline of 0.2% in the first quarter. The growth was driven by a pick-up in domestic demand as well as by net exports. The euro area's largest economy, Germany, grew by 0.7% after stagnating in the first quarter, although that relatively strong performance was partly due to catch-up activity in the construction sector which followed a hard winter, and this effect cannot be expected in subsequent quarters. Among the other large euro area economies that reported real GDP growth was France. By contrast, the Italian, Dutch, and Spanish economies continued to shrink, although more moderately than in the previous quarter. Portugal's economy, one of the hardest hit by the sovereign debt crisis, grew quite strongly. In the euro area, economic sentiment in the business sector and consumer confidence are gradually improving. Several forward-looking indicators suggest that the economy will continue to expand moderately in the second half of the year. However, continuing obstacles to a more robust recovery are the uncertainty surrounding the sovereign debt crisis and the subdued situation in the labour market, which is preventing stronger growth in consumer demand.

The Czech economy grew after six quarters of contraction.

The Czech Republic, a key trading partner of Slovakia, saw its economy grow in the second quarter by 0.6% over the first quarter and thus emerge from a long slump. The growth was driven by net exports, with both exports and imports picking up substantially. Growth was negatively affected by other components, including a renewed fall in household consumption, which had risen sharply in the first quarter.

The Slovak economy continued to record moderate growth based on improving export performance

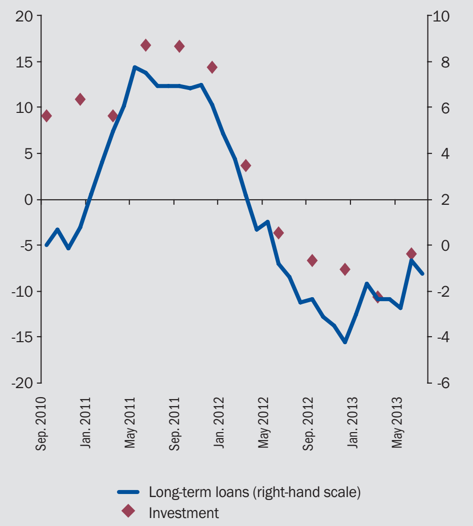
The upturn in the euro area and other EU countries (notably the Czech Republic) provided a boost to Slovak economic growth,[1] which has been increasing marginally since the last quarter of 2012. The economy expanded in the second quarter by 0.3% over the first quarter, exceeding the projections of the previous forecast. The deviation was explained mainly by the improved situation in the euro area, where recovery came earlier than expected (although remains fragile). Slovakia's growth was accounted for largely by exports, as those to both euro area and non-euro area countries picked up again and as services exports joined goods exports in growth territory. Despite relatively weak demand, Slovak exports managed to gain market share. The nominal trade surplus increased to an all-time high level. Not only did external demand grow in the second quarter, so did domestic demand following five quarters in decline; this contributed to an increase in imports, which had fallen in the previous two quarters. The upturn in domestic demand was partially offset by destocking.

Investment demand stopped declining

After declining in the first quarter of 2013, investment increased in real terms in the second quarter by 1.7% (seasonally adjusted) over the previous quarter. Firms' investment activity continued to be adversely affected by uncertainty and a moderate tightening of lending conditions, and there was still no pick-up in corporate lending. Investment demand for the first half of the year was lower than projected, partially due to the overestimation of investment in the car industry in 2013, which has so far not been implemented in the amounts planned. Investment has, however, been substantially constrained by the effect of fiscal consolidation measures.

Investment activity is expected to pick up significantly in the wake of improving sentiment and rising income in both sectors. Increases in corporate profits and salaries are essential to the recovery of investment activity in the economy. This will set an upward trajectory for asset prices (and hence for collateral, which matters particularly to non-financial corporations), which could give a boost to lending, above all to enterprises. Monetary policy continues to support the economy through the interest rate channel, with lending rates, especially those for firms, at relatively low levels.

Chart 1 Investment and long-term loans (annual percentage changes)



Source: SO SR.

Chart 2 Investment and income of households (annual percentage changes)

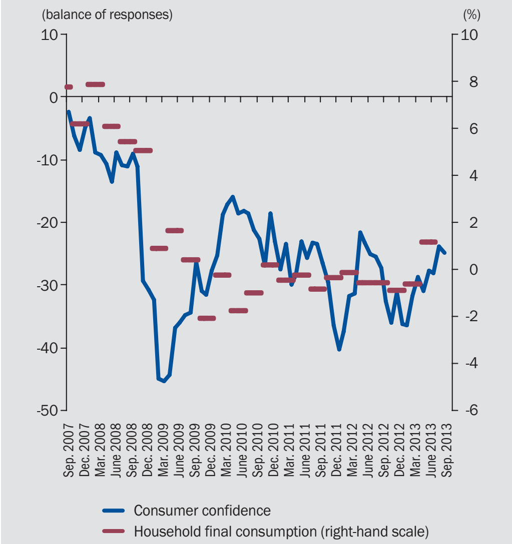
Source: SO SR.

1 *Details of the composition of GDP growth were not available for the June forecast, which therefore referred only to the flash estimate for first-quarter growth. For this reason, the latest forecast covers growth for the first two quarters of 2013.*

Chart 3 Investment and income of non-financial corporations (annual percentage changes)

Source: SO SR.

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

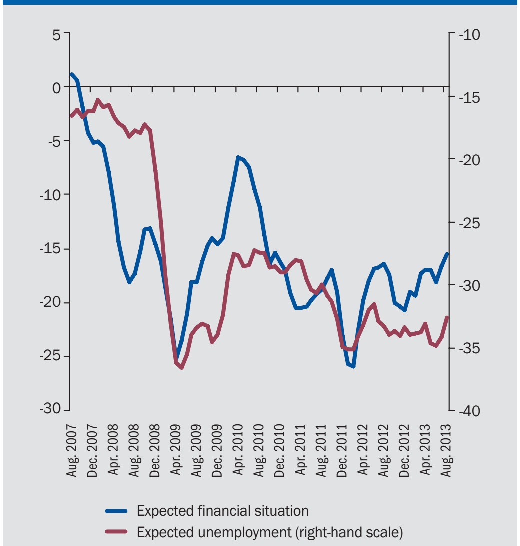


Source: SO SR and European Commission.

Private consumption rallying

After a long slump, private consumption grew in quarter-on-quarter terms in the first two quarters of 2013, even accelerating to 1.1% in the second period. This upturn was partly caused by price developments, mainly in relation to the composition of households' private consumption growth. The main contributors to this growth were food and beverages, whose price inflation was more favourable than in the previous period. Households also increased spending on services (in the sectors of restaurants and hotels, transportation and communication). Private consumption growth also reflected an increase in household disposable income and an overall improvement in sentiment, particularly evident in households' assessments of their future financial situation (on the other hand, expectations for unemployment remained relatively pessimistic). Disposable income growth was largely accounted for by increases in gross mixed income (i.e. by income of self-employed persons) and to a lesser extent in workers' remittances from abroad. Labour income of employees increased at a slightly slower pace. Households partly funded their higher consumption from savings.

Chart 5 Household expectations (balance of responses)



Source: European Commission.

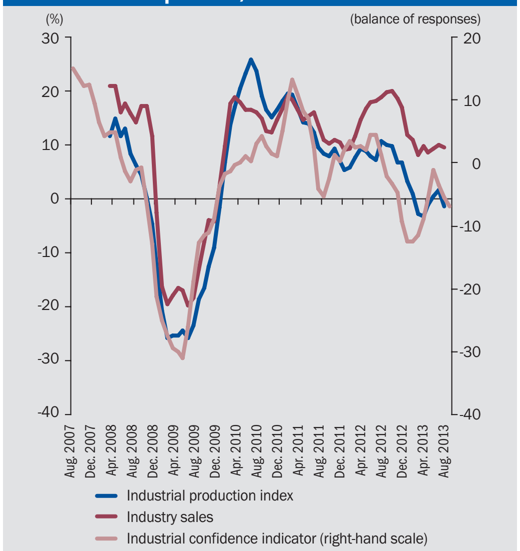
Government spending increased in the first half of the year

General government final consumption increased moderately in each of the first two quarters of 2013, making a marginal positive contribution to economic growth. Although intermediate consumption declined, there were increases in employee compensation and social benefits in kind.

Fragile recovery continues

The latest third-quarter quarter data (for July and August 2013) indicates that the fragile recovery is continuing. Industry sales growth remained at the levels of previous months (around 2.5% year-on-year). Slight declines in manufacturing production and exports did not have negative implications, since they probably resulted from a shift in the timing of car factories' summer shutdowns. Industrial confidence in Slovakia fell in August as the current level of order books was more negatively assessed. Assessments of the future situation – a more relevant indicator for the forecast – improved moderately. Private consumption indicators point to a continuation of the positive trend recorded in the second quarter.

Chart 6 Forward-looking indicators (3-month moving average; annual percentage changes; balance of responses)



Source: SO SR and European Commission.

Labour market conditions remained difficult

The labour market situation became increasingly difficult in second quarter. The economy expanded in the second quarter by 0.4 % over the first quarter, exceeding the projections of the previous forecast. Although monthly figures had suggested that employment was stabilising, the quarterly data revealed adverse developments in small firms and among self-employed persons, two groups that to some extent fall under the radar of monthly surveys. While domestic demand picked up moderately, it did not lead to higher employment in sectors dependent on that demand. In fact, the number of employees in both trade and services declined in the second quarter. The quarterly figures pointed to an improvement, as the downward trend in industry employment came to a halt. According to the July figures, employment continued to stabilise.

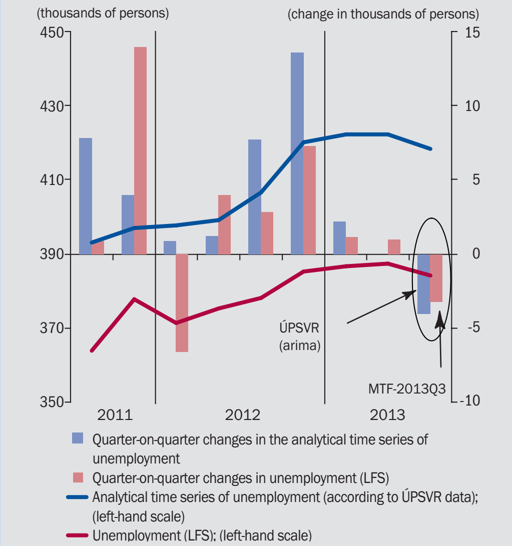
The negative employment situation was reflected in the unemployment rate, which increased, although by marginally less than projected in the previous forecast. The first-quarter increase in the jobless rate was partially mitigated by the placement of a higher number of people on labour activation schemes and by people leaving the country to work abroad, the effect of which carried over into the second quarter. The marginal increase in the second-quarter unemployment rate stemmed partly from a decline in employment (adding around 1,000 people to the unemployment rolls, according to the Labour Force Survey) and partly from a drop in the number of economically active people, which reflected an increase in the number of people who retired or went on parental leave. According to monthly figures for July and August, the upward trend in the jobless rate stopped in these months. The number of unemployed fell slightly, even after adjusting for seasonal factors and a change in methodology (including a higher number of people who came off the unemployment rolls for reasons other than finding work). Furthermore, the number of job vacancies increased and therefore a higher number of job seekers found employment.

Box 1

ANALYTICAL TIME SERIES OF THE UNEMPLOYMENT RATE BASED ON DATA FROM THE CENTRAL OFFICE OF LABOUR, SOCIAL AFFAIRS AND FAMILY (ÚPSVR)

The purpose of the analytical time series (ATS) of unemployment is to capture the change in the overall number of job seekers which has the potential to explain the change in the number of unemployed according to the Labour Force Survey (LSF) methodology, i.e. generated predominantly by the economy. The ATS of unemployment is based on ÚPSVR figures for the total number of job seekers. For the period up to June 2013 (inclusive), these two time series are identical. In July, the decline in total unemployment according to ÚPSVR was reduced by 2,000 people for the purpose of the analytical time series, and in August it was reduced by 3,000 people; these numbers constitute NBS's estimate of the impact on reported unemployment of the unusually higher number of unemployed who were deregistered as unemployed for reasons other than finding work. September's unemployment was projected using an ARIMA model. The ATS is an auxiliary indicator used to forecast the unemployment rate as measured by the LFS, based on an estimate of employment developments and their interaction with demographic changes and the economic activity of the population.

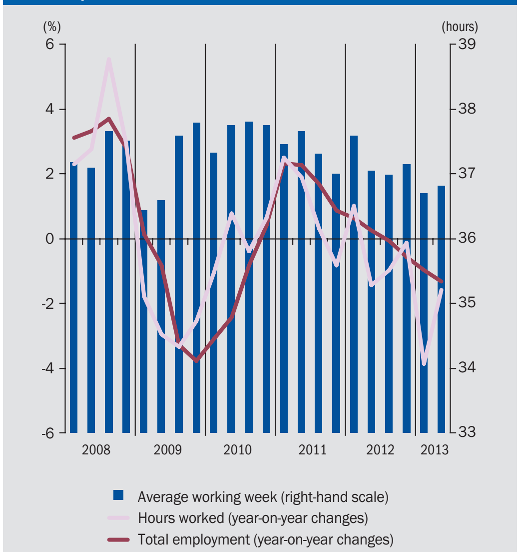
Chart A Analytical time series of unemployment (thousands of persons; seasonally adjusted)



Source: SO SR, ÚPSVR, and NBS calculations.

The average wage of employees grew at a faster pace, reflecting not only standard growth in negotiated wages, but also the fact that an increasing number of people were being paid under standard employment contracts rather than fixed- term contracts. Although wage growth was higher than projected in the previous forecast, it did not affect growth in the total compensation of employees or disposable income. This wage growth was not an increase grounded in economic fundamentals such that would cause a change in household consumption behaviour, but rather reflected shifts between different types of income (the overall impact on wage growth of an increasing movement of people from fixed-term contracts to standard employment contracts may have amounted to as much as 1 percentage point). Because the number of employees declined, the number of hours worked in the economy increased. As the economy (labour productivity) grew, unit labour costs fell, which along with an undervalued real exchange rate may have boosted exported performance.

Chart 7 Current labour market indicators (annual percentage changes; number of hours)

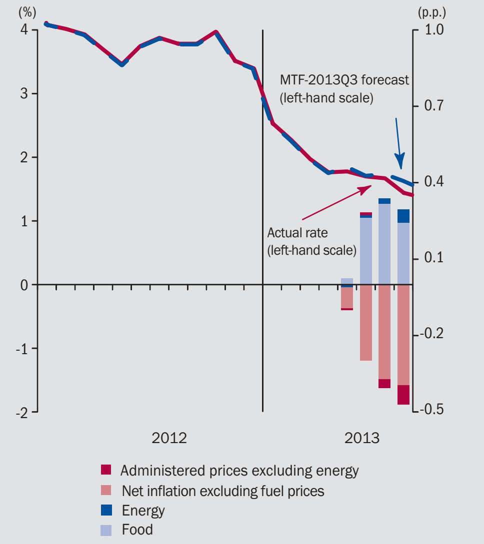


Source: SO SR.

Inflation continues to decelerate

The disinflation trend in recent months was slightly stronger than projected in the previous forecast. On the one hand, food price inflation moderately exceeded estimates, and although agricultural commodity prices stabilised, prices of certain unprocessed foodstuffs increased more than forecast. On the other hand, net inflation excluding fuel prices increased at a slower pace, although that largely reflected the cancellation of bank fees for the maintenance of mortgage loan accounts, which had an impact of -0.2 percentage point on the rate. Low inflation was largely the result of declines in import prices and producer prices. The tentative recovery in consumer demand has not as yet put any significant upward pressure on prices of goods and services.

Chart 8 Inflation (annual percentage changes; contributions in p.p.)



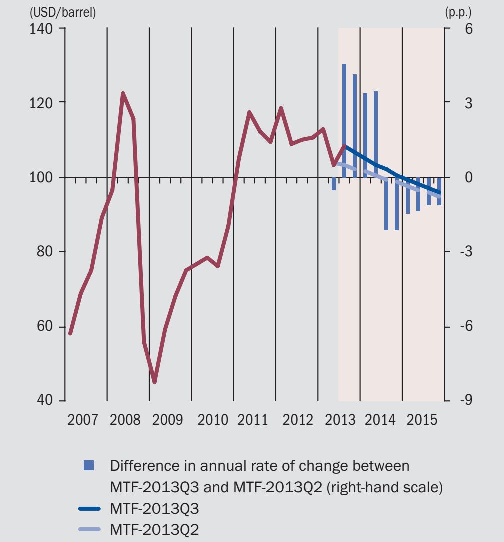
Source: SO SR and NBS forecast.

3 Technical assumptions[2]

Since the beginning of June and publication of the previous forecast, the **exchange rate** of USD per EUR has remained at around 1.31, reflecting mainly sentiment in financial markets as well as developments in economic indicators in the euro area and the United States. This forecast assumes that the average exchange rate of USD per EUR will be 1.32 in 2013 and 1.33 in 2014 and 2015.[3]

The oil price in the second quarter of 2013 was relatively stable, fluctuating between USD 98 and 110 per barrel, and the average barrel price was almost 9% lower than in the previous quarter. At the beginning of the second quarter, oil prices fell owing mainly to a decline in oil demand estimates and there was an increase in estimates for North American oil production. In July and August, however, oil prices increased gradually in response to mounting geopolitical tensions in certain countries. This forecast assumes that the average barrel price will be USD 107.8 in 2013, falling to USD 102.8 in 2014 and USD 97.6 in 2015, and that the price in euro will be €81.7 in 2013, €77.4 in 2014 and €73.5 in 2015.

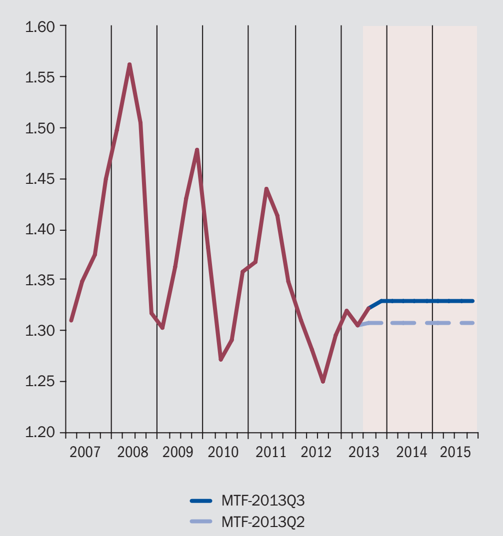
Chart 10 Price per barrel of Brent crude oil (USD)



Source: NBS and ECB.

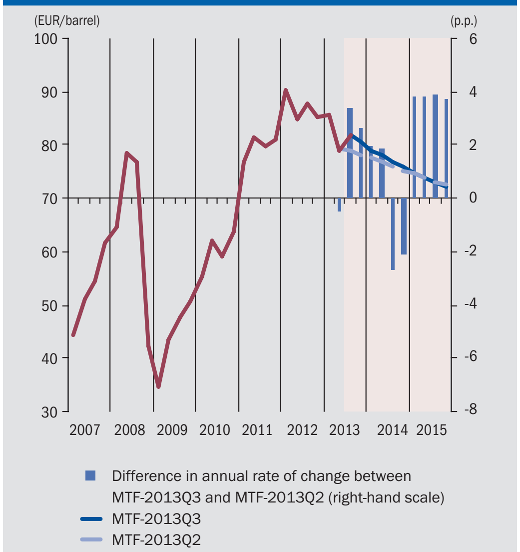
Prices of **non-energy commodities** declined in the second quarter of 2013, largely because metals prices were being pushed down by falling demand. This forecast assumes that non-energy

Chart 9 USD/EUR exchange rate



Source: NBS and ECB.

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

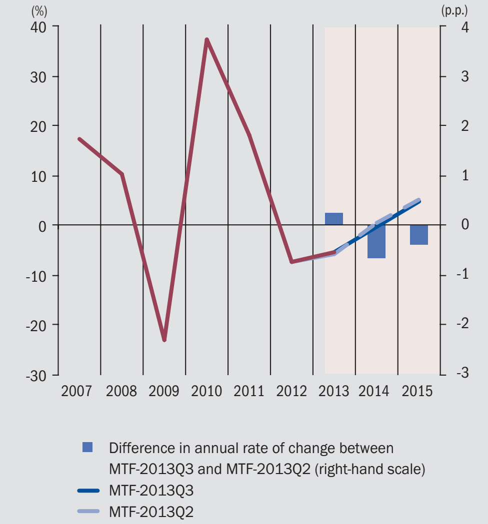


Source: NBS and ECB.

2 *The technical assumptions of the Medium-Term Forecast are based on the "ESB Staff Macroeconomic Projections for the Euro Area" of September 2013, with a cut-off date of 15 August 2013.*

3 *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 12 Non-energy commodity prices (annual percentage changes)



Source: NBS and ECB.

commodity prices will decline by 5.4% in 2013 and by 0.1% in 2014, and then increase by 4.8% in 2015.

The average level of **short-term interest rates**[4] (three-month EURIBOR) is expected to be 0.2% in 2013, 0.5% in 2014, and 0.8% in 2015.

4 *The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 15 August 2013. The assumption for short-term interest rates is of a purely technical nature.*

4 Forecast for the external environment[5]

The **world economy** expanded by 3.2% in 2012 and its growth is expected to slow moderately in 2013, to 2.8%, before accelerating to 3.6% in 2014 and 3.8% in 2015. Upside risks to the forecast for the global economy include the possibility of stronger upward pressure from improved financial conditions and firmer growth in confidence in the US economy. On the downside there is the significant risk that tensions related to the euro area sovereign debt crisis re-escalate, as well as fiscal risk in certain advanced economies and uncertainty about monetary policy developments in several countries. Another risk is that the slowdown in emerging world growth and the geopolitical tensions in certain parts of the world may be more substantial than projected.

Euro area GDP is expected to be slightly lower in the third quarter of 2013 owing to the fading effect of temporary factors (catch-up activity following cold weather). It is assumed that activity will be supported over the entire projection horizon by the favourable impact of a gradual strengthening of external demand. In the shorter-term, domestic demand will benefit from a drop in commodity price inflation that should support real incomes. In addition, the accommodative monetary stance, further strengthened by the recent forward guidance provided by the ECB's Governing Council, and improving confidence in an environment of declining uncertainty are expected to bolster domestic demand. Beyond the short term, domestic demand is also expected to benefit from a less restrictive fiscal policy stance and the gradual weakening of credit supply constraints. However, the adverse impact on domestic demand stemming from limited labour market developments and remaining deleveraging needs in some countries is expected to diminish only gradually. The recovery should therefore be relatively subdued, with GDP expected to decline by 0.4% in 2013 – largely reflecting a negative carry-over effect from the slump at the end of 2012 and beginning of 2013 – before increasing by 1.0% in 2014. [6]

The headline HICP **inflation rate in the euro area** is projected to average 1.5% in 2013 and 1.3% in 2014.[7] The decline in HICP inflation 2013 is expected to reflect a strong decline in energy price inflation from its elevated levels of 2012. The drop in energy price inflation stemmed in turn from the decline in oil prices and the appreciation of the euro over the past year, as well as from downward base effects owing to fading away of the impact of past increases in oil prices. Looking ahead, energy prices are expected to decline over the projection horizon, reflecting the assumed path of oil prices. The contribution of the energy component to overall HICP inflation is expected to be negligible, and thereby significantly lower than its historical average, explaining to some extent the modest profile for headline inflation. Food price inflation is assumed to decline somewhat owing to downward base effects and the expected decline in international and European food commodity prices. HICP inflation excluding food and energy is expected to edge up slightly in 2014, reflecting the modest recovery in activity and increase external price pressures.

Turning to domestic price pressures, the annual growth rate of compensation per employee is expected to remain subdued over the projection horizon on account of the weakness of the labour market. Given the inflation projection, growth in real compensation per employee is assumed to rise over the projection horizon. Unit labour cost growth is projected to decelerate in 2013 and 2014 owing to a cyclical increase in productivity growth. Profit margins are expected to stagnate in 2013, reflecting the weakness in domestic activity. Thereafter, lower 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.

Global trade growth, after slowing from 6.2% in 2011 to 3.0% in 2012, is expected to remain at the same level in 2013, and then accelerate strongly to 5.2% in 2014 and, more moderately,

5 The assumptions for developments in the international economy are based on the "ECB Staff Macroeconomic Projections for the Euro Area" of September 2013, which were prepared using information available up to 23 August 2013.

6 The figures are in the middle of the forecast range for GDP growth. The Eurosystem's projection ranges for GDP growth are -0.6% – 0.2% in 2013 and 0.0% – 2.0 % in 2014. The forecast for 2014 includes Latvia.

7 The figures are in the middle of the forecast range for the HICP rate. The Eurosystem's projection ranges for the HICP rate are -1.4% – 1.6% in 2013 and 0.7% – 1.9% in 2014. The forecast for 2014 includes Latvia.

to 6.1% in 2015. After decelerating sharply in 2012, the growth in **Slovakia's export markets** is projected to remain modest in 2013, at 0.9%, before gradually increasing to 4.4% in 2014 and 5.3% in 2015 with support from the pick-up in global trade.

5 Macroeconomic forecast for Slovakia

5.1 ECONOMIC GROWTH

Gradually accelerating demand for Slovak exports

Demand for Slovak products and services boosted the export performance of Slovakia. In the second quarter, too, exports of goods and services grew far more than external demand, and the forecast for this year reflects that fact. This trend, however, is considered to be a temporary effect of the current composition of exported production. Export growth and the acquisition of market share is expected to be supported not only by increasing external demand, but also by a moderate increase in labour costs and the undervalued real exchange rate.

Chart 13 Forecasts for external demand and for Slovak exports of goods and services (annual percentage changes; constant prices)

Source: NBS.

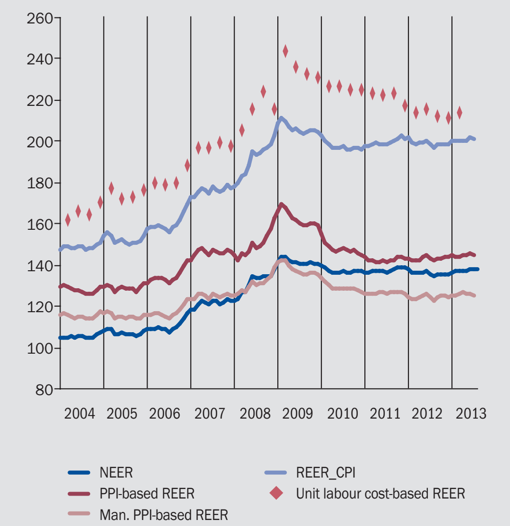
Box 2

IS THE EURO HELPING SLOVAKIA TO MAINTAIN COMPETITIVENESS?

Goods and services exports have long been the main growth driver of Slovakia's highly open economy. Since a tempory fall in 2009, export growth has been on a strong upward trend that compares relatively favourably with export growth of other countries in the region and of the euro area. Although the slump in Slovak exports during the crisis was the most pronounced, their growth from 2010 until the present day has been the highest. Besides reflecting differentiation between countries in the composition of their industrial sectors, the buoyancy of Slovakia's export performance may stem from the continuing inflow of foreign investment and production innovations, **as well as from the effect of the exchange rate on the economy's competitiveness**.

According to NBS estimates,[8] the exchange rate was overvalued in 2009 (whereas neighbouring countries saw their currencies depre-

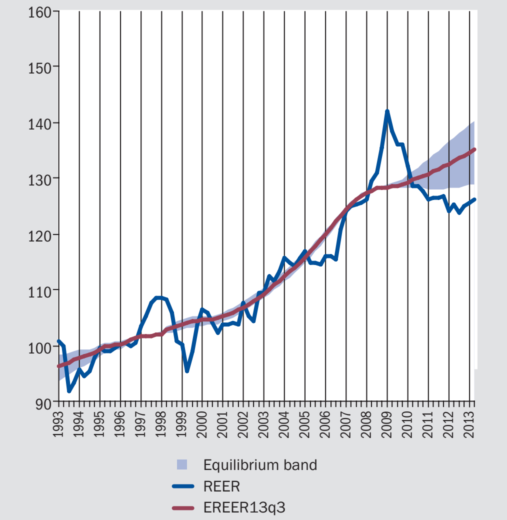
Chart A NEER and REER indices (15 trading partners; index: 1993M1/Q1 = 100)



Source: NBS.
Note: index appreciation (+), depreciation (-).

8 *Gylánik, M. (2012), Equilibrium real effective exchange rate estimation for the Slovak economy, Monetary Policy Department, Národná banka Slovenska, http://www.nbs.sk/_img/Documents/_Publikacie/MU/2012/EREER_EN_032012.pdf*

Chart B Equilibrium real effective exchange rate

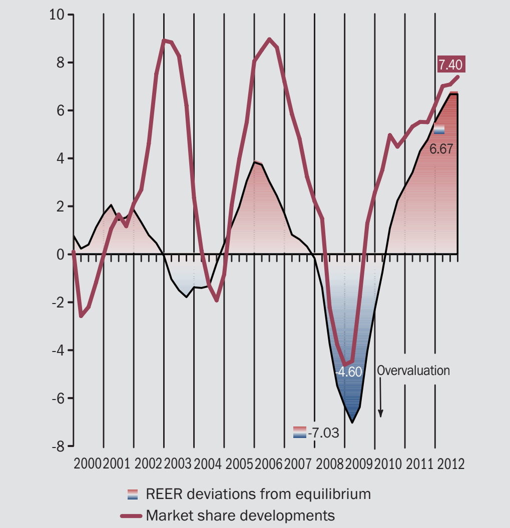


Source: NBS.
Note: Manufacturing PPI-based REER; EREER 13q3 – corresponding to the equilibrium exchange rate in the NBS Medium-Term Forecast (MTF-2013Q3); index appreciation (+), depreciation (-).

ciate during the crisis, Slovakia's introduction of the euro meant a fixed nominal exchange rate of its currency vis-à-vis other euro area countries). Recently, by contrast, while the euro area and neighbouring countries were struggling with recession, the Slovak economy enjoyed a stable real effective exchange rate that allowed it to preserve competitiveness through keeping costs low. **The exchange rate is now assumed to be depreciated** so that it can contribute to further expansion of market shares of Slovak exports.

In Chart C, this Medium Term Forecast compares Slovakia's market share with deviations in the manufacturing producer prices-based REER from its equilibrium. At times of a depreciated REER Slovakia's market share was increasing. The combination of a depreciated real effective exchange rate and a relatively stable nominal effective exchange indicates that **producers are managing to maintain their price increases at an internationally competitive level. The market share growth supports this view and suggests the domestic exporters are sufficiently competitive.**

Chart C REER (manufacturing PPI-based) deviations from equilibrium and year-on-year market share growth (centred moving average for 5 quarters; percent)



Source: NBS.

Investment demand to recover gradually

After falling in the first half of 2013, investment is expected to begin rising gradually, although its first-quarter slump would result in a higher overall decline in 2013 than in the previous year. Investment growth is expected to be supported by the completion of investment projects in the car industry in the second half of the year. Based on the latest figures for the first half of the year, government investment is assumed to have a negative impact on overall investment demand for the whole of 2013; it should then pick up in subsequent years. The forecast envisages a recovery in investment demand which is expected to reflect falling uncertainty and a partial increase in confidence in the construction sector, resulting in turn from the assumed pick-up in civil engineering construction and from a moderate revival in the property market. More apartments started to be built in the second quarter than in any quarter since 2009. Hence investment demand is expected to recover over the projection horizon, with a growth rate similar to that of the economy as a whole.

Table 1 Forecast for gross fixed capital formation (annual percentage changes)

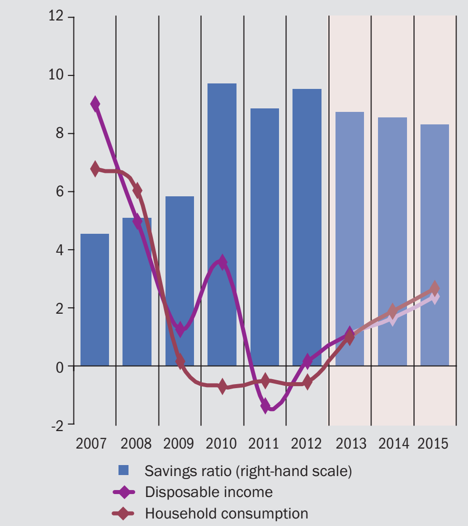
	2013	2014	2015
Gross fixed capital formation (GFCF)			
– total GFCF	-5.8	0.9	3.2
– GFCF adjusted to exclude one-off investment in the automotive industry	-6.2	3.2	3.2

Source: SO SR and NBS.

Private consumption to continue recovering

Private consumption growth was strong in the second quarter of 2013, but although that increase will buoy the full-year figure, it is expected to have been a temporary spike; the pace of growth is projected to slow in the second half of the year to reflect growth in disposable income less savings. Looking at monthly figures for the third quarter and the brightening of expectations, private consumption growth is expected to continue moderately and then gradually accelerate over the projection horizon, as disposable income is boosted by the assumed increases in wages and employment. In spending on items for which they had deferred consumption, households are expected to dip into their savings, thereby reducing the savings ratio.

Chart 14 Household income and consumption (annual percentage changes) and the household savings ratio (%)



Source: SO SR and NBS.

General government spending projected to decline this year

After rising in the first half of 2013, real general government spending is expected to be substantially constrained in the second half and to decline over the year as a whole, since the forecast assumes that the 2013 general government deficit target of 3% of GDP will be met. Fiscal consolidation measures adopted last year for 2013 are taken into account in the forecast, and include a wage freeze for public sector workers other than teachers and a decline in intermediate consumption. Looking at current developments, the wage freeze has been overestimated and its impact on nominal growth is now expected to be moderate. For subsequent years, the forecast takes account of additional consolidation measures contained in the draft budget, which will affect macroeconomic developments[1] and amount to €300 million. Real wage growth is assumed to pick up until 2015. Since information on further specific measures was not available when this forecast was prepared, the additional consolidation effort is expected to moderate gradually.

Table 2 Forecast for general government consumption and investment (annual percentage changes)

	2012	2013	2014	2015
General government final consumption (at constant prices)	-0.6	-0.3	-0.4	1.4
General government investment (at constant prices)	-14.3	-24.2	-7.4	8.4
Contribution of general government consumption and investment to GDP growth	-0.4	-0.5	-0.2	0.3

Source: SO SR and NBS.

9 *Although the amount of the announced consolidation measures is higher, the forecast assumes their impact on the real economy to be €300 million. The forecast envisages the adoption of additional measures (the sale of strategic oil reserves, extraordinary dividends, income from the digital dividend, etc.), but these are not expected to affect economic growth).*

Imports expected to rebound along with domestic demand

Imports increased in the second quarter amid rising domestic demand and exports, while import intensity further declined, the assumption being that this is only the short-term effect of an outflow of suppliers, particularly in the electrical equipment industry. Hence imports are projected to grow more than exports over the next two quarters, and import intensity should be back up to its end-2012 level at the beginning of 2014. Import growth is expected to be stable over the projection horizon, reflecting export growth and recovering domestic demand. Price developments in foreign trade are not weighing on competitiveness. The assumption of export prices rising more than import prices is largely predicated on declining oil prices and their substantial downward effect on import prices. Therefore developments in nominal prices are supporting the rising trade surplus.

Economic growth to accelerate gradually in the medium term

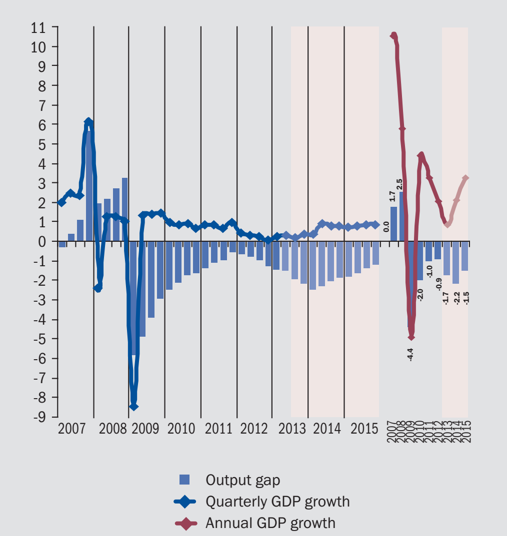
Economic growth in 2013 is expected to be driven mainly by export performance. Although the domestic part of the economy showed some positive signs in the second quarter, its contribution is projected to be negative. The assumed growth in external demand over the projection horizon should support a further increase in exports, which in turn is expected to stimulate domestic demand. In time, domestic demand should also have a positive impact on growth. **The economy is projected to grow by 0.9% in 2013, accelerating gradually to 2.1% in 2014 and 3.2% in 2015**. The current improvement in the economy has had a moderately positive effect on the cyclical position, but without any impact on inflation. The economy is still assumed to continue performing below potential. The output gap will widen further in 2014 owing to slower investment growth and to fiscal consolidation efforts, and it will begin to close in 2015 when growth in both external and domestic demand accelerates. In 2013, however, the output gap will remain substantially negative.

5.2 THE LABOUR MARKET

Labour market expected to stabilise

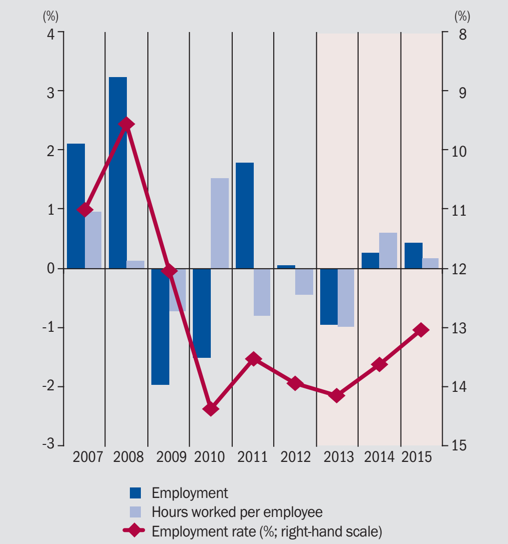
Negative tendencies in the labour market were to the fore during the first half of the year. Employment fell substantially and, taking this into account, the full-year decline in employment is projected to be -1%. In the second half of 2013, however, employment is not expected to deteriorate but rather to remain flat in quarter-on-

Chart 15 GDP growth and the output gap (%)



Source: SO SR and NBS.

Chart 16 Employment, hours worked (annual percentage changes) and the unemployment rate (%)



Source: SO SR and NBS.

quarter terms. This view is supported by the near-term employment expectations of employers in most sectors as well as by moderate declines in unemployment in July and August. As the economy accelerates, job creation should gradually begin to increase and employment is projected to rise moderately in 2014 and 2015. The unemployment rate, however, remains at relatively high levels and is forecast to decline to 13% by the end of the projection horizon. Labour productivity over the forecast period is expected to be maintained by an increase in hours worked per employee. Gradually, however, as outlooks improve, employment is expected to rise and the number of hours worked per employee should increase more moderately.

5.3 LABOUR COSTS AND PRICE DEVELOPMENTS

Restrained labour cost growth

Unit labour costs are expected to increase by around 1% over the projection horizon. This year they are affected by an increase in the tax and contribution burden, although it is assumed that firms are covering the higher costs with increased labour productivity growth and by relinquishing some of the labour productivity gains from the previous period. Hence the impact on the price level is not expected to be significant.

Inflation to fall further in 2014 and then increase in 2015

The inflation rate is reflecting the cyclical position of the economy and the stabilisation of the commodity prices as a cost-push factor. Weak consumer demand is causing disinflation, and that factor is expected to further exert an effect during the projection horizon. Falling producer prices and import prices are reflected in the subdued inflation rate of non-energy industrial goods, and that should remain the case in the near term. As external and domestic demand recovers, non-energy industrial goods inflation is expected to accelerate moderately. Energy prices are assumed to fall over the projection horizon. Services prices are expected to reflect only cost-push pressures, as the rate of increase in these prices should be constrained by sluggish growth in consumer demand. Food price inflation is projected to stabilise at around 3% and should reflect technical assumptions for farm-gate prices.

Table 3 Unit labour costs (annual percentage changes)

	2012	2013	2014	2015
Nominal compensation (ESA)	2.0	2.9	3.0	3.8
Real productivity	2.0	1.8	1.8	2.8
Unit labour costs	0.1	1.0	1.0	1.2

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

Table 4 Wages (annual percentage changes)

	2012	2013	2014	2015
Whole economy – in nominal terms	2.5	2.6	2.8	3.8
Whole economy – in real terms	-1.1	1.1	1.3	2.0
Public administration, education and health care – in nominal terms	3.5	2.6	2.9	2.9
Public administration, education and health care – in real terms	-0.2	1.0	1.4	1.0
Private sector – in nominal terms	2.2	2.7	2.7	4.1
Private sector – in real terms	-1.3	1.1	1.3	2.3

Source: SO SR, NBS calculations.
Note: Deflated by the CPI. Nominal wage growth in the general government sector (ESA S.13) is projected to be 0.8% in 2013, 0.3% in 2014 and 2.6% in 2015.

6 Risks to the forecast

In this medium-term forecast, risks to the outlook for the real economy in 2013 and 2014 are balanced. The principal downside risks are external demand developments and the impact of additional fiscal consolidation measures, both in Slovakia and abroad; these could be a substantial constraint on the recovery. An upside risk to the growth forecast is that the drawing of EU funds in coming years may be greater than projected, as the period within which such funds may be drawn under the current financial programming is coming slowly to its end. Another upward effect could arise from accelerated progress on highway infrastructure projects. The risks in 2015 are moderately on the downside. Additional fiscal consolidation measures and possible activation of the debt brake could weigh on the recovery. The risks to the labour market outlook appear to be balanced, and it is not expected that methodological and legislative effects from the beginning of the year will pose a risk to the employment outlook.

According to the Finance Ministry's latest projection, the shortfall in tax and contribution revenues for 2013 from their budgeted amount will be equivalent to 0.8% of GDP and that gap will widen in subsequent years.

The slight divergence between NBS assumptions for macroeconomic development and the Finance Ministry's forecast indicates that the tax revenue situation may be marginally more favourable. The principal difference is related to higher assumptions for household consumption. Expenditure risks are not specified since there is not as yet a detailed budget covering the period up to the end of the projection horizon.

The inflation forecast for 2013 is not subject to any significant risks. There are moderate upside risks to the inflation outlooks for 2014 and 2015, mainly in the technical assumptions (particularly the oil price and imported inflation). A downside risk to the 2015 forecast is the envisaged reduction in the VAT rate, from 20% o 19%.

Table 5 Differences in the projected tax and contribution revenues of Slovakia's public finances

MTF-2013Q3 macro scenario versus Institute of Financial Policy estimate of September 2013 (EUR millions)	2013	2014	2015
Total	**39**	**93**	**151**
Income tax of natural persons	1	1	6
Income tax of legal persons	3	15	24
Value added tax	30	65	87
Consumption tax	4	9	15
Social and health insurance	2	2	19

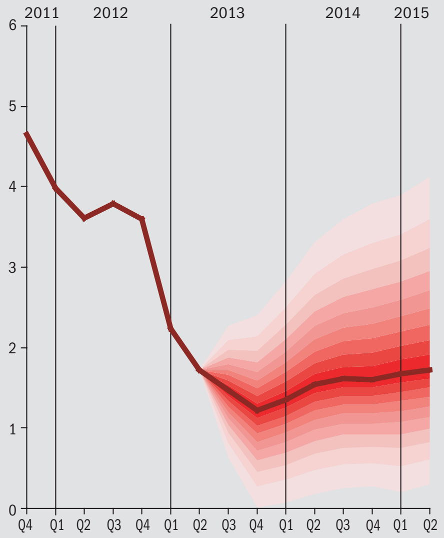
Source: NBS (based on the IFP calculator).
Note: Expenditure risks are not set out since expenditure-based consolidation measures in the draft budget for 2014 have yet to be specified.

Table 6 Risks to the forecast

	2013	2014	2015
GDP	↓ Sovereign debt crisis, fiscal consolidation ↑ Soft indicators	↓ Fiscal consolidation, sovereign debt crisis, external demand ↑ EU funds	↓ External demand, consolidation measures, debt brake
Inflation		↑ Technical assumptions	↑ Technical assumptions ↓ VAT reduction

Source: NBS.

Chart 17 HICP inflation forecast (%)



Source: SO SR and NBS.

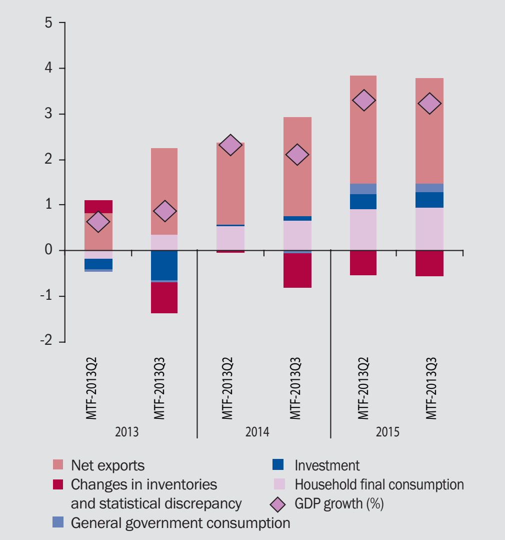
7 Comparison with the previous forecast

Comparing the technical assumptions of this forecast with those of the previous forecast (MTF-2013Q1), the projection for external demand growth in 2014 and 2015 has been revised down slightly and the exchange rate is expected to be stronger. The oil price assumptions are not significantly different. The fiscal consolidation effort was largely unchanged for 2013, while for 2014 it was expanded to include additional measures specified in the draft general government budget, which were disclosed on the cut-off date for this forecast.

Despite current developments the medium-term outlook for the economy is unchanged

Following disclosure of the composition of economic growth for the first two quarters for 2013, the economic outlook for the whole of 2013 was revised to include higher contributions to GDP growth from both domestic demand and exports. Taking into account the assumption of the one-off nature of recent positive developments, the economy is expected to progress as projected in the previous forecast. Nor are there changes to the economic outlook for the medium term. The main driver of growth is expected to be exports, especially so in 2013, with domestic demand also projected to make a positive contribution in subsequent years. Private consumption in 2013 and 2014 has been revised up based entirely on its improvement in the second quarter. Investment growth in the second half of 2013 is now projected slightly higher, and this has had an upward effect on the full-year forecast for 2014. In foreign trade, export growth has been revised up slightly in response to current developments. Import growth in the short-term horizon is slightly higher, and import intensity is set to return to its end-2012 level. Domestic demand is expected to be partially restrained by fiscal consolidation measures.

Chart 18 Composition of GDP growth[1)] (annual percentage changes; contributions in p.p.; comparison with previous forecast)

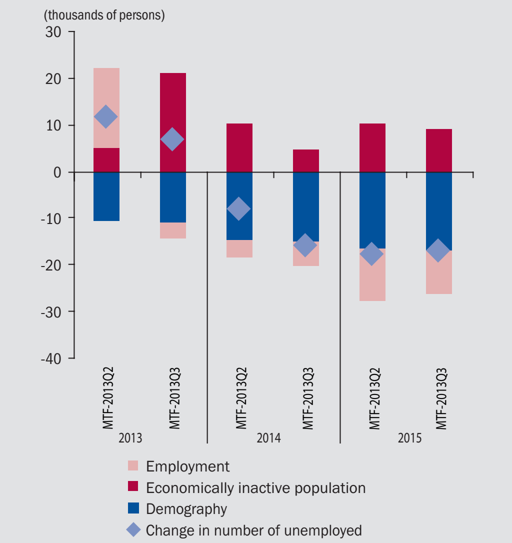


Source: SO SR and NBS.
1) The composition of GDP growth is calculated as the contributions of components to GDP growth after deducting their import intensity. In this case the calculation uses the constant import intensity of the different GDP components (household final consumption – 30%, general government consumption – 7%, investment – 50% and exports – 60%). Remaining imports were included under changes in inventories and the statistical discrepancy.

Overall economic growth in 2013 is expected to be higher than previously projected by 0.3 percentage point, due solely to the improved situation in the second quarter. The incorporation of consolidation measures in 2014 is expected to shave 0.2 percentage point of the year's growth. The previous forecast's projection of moderately accelerating GDP growth in 2015 is retained in this forecast.

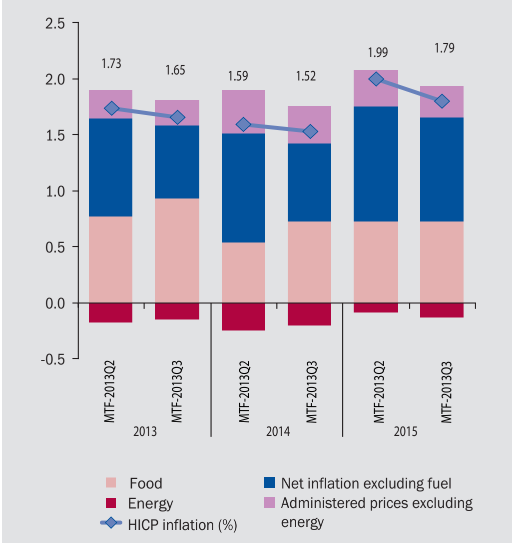
The labour market outlook for the near term has been adversely affected by recent developments. The projected decline in employment in 2013 has been revised up from the previous forecast. Looking ahead, there is no change to the projection of moderate employment growth amid an increase in economic activity. The unemployment rate forecast remains high, although lower than previously projected owing to higher utilisation of labour activation schemes and people leaving the country to work abroad (two factors that were reflected in the figures for the first half of 2013) as well as new job creation and the effect of demographic developments (resulting in a lower number of people of working age). The forecasts for other labour market indicators did not change significantly. Labour costs and com-

Chart 19 Comparison of labour market indicators (contributions to unemployment)



Source: SO SR and NBS.

Chart 20 Comparison of inflation projections broken down by component (annual percentage changes; contributions in p.p.)



Source: SO SR a NBS.

pensation are assumed to follow a similar path to that described in the previous forecast. The higher wage growth in 2013 reflects the fact that an increasing number of people are being paid under standard employment contracts rather than fixed-term contracts (this has an impact of up to one percentage point), and the remaining part of the growth figures is accounted for by wage developments in the second quarter.

The inflation outlook has been revised to reflect more favourable recent price developments (a lower increase in demand-pull prices) with price growth in 2013 and 2014 now expected to be lower than projected in the previous forecast. Food price inflation has been revised up owing to an acceleration in certain agricultural commodity prices. The forecast for energy price inflation is unchanged.

Table 7 Medium-Term Forecast (MTF-2013Q3) – main macroeconomic indicators (year-on-year changes)

Indicator (annual percentage changes unless otherwise indicated)	2012	2013	2014	2015	2013	2014	2015
	Actual	Forecast			Difference versus MTF-2013Q2		
Prices							
HICP inflation (average)	3.7	1.7	1.5	1.8	0.0	-0.1	-0.2
CPI inflation (average)	3.6	1.6	1.4	1.8	-0.1	-0.2	-0.2
ULC[1] (compensation per employee at curr.p./ labour productivity ESA 95 at const.p.)	0.1	1.0	1.1	1.0	-0.4	0.1	-0.2
Labour productivity ESA 95	2.0	1.8	1.8	2.8	0.4	-0.3	0.0
Compensation per employee ESA 95	2.0	2.9	3.0	3.8	0.1	-0.1	-0.2
Nominal wages[2]	2.5	2.6	2.8	3.8	1.1	-0.3	-0.2
Real wages[3]	-1.1	1.1	1.3	2.0	1.3	-0.2	0.0
Economic activity							
Real GDP	2.0	0.9	2.1	3.2	0.3	-0.2	-0.1
Final consumption of households	-0.6	1.0	1.9	2.7	1.5	0.4	0.1
Final consumption of general government	-0.6	-0.3	-0.4	1.4	0.0	-0.5	-0.2
Gross fixed capital formation	-3.7	-5.8	0.9	3.2	-3.8	0.6	0.3
Exports of goods and services	8.6	4.8	5.3	5.5	2.7	0.8	-0.3
Imports of goods and services	2.8	2.3	5.3	5.3	1.0	1.5	-0.2
Real gross disposable household income	0.1	1.1	1.6	2.4	0.1	0.3	-0.1
Output gap (% of potential output)	-0.9	-1.7	-2.2	-1.5	0.5	0.1	0.1
Labour market							
Employment (ESA 95)	0.1	-1.0	0.3	0.4	-0.2	0.1	-0.1
Employment in persons (thousands, ESA 95)	2,209.4	2,188.3	2,194.0	2,203.4	-3.6	-1.6	-3.7
Unemployment rate (Labour Force Survey, %)	13.9	14.2	13.6	13.0	-0.2	-0.5	-0.5
Number of unemployed people (thousands)	377.5	384.4	368.7	351.7	-4.8	-12.7	-12.0
Balance of payments							
Economic openess (% of GDP)	185.8	185.3	189.5	193.1	-0.4	1.2	0.8
Trade balance (% of GDP)	5.0	7.1	7.4	7.8	1.3	1.1	1.0
Balance of services (% of GDP)	0.4	0.2	0.2	0.3	-0.1	-0.2	-0.2
Current account (% of GDP)	2.2	4.2	4.7	5.7	0.6	0.3	0.6
Current and capital account (% of GDP)	4.2	5.7	6.3	7.5	0.4	0.2	0.6
External assumptions for the forecast							
External environment							
Slovak foreign demand growth	0.9	0.9	4.4	5.3	0.0	-0.3	-0.4
Technical assumptions							
Exchange rate (EUR/USD)[4]	1.28	1.32	1.33	1.33	0.8	1.5	1.5
Brent crude oil (USD per barrel)[4]	112.0	107.8	102.8	97.6	2.2	2.8	1.5
Brent crude oil (EUR per barrel)[4]	87.1	81.7	77.4	73.5	1.5	1.3	0.0
Oil prices growth (in USD)	0.9	-3.7	-4.6	-5.1	2.0	0.6	-1.3
Oil prices growth (in EUR)	9.3	-6.3	-5.2	-5.1	1.3	-0.1	-1.3
Prices of non-energy commodities growth (in USD)	-7.2	-5.4	-0.1	4.8	0.2	-0.6	-0.4
EURIBOR 3M (%)	0.6	0.2	0.5	0.8	0.0	0.2	0.3

Source: NBS, ECB, SO SR.
Note:
1) ULC – unit labour costs.
2) Average monthly wages according to SO SR statistics.
3) Wages deflated by the CPI.
4) Changes against the previous forecast in %.

Table 8 Medium-Term Forecast (MTF-2013Q3) – main macroeconomic indicators (quarter-on-quarter changes)

Indicator (quarterly percentage changes unless otherwise indicated)	1Q 2012	2Q 2012	3Q 2012	4Q 2012	1Q 2013	2Q 2013	3Q 2013	4Q 2013	1Q 2014	2Q 2014	3Q 2014	4Q 2014	1Q 2015	2Q 2015	3Q 2015	4Q 2015
	Actual						Forecast									
Prices																
HICP inflation (average)	2.0	0.7	0.3	0.6	0.7	0.2	0.0	0.4	0.8	0.4	0.1	0.4	0.9	0.4	0.1	0.6
ULC[1] (compensation per employee at curr.p./ labour productivity ESA 95 at const.p.)	0.3	1.6	-0.4	0.5	0.9	-1.2	0.7	0.7	0.4	0.0	0.2	0.2	0.1	0.5	0.3	0.3
Labour productivity ESA 95	0.3	0.4	0.4	0.5	0.5	0.7	0.2	0.3	0.2	0.8	0.8	0.8	0.6	0.7	0.7	0.7
Compensation per employee	0.6	2.0	0.0	0.9	1.4	-0.6	0.9	0.9	0.6	0.9	1.0	1.0	0.7	1.2	1.1	1.0
Economic activity																
Real GDP	0.4	0.3	0.2	0.1	0.2	0.3	0.2	0.4	0.4	0.9	0.8	0.8	0.7	0.8	0.8	0.8
Final consumption of households	0.0	-0.7	-0.1	-0.1	0.3	1.1	0.2	0.5	0.3	0.5	0.6	0.6	0.6	0.8	0.7	0.7
Final consumption of general government	1.6	-1.5	0.3	-0.2	0.5	0.1	-0.9	0.0	-0.5	0.3	0.4	0.3	0.1	0.5	0.5	0.4
Gross fixed capital formation	-2.5	-3.4	-1.4	-0.6	-5.6	1.7	0.9	0.6	-1.8	1.0	0.9	0.9	0.9	0.6	0.5	0.4
Exports of goods and services	4.3	2.7	0.3	0.8	-0.2	3.9	0.6	1.1	1.1	1.4	1.4	1.4	1.3	1.3	1.4	1.4
Imports of goods and services	2.3	2.8	1.6	-2.5	-0.5	2.8	1.6	1.4	0.9	1.2	1.3	1.3	1.3	1.3	1.3	1.3
Real gross disposable household income	0.9	-0.3	-0.1	0.5	0.1	0.8	0.3	0.1	0.4	0.5	0.6	0.6	0.4	0.8	0.7	0.6
Output gap (% of potential output)	-0.6	-0.8	-0.9	-1.3	-1.4	-1.5	-1.9	-2.1	-2.5	-2.2	-2.1	-1.9	-1.8	-1.6	-1.4	-1.2
Labour market																
Employment (ESA 95)	0.1	-0.1	-0.2	-0.4	-0.3	-0.4	0.0	0.1	0.2	0.1	0.0	0.0	0.2	0.1	0.1	0.1
Unemployment rate (Labour Force Survey, %)	13.7	13.8	13.9	14.3	14.2	14.3	14.2	14.0	13.8	13.7	13.6	13.5	13.3	13.1	13.0	12.8

Source: NBS, ECB, SO SR.
Note:
1) ULC – unit labour costs.