NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

MEDIUM-TERM FORECAST

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1 Summary

The medium-term forecast of Národná banka Slovenska (NBS) has been updated to take into account new technical assumptions for the external environment, the latest developments in real economy indicators, and the effect of the Slovak Government's planned measures for improving the performance of public finances. At the same time, the projection horizon has been extended to 2013.

This medium-term forecast (MTF-2011Q1) is based on more favourable assumptions for external demand as well as on higher estimates for external prices and oil prices. The size of public financial consolidation remained the same as in December's medium-term forecast, although there was a partial change in its structure.

The gross domestic product for the last quarter of 2010 was lower than expected and this was reflected in a more moderate rate of growth for the year as a whole, according to the latest economic data published by the Statistical Office of the Slovak Republic (SO SR). The main factors behind this development were a decline in general government consumption and slower growth in household consumption. Quarter-on-quarter economic growth is expected to continue in 2011, although it will be weaker than in the previous year owing to the effects of planned consolidation measures.

Looking at the GDP components, household final consumption is expected to rise in 2011. The boost from an upturn in the labour market is expected to be dampened by real household disposable income, which is projected to be lower as a result of the Government's consolidation measures. It also assumed, however, that households will to a certain extent tap into their savings, with the effect that their consumption expenditure will not fall in proportion to the decline in their income. The main drag on economic growth is expected to be general government final consumption, as its decline since the end of 2010 is assumed to become more pronounced due to the planned deficit reduction measures in the public sector. The consolidation process is also expected to put downward pressure on government investment, although this should be offset by the revival of investment activity in the private sector, which began in 2010 after declining substantially during the crisis. The assumption is that investments which were postponed during the crisis will now be implemented and be reflected in new fixed capital formation. As external demand continues to pick up, it should gradually benefit the economy through an increase in export performance and, given the current import intensity, through a rise in this year's imports. However, imports of goods and services are assumed to rise more slowly owing to low domestic demand, with the result that net exports will make a positive contribution to GDP growth. The upturn in the labour market recorded at the end of 2010 is assumed to continue in 2011 in conjunction with the expected economic growth.

Consumer prices showed a rising trend in the first months of 2011 owing to higher inflation in energy and food prices. This development reflected rises in prices of oil and other commodities as well as increases in excise taxes. Price inflation is assumed to accelerate throughout 2011, although persistent weaknesses on the demand side should to some extent temper its rise.

In the medium-term horizon, the economic situation is expected to be affected by continuing growth in external demand as well as by accelerated growth in domestic demand. This should see an increase in household consumption as well as in fixed capital formation. The contribution of general government consumption to economic growth is assumed to be minimal. Continuing GDP growth is expected to give a gradual stimulus to labour market indicators. The rate of inflation is projected to slow down in the medium-term horizon as the effects of indirect tax rises and commodity supply shocks fade away.

GDP growth throughout the projection horizon is expected to be higher than stated in the previous forecast (MTF-2010Q4), owing to stronger growth in both domestic and external demand. In the area of foreign trade, the production launch of a new car model has been postponed until the end of 2011, and therefore economic growth should be lower in this year and higher in 2012. However, the effect of the postponement on this year's figures is expected to be offset by increased production by external investors in other branches. Given current developments, the acceleration of inflation in 2011 is expected to be slightly lower than projected in the previous forecast, although consumer prices in 2012 are expected to rise at a faster pace owing to the higher increase in regulated prices.

The current forecast for GDP remains subject to upside risks in relation to the structure and impact of public finance consolidation in 2011. Another upward risk to the projection for economic growth is that postponed investments are implemented to a greater extent than envisaged in this forecast and also that there are additional infrastructure investments due to the higher utilisation of money from EU Structural Funds. Downside risks to the GDP forecast include the possibility that the Government has to introduce further consolidation measures or that commodity prices will be higher than projected.

It appears that the prevailing risks to the forecasted price inflation for the entire projection horizon are on the upside; the main risks to the inflation forecast are oil prices, agricultural commodity prices, external inflation and employment. The downside risks include persistently low household demand as well as the possible stagnation of cigarette prices despite the rise in excise tax on cigarettes.

2 Technical assumptions and the international environment

The technical assumptions for the medium-term forecast as well as developments in the international economy were taken from the ECB's March forecast (ECB Staff Macroeconomic Projections for the Euro Area).[1]

The technical assumptions about interest rates and about commodity prices are based on market expectations, with a cut-off date of 10 February 2011. The average level of short-term interest rates is expected to be 1.5% for 2011 and 2.4% for 2012. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.5% in 2011 and 4.9% in 2012. Regarding financing conditions, the projection assumes that over the projection horizon bank lending rate spreads vis-à-vis long-term rates will gradually increase and will return to their historical average level at the end of the horizon. Credit supply conditions are assumed to normalise further. As regards commodities, oil prices per barrel are assumed to average USD 101.3 in 2011 and USD 102.4 in 2012. The prices of non-energy commodities in US dollars are assumed to increase strongly, rising by 27.5% in 2011 and by 1.0% in 2012. The bilateral EUR/USD 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. This implies a USD/EUR exchange rate of 1.37 in 2011 and 2012 and an effective exchange rate of the euro that, on average, depreciates by 1.1% in 2011 and increases by 0.1% in 2012.

Compared with the projections published in December 2010, the March projections assume a substantially higher level of oil prices. Given, however, the current geopolitical situation, the expected oil-price developments represent a risk to the projections in regard to their technical assumptions. The current NBS forecast (MTF-2011Q4) includes a separate box that examines an alternative scenario in which oil prices rise by 20% in the first two quarters of 2011.

The rise in non-energy commodity prices is assumed be substantially higher in 2011, and then lower in 2012, than was forecasted in the December projections.

The global economy showed some renewed growth momentum at the turn of the year, supported by overall improved global financial conditions. The near-term outlook for economic activity is also supported by the new US fiscal stimulus measures. In advanced economies, the medium-term growth prospects remain rather subdued. Moreover, widespread housing market weakness and persistently high unemployment rates are expected to cloud the outlook for private consumption in these economies. In some

Table 1 Technical assumptions (annual percentage changes, unless otherwise indicated)

	Published in		Projection	
		2010	2011	2012
Oil (USD/barrel)	December 2010	79.5	88.6	90.7
	March 2011	79.6	101.3	102.4
Non-energy commodities	December 2010	40.6	19.2	2.3
	March 2011	37.1	27.5	1.0
USD/EUR exchange rate	December 2010	1.34	1.39	1.39
	March 2011	1.33	1.37	1.37

Source: ECB.

1 *More detailed information about the ECB projections is available at www.ecb.int*

emerging economies, by contrast, robust growth and increasing inflationary pressures are expected to prevail. World real GDP outside the euro area is assumed to grow, on average, by 4.7% in 2011 and 4.6% in 2012. Growth in euro area foreign demand is assumed to be higher than in the previous projections, at 7.9% in 2011 and 7.6% in 2012.

The NBS forecast for 2013 assumes that commodity prices will stabilise and that the global economy will continue to recover.

3 Medium-term forecast for the euro area

Euro area real GDP increased by 0.3% in the fourth quarter of 2010, the same rate as in the previous quarter. Looking ahead, the economic recovery is projected to continue, with domestic demand increasingly taking over from exports as the main driver. This rebalancing reflects the effects of past monetary policy moves, as well as the significant efforts made to restore the functioning of the financial system. However, the need for balance sheet repair in various sectors, as well as the fiscal adjustment efforts aimed at restoring confidence in medium-term sustainability assumed in the projections, are anticipated to weigh on the outlook for growth in the euro area. As annual potential growth is projected to be significantly lower than the pre-crisis rates, the output gap is expected to narrow over the projection horizon.

Compared with the December projections, the lower ends of the projection ranges for real GDP growth in 2011 and 2012 have been revised upwards.

Overall HICP inflation is projected to stay above 2% until the end of 2011, largely owing to recent increases in energy and food prices. Thereafter, on the basis of current futures prices for commodities, import price increases are projected to moderate. In contrast, domestic price pressures are expected to intensify somewhat, reflecting the gradual improvement in activity and higher wage growth, leading to a gradual rise in the inflation rate of the HICP excluding food and energy over the projection horizon. Growth in compensation per employee in the euro area is projected to pick up over the next two years, in line with the gradual improvement in labour market conditions. Nevertheless, real compensation per employee is expected to decline somewhat in 2011, owing to the rise in inflation, and to turn slightly positive in 2012. As productivity growth is projected to moderate over the next two years, unit labour costs, which exhibited a cyclical decline in 2010, are expected to rebound in 2011 and to grow at a faster pace in 2012. This, in turn, is projected to curtail increases in profit margins.

With regard to HICP inflation, the ranges for 2011 and 2012 have been revised upwards compared with the December 2010 projections.

Table 2 Projections of selected euro area indicators (average annual percentage changes)

	Published in	Actual data	Projections	
		2010[1)]	2011	2012
HICP	December 2010	1.5 – 1.7	1.3 – 2.3	0.7 – 2.3
	March 2011	1.6	2.0 – 2.6	1.0 – 2.4
Real GDP	December 2010	1.6 – 1.8	0.7 – 2.1	0.6 – 2.8
	March 2011	1.7	1.3 – 2.1	0.8 – 2.8
Private consumption	December 2010	0.6 – 0.8	0.4 – 1.4	0.5 – 2.3
	March 2011	0.7	0.6 – 1.4	0.4 – 2.2
Government consumption	December 2010	0.5 – 1.3	-0.8 – 0.6	-0.4 – 1.0
	March 2011	0.8	-0.3 – 0.5	-0.5 – 0.9
Gross fixed capital formation	December 2010	-1.4 – -0.6	-0.5 – 3.1	0.1 – 5.3
	March 2011	-0.8	0.4 – 3.4	0.7 – 5.5
Exports (goods and services)	December 2010	9.9 – 11.7	3.7 – 8.7	2.5 – 8.7
	March 2011	10.9	4.9 – 9.5	3.0 – 9.2
Imports (goods and services)	December 2010	8.2 – 9.8	2.6 – 7.6	2.3 – 8.1
	March 2011	9.0	3.5 – 7.7	2.8 – 8.4

1) Data published in December 2010 were predicted.
Source: ECB.

4 Medium-term forecast for Slovakia

This medium-term forecast takes into account the aforementioned technical assumptions and the latest developments in real economy indicators. The medium-term projection horizon is extended to 2013. The size of public finance consolidation remained the same as in December's medium-term forecast, although there was a partial change in its structure. The March forecast takes into consideration current developments in the labour market, where, according to the information available, the previous forecast's assumptions for the number of public sector redundancies have not as yet fully materialised. If, therefore, the approved scope of the fiscal deficit reduction is preserved, it may be assumed that spending cuts will be made to a lesser extent through lay-offs and to a greater extent through reducing compensation. This updated forecast also includes a reassessment of the scope and timing of the production launch of foreign investments, where their contribution to growth is put back to 2012, from 2011 in the previous forecast.

4.1 The real economy

Current account

The balance of payments **current account** for the fourth quarter of 2010 continued to record growth in exports and imports, which were boosted by the recovery in external demand. With external demand expected to carry on rising in the years ahead, it may be assumed that export and import growth will continue increasing in 2011 and 2012 and that the **trade balance** surplus will increase gradually in year-on-year terms. Compared with the previous forecast, the trade balance will be moderately worse owing to the effect of high prices of raw materials in global markets. The 2011 trade balance will also be adversely affected by the inclusion of modified assumptions for the automotive industry in regard to the postponed production of a new car model. The expected rise in external demand in 2013 is expected to support a year-on-year improvement in the trade balance. The main **risk** to the trade balance forecast is a steeper rise in prices of raw materials as well as higher import intensity, which could put further upward pressure on imports. Another risk is that the effect of estimated investments on exports and imports is different from what was expected.

Current developments in the **services balance** were reflected mainly in lower expenditure on certain types of services and consequently had a positive effect on the overall deficit. The lower spending on services was probably related to the fact that services from abroad were being used more effectively as a result of the crisis, which meant that expectations about the further development of services could also be modified. Hence, the balance of services deficit in 2011 and 2012 could be lower than the originally expected deficit. In 2013, the deficit is expected to continue its moderate improvement of previous years owing to rising external demand.

Forecasts for other current account components in 2011 and 2012 have remained unchanged in the light of current developments. Economic growth in 2013 is expected to be accompanied by a slight worsening in the income balance, owing to the higher profitability of firms with foreign participating interests (which should be reflected in higher dividend payments or reinvested earnings). On the other hand, the expected increase in the utilisation of EU funds is assumed to cause an improvement in the current transfers deficit.

In line with the previous forecast, the **current account deficit** to GDP ratio in 2011 and 2012 is expected to decline in year on year terms due to the gradual rise in external demand. The change in the deficit in comparison with the previous forecast is assumed to be minimal in both years. In 2013, the balance of payments current account is expected to improve – mainly due to the continuing growth in foreign trade – and could report a slight surplus.

Labour market

The post-crisis recovery of the labour market started to emerge in the second half of 2010 when **employment** recorded quarter-on-quarter increases, including a fourth-quarter rise that slightly exceeded NBS's expectations. This development was reflected also in the current forecast, which assumes that employment in 2011 will grow in year-on-year terms after a two-year decline. The main component of this growth is expected to be the increase in the number of workers employed primarily in industry. The current forecast for employment also takes into account new information about announced mass redundancies, on which basis the assumption for the number of lay-offs in the public sector was reduced. However, the employment forecast also assumes a decline in employment at the state-owned railway companies.

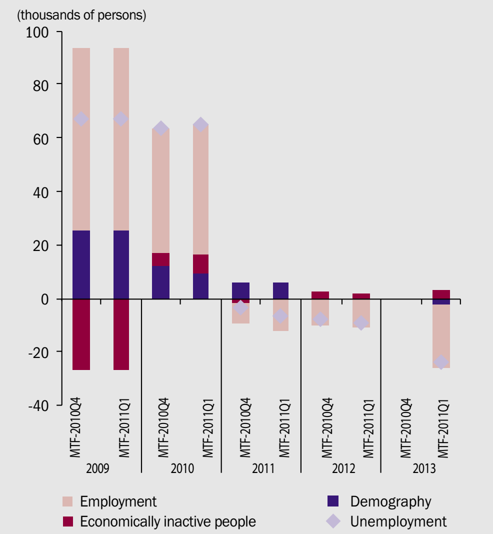
In the medium-term horizon, the number of employed persons is projected to increase in comparison with the levels recorded during the crisis, albeit at a slower pace than the recovery of economic activity. This also relates to the fact that the impact of the economic crisis on employment probably had a structural dimension in the form of an increase in total factor productivity. Thus, overall output can be ensured by a lower number of workers. This is also confirmed by the number of hours worked, which although it is rising at a faster pace than the number of employed persons, still lags behind pre-crisis levels. The trend improvement in labour market indicators amid stronger growth in economic activity can be expected to continue. Such economic recovery is assumed to show up in higher labour productivity and also in rising compensation per employee. In 2013, after the impact of the mentioned factors has expired and eased, employment growth is expected to accelerate in year-on-year terms.

The projected employment growth in 2011 is higher than was stated in the previous forecast, owing both to current developments and to the projected change in the structure of fiscal consolidation. The pace of employment growth in the following year is expected to develop similarly.

Compensation per employee in 2010 increased more slowly than projected in MTF-2010Q4, since it reflected the relatively substantial effect of statistical data revision (a reduction in the amount of compensation) as well as the slowdown in compensation growth in the second half of 2010. In 2011, nominal compensation per employee is expected to be affected by, on one hand, the projected reduction in the public sector wage bill and, on the other hand, an increase in payroll contributions. After taking account of current monthly indicators, compensation growth can be expected to accelerate in comparison with the previous forecast. As for employee compensation growth in the medium-term horizon, it is expected to accelerate given the projected developments in labour productivity and other macroeconomic indicators. Compared with the previous forecast, employee compensation is expected to be more moderate in 2011 and to record a similar rate of growth in 2012.

As for **unemployment**, the assumption is that its level will gradually respond to the economy's improving performance and that employment will subsequently rise. But owing to projected demographic trends, and despite the rising number of people in employment, the expected decline in the unemployment rate should not be substantial. In the medium-term horizon, the unemployment rate is assumed to decline by 1.5 percentage points from where it stands at present. In 2013, the unemployment rate is projected to record its largest decline, since it is assumed that economic growth will positively affect the number of people in employment. Compared with the previous forecast there are no substantial changes in the unemployment figures.

Chart 1 Contributions of labour market indicators to unemployment



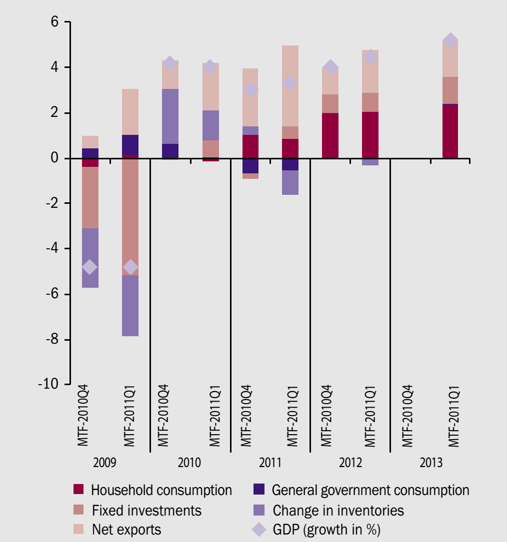
Source: NBS.
Note: The contributions of individual labour market indicators refer to their impacts on the number of unemployed: for example, unemployment is increased by a decline in employment, a rise in the number of people of productive age (demographics), and a decrease in the economically-inactive population.

The risks to the forecast for labour market indictors are mostly positive. In the case of the employment forecast there is the upside risk that robust economic growth may gradually generate more jobs. Employment may also come under stronger upward pressure from additional investments in infrastructure in connection with the higher utilisation of money from EU structural funds. Another factor that could create scope for employment growth is the draft amendment to the Labour Code and the possibility that it will make the labour market more flexible. At the same time, however, an increase in the limits on overtime work which is being considered for inclusion in the amendment could have a dampening effect on employment growth, especially in the short term. Over the longer term, an increase in overtime would probably not be able to meet the demands of continuing output growth, and, therefore, the more flexible labour market would exert a positive effect on employment. Another risk is the implementation and impact of fiscal consolidation, if it were carried out differently from how it is currently envisaged, i.e. through a combination of reducing employment and cutting the amount of compensation, or even through other sources (taxation of emission quota sales; higher revenues, etc.).

GDP

GDP growth in 2010 was slightly lower than projected in the previous NBS forecast, according to revised data from the SO SR. In terms of its structure, economic activity was influenced mainly by slower growth in domestic consumption demand. The positive developments were concentrated in exports, which reflected higher external demand, and also in fixed investments, which recovered more strongly than had been expected.

Chart 2 Contributions to GDP growth at constant prices (p.p.)



Source: NBS.

As in the previous forecast, GDP growth in 2011 is projected to be lower than in 2010 mainly because of the expected consolidation of public finances. The assumption is that it will directly affect the economy through a decline in general government financial consumption and lower government investments. The gradual upturn in the labour market is expected to be reflected in household incomes and consumption. Considering, however, the effects of Government measures on household income, consumption growth is assumed to be modest. Fixed investments that had previously been postponed have started and their implementation should continue in 2011 and contribute to economic growth. Net exports, too, are expected to boost growth, as the continuing rise in external demand is assumed to support the economy's increasing export performance.

The forecast for 2012 and 2013 includes further growth in the domestic part of the economy, particularly in private consumption and fixed investments. The contribution of government consumption to GDP is expected to be very slight. GDP growth should also be driven up by developments in external demand.

The current forecasts for growth in GDP at constant prices are 3.3% in 2011, 4.5% in 2012, and 5.2% in 2013. Compared with MTF-2010Q4, GDP growth over the entire projection horizon is expected to be slightly higher, owing to current macroeconomic developments and expected external demand, as well as to the postponement of the production launch of a new car model.

Domestic demand

Household final consumption is expected to return to growth in 2011. On one hand, its growth will be influenced by the improving situation in the labour market (rising employment and compensation per employee), but, on the other hand, it is expected to be dampened by lower income and higher prices resulting from the Government's consolidation measures. At the same time, with retail sales and consumer confidence stagnating, monthly indicators show no sign that private consumption will rise by any substantial margin. In the medium-term horizon, wages may come under upward pressure from labour productivity growth of recent years. This, along with the gradual rise in employment, may create conditions in which growth in household consumption expenditure will continue.

The recovery of investment activity in the past year, after its slump during the crisis, was supported by the gradual acceleration of industrial output, loosening of bank credit standards, and increasing profitability. It is expected that 2011 will see the continuation of **gross fixed capital formation** related to previously postponed investments and also inflows of potential new investments. The growth, however, will be slightly dampened by the decline in government investments which is expected to result from the consolidation measures. A further boost to growth in the short-term horizon should be the continuation of infrastructure investments that have already been started. In the years ahead, the trend growth in fixed capital formation is expected to be maintained as economic activity grows, with the result that the amount of fixed capital approaches pre-crisis levels.

The current forecast expects change in inventories to make a slightly negative contribution to economic growth, as existing stocks are used in the production process. In the medium-term horizon, change in inventories is not projected to affect GDP growth.

Compared with the previous forecast, the effect of domestic demand on growth is assumed to be more strongly positive, particularly through the increase in investment activity. Taking into account the revised data, the development of fixed capital was re-assessed and the recovery of investments did not begin to accelerate until the end of 2010. This trend is expected to continue during the projection horizon. Although a change in the structure of fiscal consolidation in regard to the labour market is being considered, it is not expected to affect GDP growth.

Net exports

The stronger growth in exports in the second half of 2010 and the continuing rise in external demand are expected to boost the economy's export performance in 2011. Export growth is assumed to be affected by the postponement of the production launch of a new car model until the fourth quarter of 2011. However, according to the information available, this effect should be offset by production in other sectors of the economy. Given the current level of import intensity and the relatively low domestic demand, imports are projected to grow more slowly than exports, with the result that net exports will make a positive contribution to economic growth. In the medium-term horizon, further growth in external demand will be reflected in continuing export and import growth. In 2012, foreign trade should also be boosted by the production launch of a new car model.

Chart 3 Forecast for GDP growth at constant prices (%)

Source: NBS.

Compared with the previous forecast, the positive contribution of net exports to GDP is expected to increase, mainly due to the more favourable situation in external demand.

The **risks** to the current forecast for GDP remain predominantly on the upside and concern the structure and impact of public finance consolidation in 2011.

Over the projection horizon, another upward risk to the growth forecast is that postponed investments are implemented to a greater extent than envisaged and also that there are additional infrastructure investments due to the higher utilisation of money from EU Structural Funds. Downside risks to the GDP growth forecast include the possibility that the Government has to introduce further consolidation measures or that commodity prices will be higher than projected.

Some risks to the forecast for GDP growth are both on the upside and downside, including the uncertainty surrounding the situation in Japan and its potential direct repercussions for our economy, as well as its indirect effects through spillover into the global economy.

Potential GDP and the output gap

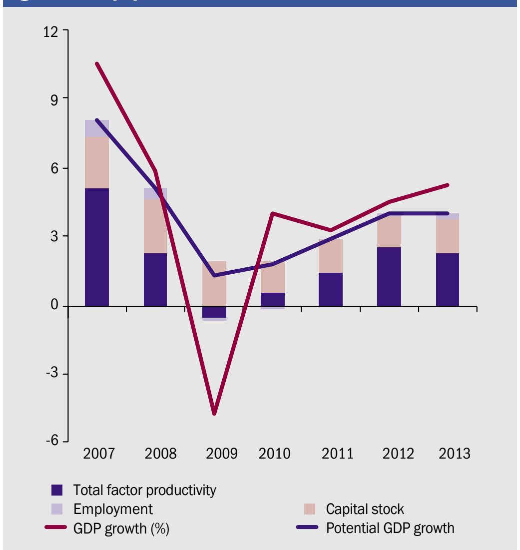
In this forecast, the outlook for the potential GDP trend in the medium-term horizon is largely unchanged from MTF-2010Q4, except for the postponement of a positive shock in total factor productivity (owing to the production launch of a new car model being delayed until the forth quarter of 2011). The potential growth of the Slovak economy is expected to reach around 4% in 2012 and in 2013, driven up by the projected increase in total factor productivity. With investment activity expected to recover over the projection horizon, after plunging during the crisis, it should generate growth in capital stock. As for potential employment, however, demographic developments mean that it will have only limited scope for growth in the future, despite the falling rate of natural unemployment. Consequently, its contribution to potential GDP is expected to remain close to zero.

Compared with the previous forecast, the outlook for the cyclical position of the economy has undergone a change due to the revised estimate for potential growth in previous years. Whereas the MTF-2010Q4 forecast took into account only the revision of overall real GDP, the current forecast reflects the complete revised structure of the historical GDP time series,2 particularly the substantial reduction in the levels of gross fixed capital formation in 2009 and 2010. As the amount of investments in this period is lower, so too is the capital stock, which implies less dynamic potential growth and therefore means that the output gap is narrower than originally estimated. The current forecast thus has a less negative output gap for 2009 and 2010, and therefore the gap can be almost completely closed by 2013. The faster closure of the output gap is also related to the current forecast's more positive outlook for real GDP growth.

4.2 INFLATION

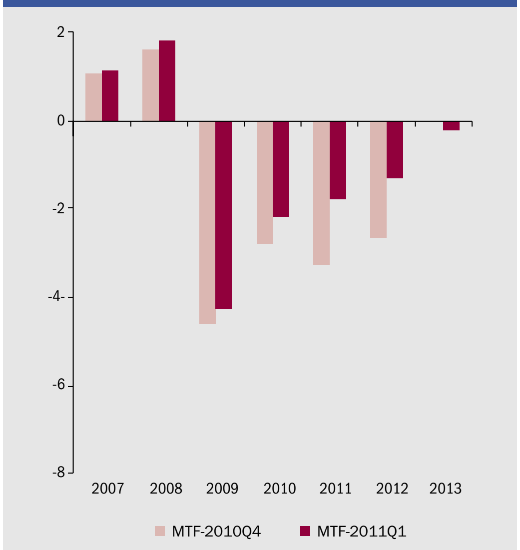
The inflation rate in the first months of 2011, as measured by the Harmonised Index of Consumer Prices (HICP), was marked by an upward trend as prices of goods and services rose at a faster pace. This development also reflect-

Chart 4 Contributions to potential GDP growth (p.p.)



Source: NBS.

Chart 5 Output gap (%)



Source: NBS.

2 *Revision of national accounts carried out by the SO SR in December 2010.*

ed adjustments to indirect taxes (VAT, excise taxes)[3] and the introduction of new charges in energy prices. The changes in goods prices include a higher year-on-year increase in energy and food prices and a slightly slower annual decline in prices of non-energy industrial goods. As for service prices, a higher rise was recorded in prices of transport-related services, housing-related services, other services, and healthcare and social services. The acceleration of the headline inflation rate in February 2011 was in line with expectations.

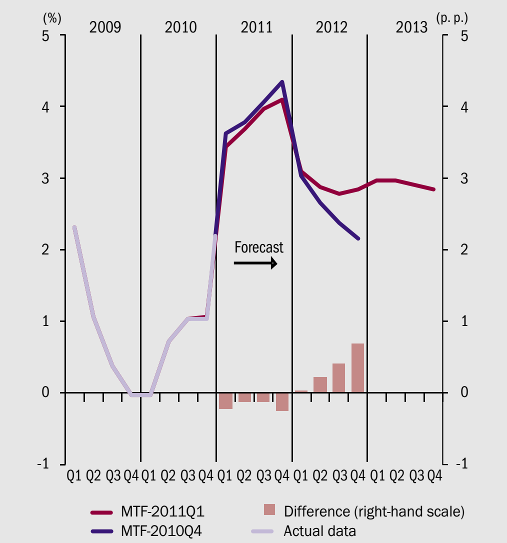
During 2011, the inflation rate may be expected to accelerate gradually, mainly due to food and fuel prices increasing in line with assumptions for commodity price developments. Prices of services and non-energy industrial goods are assumed to rise gradually in 2011 due to the recovery of demand and also as a result of cost impulses.

In the medium-term horizon, the rate of inflation is projected to slow down as the effects of indirect tax rises and commodity supply shocks fade away. The rise in the price level in 2012 and 2013 is expected to reflect an acceleration in prices of services and industrial goods, caused by positive developments in the labour market and rising consumer demand. The expected increase in prices of energy (gas and heat) in 2012 reflects not only current and expected developments in oil prices, but also the regulator's efforts to improve the efficiency of the main supplier of household gas and to take into account prices in the natural gas spot market.

This forecast assumes that consumer price inflation will reach 3.8% in 2011, 2.9% in 2012 and also 2.9% in 2013. Compared with the forecast in MTF-2010Q4, the inflation rate for 2011 is, given its current developments, expected to be lower. Consumer prices in 2012 are assumed to rise at a faster pace owing to the relatively sharp increase in regulated energy prices.

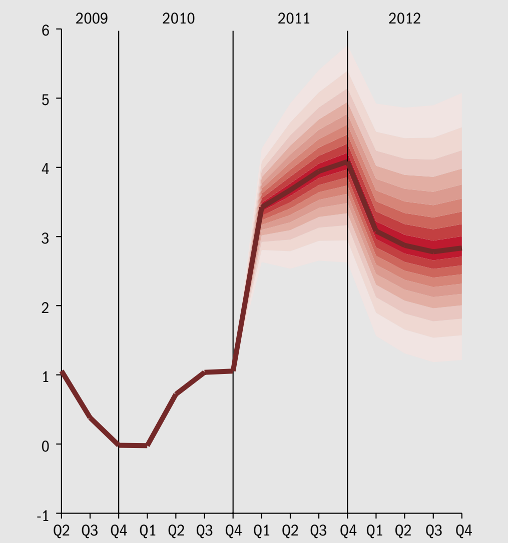
Compared to the results of a questionnaire survey, the medium-term forecast for inflation over the whole projection horizon appears to be somewhat underestimated. If all the reviewed risks materialised, the inflation rate could rise by 0.11 percentage point in 2011, 0.30 percentage point in 2012 and by 0.21 percentage point in 2013. The main upside risks to the inflation forecast may be oil prices, agricultural commodity prices, external inflation and employment. The downside risks include persistently low household demand as well as the possible stagnation of cigarette prices despite the rise in excise tax on cigarettes.

Chart 6 Changes in the HICP inflation forecast



Source: NBS.

Chart 7 HICP inflation forecast (%)



Source: NBS.

3 *According to the preliminary results of the analysis, the impact of the VAT increase on consumer prices at the beginning of 2011 was lower than projected in MTF-2010Q4.*

Box 1

SCENARIO OF FASTER OIL-PRICE INFLATION

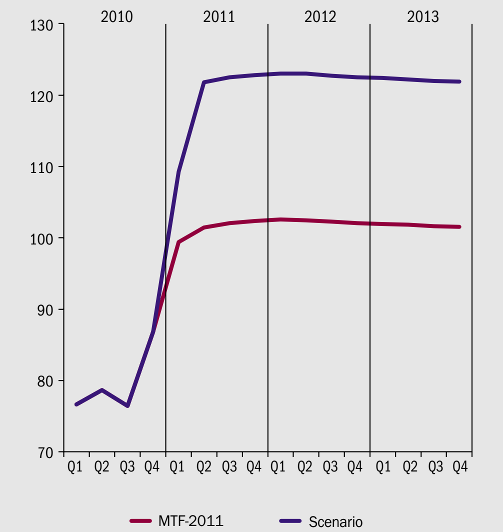
With the current political uncertainty in oil-exporting Arab countries, the risk of a further rise in world oil prices is materialising. The impact of accelerating oil prices is examined here using a risk scenario in which oil prices in the first half of 2011 are assumed to rise steadily by 20% more than the rate stated in MTF-2011Q1. The oil price in this case eventually exceeds 120 USD/barrel. The scenario assumes that the oil price throughout the projection horizon is more than 20% higher than the oil price projected in MTF-2011Q1.

Higher oil-price inflation is expected to be accompanied in the domestic market by a gradual increase in fuel prices and then also in regulated prices (mainly natural gas and heat prices). Given that higher oil prices have a longer pass-through to regulated prices (assuming that the Regulatory Office for Network Industries follows the most likely course and decides on changes to regulated prices once a year), inflation in 2011 is expected to be affected only by fuel prices and the secondary effects associated with them. This is assumed to increase the annual rate of HICP inflation by 0.3 percentage point in 2011. The full impact on the economy though regulated prices is expected in the first quarter of 2012, when the year-on-year increase in energy prices is projected to rise by 6.9 percentage points. Compared with the MTF-2011Q4 forecast, the headline inflation rate in 2012 should rise by 1.4 percentage point. In 2013, too, the fading of this price shock is expected to contribute 0.2 percentage point to the higher rise in prices.

The real economy is expected to experience mainly a slowdown in consumer demand. Higher inflation is assumed to reduce real disposable income and to have a direct impact on household consumption. There is a contrast between 2011, when economic growth is projected to be lower by 0.1 percentage point, and 2012, when the negative effect of regu-

HICP (%)	2011	2012	2013
MTF-2011Q1	3.8	2.9	2.9
scenario	4.1	4.3	3.1
difference (p. p.)	0.3	1.4	0.2

Chart A Oil price (USD/barrel)

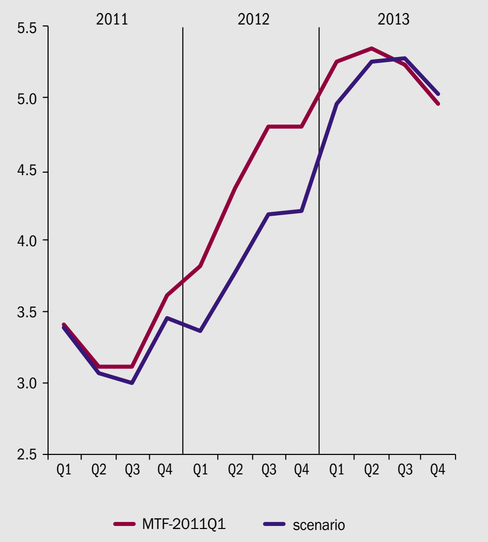


Source: NBS.

Chart B HICP (year-on-year increase)

Source: NBS.

Chart C GDP (annual percentage growth)



Source: NBS.

HDP (%)	2011	2012	2013
MTF-2011Q1	3.3	4.5	5.2
scenario	3.2	3.9	5.1
difference (p. p.)	-0.1	-0.6	-0.1

lated prices is expected to reduce all components of domestic demand by a relatively significant margin and to be most pronounced in household consumption (causing a decline of 1.2 percentage points). At the same time, import growth is projected to slow down due to import intensity. Overall, economic growth is expected to be slower by around 0.6 percentage point in 2012 and by 0.1 percentage point in 2013.

It is necessary, however, to note two factors which this scenario does not take into account and which could mitigate the impact of higher oil prices on the economy and prices. The first of them is the fact that when households are faced with economic shocks, they will usually dip into their savings as a temporary way of meeting part of their higher costs. Consequently, the reduction in household consumption would not necessarily reflect in full the decline in household disposable income, and therefore its impact on GDP growth in 2012 and 2013 could be mitigated or its transmission to the economy may be delayed. The second factor is the possibility that the oil shock is not fully transmitted to the regulated prices of natural gas and heat (owing to potential persisting differences between oil prices and gas spot prices), which could have a dampening effect on consumer price inflation. Lower inflation would then have a less negative effect on the real income of household, and therefore the impact on overall economic activity in 2012 and 2013 would be mitigated.

Table 3 Medium-term forecast (MTF-2011Q1) – main macroeconomic indicators

(annual percentage changes, unless otherwise indicated)	Actual data	Projection in MTF–2011Q1			Difference versus MTF-2010Q4		
	2010	2011	2012	2013	2011	2012	2013
Prices							
HICP inflation (average)	0.7	3.8	2.9	2.9	-0.1	0.3	-
CPI inflation (average)	1.0	3.7	2.8	2.9	-0.1	0.2	-
ULC[1] (compensation per employee at current prices / labour productivity ESA 95 at constant prices)	-2.7	1.5	2.5	2.3	-0.7	-0.3	-
Labour productivity ESA 95 (GDP at constant prices / employment ESA 95)	5.5	2.7	3.9	4.0	-0.2	0.4	-
Compensation per employee (current prices)	2.7	4.3	6.5	6.4	-0.9	0.1	-
Economic activity							
Real GDP	4.0	3.3	4.5	5.2	0.3	0.5	-
Final consumption of households	-0.3	1.6	3.8	4.5	-0.3	0.0	-
Final consumption of general government	0.1	-3.0	0.1	0.4	0.9	0.0	-
Gross fixed capital formation	3.6	2.6	4.0	5.5	3.5	0.4	-
Exports of goods and services	16.4	10.3	9.5	9.3	2.9	1.9	-
Imports of goods and services	14.9	7.1	8.5	8.8	2.2	1.6	-
Real gross disposable income of household income	-1.4	0.2	3.8	4.6	-0.3	0.0	-
Output gap (% of potential output)	-2.2	-1.8	-1.3	-0.2	1.5	1.4	-
Labour market							
Employment, (ESA 95)	4.0	3.3	4.5	5.2	0.3	0.5	-
Unemployment rate (LFSS,2%)	-0.3	1.6	3.8	4.5	-0.3	0.0	-
Balance of payments	0.1	-3.0	0.1	0.4	0.9	0.0	-
Economic openness (% of GDP)	3.6	2.6	4.0	5.5	3.5	0.4	-
Trade balance (% of GDP)	16.4	10.3	9.5	9.3	2.9	1.9	-
Services balance (% of GDP)	14.9	7.1	8.5	8.8	2.2	1.6	-
Current account (% of GDP)	-1.4	0.2	3.8	4.6	-0.3	0.0	-
Current and capital account (% of GDP)	-2.2	-1.8	-1.3	-0.2	1.5	1.4	-

Source: NBS.
1) ULC – unit labour costs.
2) LFSS – Labour Force Sample Survey.