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EUROSYSTEM



MEDIUM-TERM FORECAST

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Address:
Národná banka Slovenska
Imricha Karvaša 1, 813 25 Bratislava

Contact:
Monetary Policy Department
02/5787 2611
02/5787 2632
Communication Section
02/5787 2141
02/5787 2146

Fax:
02/5787 1128

<http://www.nbs.sk>

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SUMMARY

The first quarter of 2009 saw a substantial decline in GDP that reflected a drop in both domestic demand and net exports. The main factors in this development were the decrease in foreign demand – whose full impact on the Slovak economy was not felt until the first quarter of this year – and also the interruption of production at key companies owing to the disruption of gas supplies during the so-called “gas crisis”. The first-quarter decline in GDP is expected to contribute to the full-year fall in GDP being greater than projected in the previous forecast. The continuing slump in world demand amid the global economic crisis will affect the export performance of the domestic economy throughout the year. As a result of lower output in 2009, the employment rate is assumed to fall and compensation growth to decelerate, resulting in a slower rise in disposable income and therefore also in household final consumption over the coming period.

Because of the deepening global economic crisis, both the domestic part of the economy and foreign demand are expected to record steeper declines than projected in the previous forecast (MTF-2009Q1). Within domestic demand, the decrease in investments is expected to be more severe than that stated in the previous forecast, largely as a result of their development in the first quarter.

The inflation rate in the first months of this year was more favourable than predicted in MTF-2009Q1. The sharper than expected slowdown was caused by a decrease in the dynamics of all inflation components, but especially in food and energy prices. Inflation is expected to slow

in 2009 as the decline in economic activity leads to a lower rate of growth in all inflation components, but especially in prices of food and non-energy industrial goods.

The expectation for economic activity in the medium-term horizon is similar to that projected in MTF-2009Q1; activity is expected gradually to revive and even reach a slightly higher level. Growth in the Slovak economy should reflect a recovery in export performance in connection with the expected upturn in world demand. The acceleration of GDP growth should be driven by higher demand not only from abroad, but also from the domestic market. The rise in the output in period 2010-2011 will probably lead to favourable labour market developments and an increase in private consumption. Economic growth should receive a further boost in 2011 when the production of a new car model is launched.

The most significant risks to the MTF-2009Q2 medium-term forecast are that the global economic crisis will, through reduced foreign demand, have a deeper and more protracted impact on Slovak export performance, investments, and domestic consumption, and that lending conditions will be tightened considerably. Such developments could result in a substantially deeper decline in GDP in 2009, and in its more modest and later revival over the coming period.

As regards price developments in 2009, the prevailing risks are on the downside as a result of potentially adverse economic developments. In the medium term, there is an upward risk from price developments in commodities (especially oil).



TECHNICAL ASSUMPTIONS AND THE INTERNATIONAL ENVIRONMENT

The technical assumptions for the medium-term forecast and the international economic environment were taken from the Eurosystem's June forecast (Eurosystem staff macroeconomic projections for the euro area).^{1,2}

The assumption about short-term interest rates is of a purely technical nature. The methodology implies that the average level of short-term interest rates is at 1.2% between the second and last quarters of 2009 and at 1.6% in 2010. The projection takes into account the current tightness of financing conditions, but also includes the assumption that, over the projection horizon, they will ease gradually from their current state. The projection assumes that the average price of oil will rise in both 2009 and 2010. As regards other commodity prices, food prices are assumed to decline by 10.9% in 2009, before increasing slightly in 2010. The EUR/USD cross-rate for the

of non-energy commodities are expected to rise faster compared with the March projection (to decline more moderately in 2009). At the same time, the June projection assumes that interest rates will be lower (by 0.6 percentage points in 2009 and 0.5 p.p. in 2010) and the EUR/USD cross-rate will strengthen slightly (in March, it was projected at 1.29 EUR/USD for both years).

The current economic outlook continues to be driven mainly by the ongoing financial and economic crisis. Global trade experienced a plunge towards the end of 2008 and in early 2009. The downturn has become highly synchronized across countries, as the collapse of international trade has amplified the adverse effects of the initial financial crisis. However, it is broadly assumed that short-term indicators will stop worsening since they have probably bottomed out in recent months. Economic growth will revive

Table 1 Technical assumptions (year-on-year changes in %, unless otherwise indicated)

	Forecast from	Forecast for the period		
		2008	2009	2010
Oil (USD/barrel)	March 2009	–	49.3	57.4
	June 2009	99.9	54.5	65.5
Non-energy commodities	March 2009	–	-29.8	6.0
	June 2009	3.5	-24.7	9.2

Source: ECB.

projection was set as the average level prevailing in the two-week period ending on the cut-off date, i.e. 1.33 in 2009 and 1.34 in 2010.

In comparison with the ECB's March projection, the June projection assumes a slightly higher level of oil prices in both 2009 and 2010. Prices

steadily over the projection horizon. Overall, world GDP outside the euro area is projected to fall by 1.6% in 2009 but to grow by 2.1% in 2010. In 2011, NBS expects stability in commodity prices and a continuing modest revival in the world economy.

¹ The technical assumptions about energy and non-energy commodity prices are based on market expectations, with a cut-off date of 13 May 2009.

² More detailed information about the ECB projection is available at www.ecb.int



MEDIUM-TERM FORECAST FOR THE EURO AREA

The euro area economy has been adversely affected by the global economic weakness, fading confidence and tight financing conditions. According to Eurostat's flash estimate, real GDP in the euro area fell by 2.5% in the first quarter of 2009. This decline in GDP reflects a reduction in exports stemming from the situation in the world economy. This, in conjunction with low confidence and financing constraints, has also led to a substantial cut-back in business investment. Following a phase of stabilization, positive quarterly growth rates are expected by mid-2010. Among the domestic components of GDP, total investment is expected to decline. It is assumed that the fiscal packages announced in several euro area countries will contribute to a gradual economic revival. Private consumption growth is also expected to be subdued, but less so than growth in other demand components. This pattern reflects that of real disposable income growth, which is expected, on the one hand, to be negatively affected by the rise in unemployment, but, on the other hand, to be supported by low inflation and fiscal transfers. The economic

development will be negatively affected by the fall in employment over the whole period, particularly in 2009.

GDP growth over the projection horizon is expected to be markedly lower than was projected in March.

Following the sharp fall in HICP inflation since mid-2008, inflation is expected to continue to decline until mid-2009. In the short-term projection, inflation will reflect downward base effects and past falls in commodity prices. Thereafter, inflation is projected to rise again.

The projection range for the year-on-year rise in overall HICP inflation is slightly below that of the March 2009 projections for 2009 and unchanged for 2010. The largely unchanged projections reflect the fact that the impact of lower than expected economic activity is broadly offset by the assumed higher commodity prices, particularly oil prices.

Table 2 Projections of selected euro-area indicators (average year-on-year changes in %)

	Projection from	Projection for the period		
		2008 ¹⁾	2009	2010
HICP	March 2009	-	0.1 – 0.7	0.6 – 1.4
	June 2009	3.3	0.1 – 0.5	0.6 – 1.4
Real GDP	March 2009	-	-3.2 – -2.2	-0.7 – 0.7
	June 2009	0.6	-5.1 – -4.1	-1.0 – 0.4
Private consumption	March 2009	-	-1.2 – -0.2	-0.4 – 1.0
	June 2009	0.3	-1.3 – -0.5	-1.1 – 0.3
Government consumption	March 2009	-	1.3 – 2.1	1.1 – 1.9
	June 2009	2.0	1.4 – 2.0	0.9 – 1.7
Gross fixed capital formation	March 2009	-	-8.6 – -5.8	-4.3 – -0.3
	June 2009	-0.3	-12.3 – -10.1	-6.1 – -2.1
Exports (goods and services)	March 2009	-	-9.7 – -6.9	-0.9 – 1.9
	June 2009	0.8	-16.6 – -14.0	-2.0 – 1.0
Imports (goods and services)	March 2009	-	-8.0 – -5.0	-1.6 – 2.6
	June 2009	0.9	-13.8 – -11.2	-3.0 – 1.4

Source: ECB.

1) Actual data.



MEDIUM-TERM FORECAST FOR SLOVAKIA

THE REAL ECONOMY

BALANCE OF PAYMENTS CURRENT ACCOUNT

The **trade balance** for the first quarter 2009 was better than projected in the previous forecast, despite a sharp decline in imports and exports. This has been reflected in a slight improvement in the trade deficit estimate for the whole of 2009. It is expected that foreign demand will gradually revive in 2010 and 2011, in line with the previous projection, and that exports will return to growth. In terms of the trade balance in 2010, however, export growth is expected to be offset on the import side partly through the implementation of PPP projects (as also stated in MTF-2009Q1), meaning that the trade deficit improves only slightly. In 2011, as projected in the previous forecast, the positive impact of growth in foreign demand is expected to be largely offset by higher imports stemming from an increase in domestic demand. On the other hand, it is assumed that exports, as well as the overall trade balance, will be boosted in 2011 when the VW car factory launches production of a new model. Investment in the preparation for this new production is expected to be reflected negatively in increased imports in the second half of 2009 and early 2010.

Owing to the fall in foreign demand and consequent decline in the economy's export performance, it is expected that both exports and imports will show negative dynamics in 2009 and decline year-on-year by more than 20%. In 2010 and 2011, however, both exports and imports are assumed to make a gradual return to positive dynamics.

The main risks to the forecast are that the economic crisis may affect Slovakia's export performance in an unexpected way and that the oil price assumptions may change. The trade balance could also be adversely affected over the projection horizon by the possible construction of new nuclear and steam power plants, plans for which are currently under consideration. This

would cause a temporary deterioration in the trade balance by drawing in more imports.

Compared with the previous forecast, the **balance of services** is also expected to worsen in the period 2009–2011, owing to current developments in early 2009 that were largely reflected in lower revenues on services. The most severe negative effect may be expected in 2009, though the services balance will gradually improve on a year-on-year basis. By contrast, the **balance of current transfers** is expected to improve gradually over the projection horizon, in line with the previous forecast, and the **balance of income** deficit is likely to increase only slightly.

The **current account deficit** as a share of GDP is assumed to increase moderately in 2009, but the following years are expected to see a gradual decline in the deficit. Compared with MTF-2009Q1, the only substantial change in the ratio of the current account balance to GDP is projected for 2011, when the deficit is expected to decline owing to a rise in exports related to the expansion of car production.

LABOUR MARKET

In 2009, as projected in the previous forecast, **compensation per employee** is expected to reflect one-off effects (e.g. severance payments related to mass redundancies). The flexibility with which compensation reacts to the fall in economic activity is not, in the current climate, expected to be sufficient, and therefore the forecast assumes a negative correlation between productivity and labour costs. In the period 2010–2011, compensation per employee is assumed to increase more slowly than projected in MTF-2009Q1 as a result of a deterioration in economic activity and profitability in 2009. Since the labour market lags behind economic revival, the growth in compensation per employee is expected to slow in 2010. Related to this development is the cautious approach of employers (as well as government institutions) to higher-level collective agreements and the consequent mod-



erate agreed wage growth. In 2011, employee compensation is assumed to accelerate gradually in response to the economic revival and accompanying rise in labour productivity.

Owing to the severe downturn in economic activity and the related production constraints and mass redundancies, **employment** in 2009 is expected to be declining more sharply than projected in MTF-2009Q1. The rate of unemployment is therefore assumed to rise more sharply. The marked decline in real GDP in 2009 is expected to be reflected in the employment figures for the next year, too. Employment is likely to rise moderately in 2011 as a result of the gradual acceleration of economic growth.

In standard conditions, without pronounced structural changes, the trend development in the number of employed persons is not expected to diverge markedly from the number of hours worked in the economy. In view of the continuing economic crisis, however, it may be

assumed that employers will seek to respond to demand firstly by cutting down substantially the number of hours worked by their employees (through a reduction in working time, shorter working hours, fewer shifts) and then by significantly reducing their workforces. The forecast for 2009 therefore envisages that the number of hours worked will decline more sharply in comparison with the fall in the number of employees. It may therefore be expected that when the economy begins to revive, the number of hours worked will initially rise at a faster pace, and only then will the number of persons in employment increase.

The main risks to the labour market forecast for 2009-2011 are the real impact of the economic crisis, uncertainty about the effectiveness and duration of the government's measures aimed at eliminating the effects of the economic crisis, and the assumed behaviour of enterprises in response to lost profitability.

Box 1

ONE-OFF EFFECTS

In the current forecast (MTF-2009Q2), consideration is given to several one-off effects within individual components of GDP. One of these was the stocking-up of cigarettes in anticipation of an increase in the excise tax on tobacco and tobacco products as from February 2009. This effect was reflected in rising inventories in the 1st quarter of 2009, followed by the reduction and depletion of inventories during the next quarters, without having any impact on GDP growth in 2009. Another effect was the short-term shift in the behaviour of consumers, where they took advantage of exchange rate fluctuations by making some of their purchases in neighbouring countries. Household final consumption was substantially affected by the introduction of a scrapping scheme in Slovakia and the increased interest this generated in the purchase of cars. Consumption has risen, with car sales for the first three quarters of 2009 estimated to reach 44,000 (15,000 in 1Q, 20,000 in 2Q, and 9,000 in 3Q). With an im-

port intensity of 90%, the scrapping scheme has had the effect of increasing imports in 2009, and therefore its overall effect on full-year GDP is estimated to be minimal. It may likewise be assumed that the decline in household final consumption in the first quarter was partly caused by the sharp deterioration in consumer expectations amid the repercussions of the global economic crisis. Household confidence may, however, revive or correct during the rest of 2009. GDP in 2009 has also been significantly affected by the so-called gas crisis, which saw the interruption of production at major companies. It is assumed that this lost production will be partially made up for in the first and second quarters of 2009. Economic growth may be stimulated by infrastructure investments through PPP projects, the amount of which is expected to peak in 2010. An assumption incorporated for 2009 and 2010 is new investment in the car industry, which will be reflected in export production in 2011.

GDP

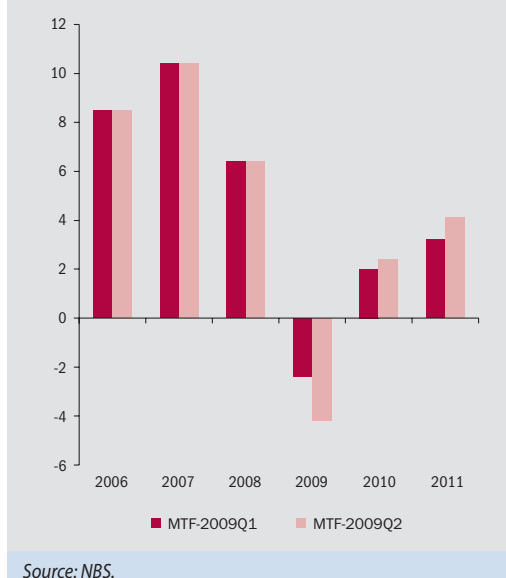
At the beginning of 2009, the development of the Slovak economy was determined mainly by the sharp drop in domestic demand, the deepening decline in foreign demand, and the interruption of production for several days in key Slovak industrial enterprises as a result of the gas crisis. Consequently, the decline in first-quarter GDP, both quarter-on-quarter and year-on-year, was more pronounced than had been expected. This was also reflected in the published monthly indicators (with falls in industrial production, revenues, and exports). In the coming period, the slowdown in the decline of foreign demand should prevent further deepening of the GDP decline from occurring. Domestic demand is likely to be boosted by infrastructure investments through PPP projects, and, to a certain extent, by the government's anti-crisis measures (e.g. the introduction of a "scrapping scheme"). As a result, however, of the economy's sharp downturn in the first quarter, the decline in full-year GDP for 2009 will be steeper than projected in the previous forecast.

The medium-term forecast for GDP for period 2010–2011 takes into account the expected revival of the world economy and investments in the automobile industry, all of which is expected to boost Slovakia's export performance, especially in 2011 (when the production of a new car model is due to be launched). Economic growth is therefore assumed to accelerate over the medium-term horizon and to reach slightly higher levels than those projected in MTF-2009Q1.

Domestic demand

Household final consumption in 2009 is expected to slow down in comparison with 2008, as a result of weaker growth in disposable income stemming from the labour market situation (a slower increase in compensation per employee and a decline in employment). The first quarter of 2009 saw a marked fall in consumption – largely resulting from a deterioration in household confidence that coincided with the most severe effects of the global crisis – and a sharp rise in the propensity to save. In 2010, household final consumption is expected to record modest growth in response to developments in real compensation per employee. It is also assumed that

Chart 1 GDP growth projection (annual percentage growth; constant prices)



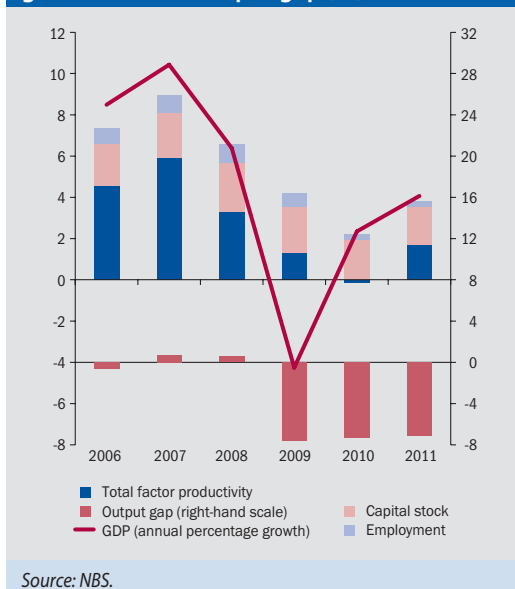
the economic revival in the following year will be favourably reflected in the labour market.

The forecast for **fixed investments** takes account of the negative effect of weaker foreign demand, which to a greater than expected degree has undermined companies' profits and the implementation of their investment plans, especially in the first quarter of 2009. This situation will be reflected in a substantial decline in investment in 2009. On the positive side, investment activities are expected to be boosted by PPP projects for infrastructure investment, as well as by significant investment in the car industry. In the medium-term horizon, investments in machinery and construction are likely to increase as a result of the economic revival.

Net exports

A greater than originally projected slowdown in foreign demand is expected to affect exports and imports of goods and services. Thus, net exports are expected to have a marked dampening effect on economic growth in 2009. With a moderate improvement in foreign demand assumed for 2010 and 2011, exports are expected to increase and net exports to make a positive contribution to GDP growth. A further boost to export performance is expected in 2011, when production of a new car model is launched.

Chart 2 Contributions to potential GDP growth and the output gap (%)



Despite the deterioration in the Slovak economy in comparison with the previous projection, there remains a downward risk to GDP development in 2009. The risk of a marked decline in GDP persists due to uncertainty about foreign demand in relation to the impact and duration of the global economic crisis. This risk could be passed on to export performance, investment, and domestic consumption through reduced foreign demand, and to domestic consumption and investment through lending conditions being tightened more severely than expected.

POTENTIAL GDP AND THE OUTPUT GAP

In this medium-term forecast of NBS, the current economic crisis is perceived as a crisis of demand. In other words, it is neither explained nor generated by the supply side of the economy – the supply side merely reflects the consequences of the crisis, whether through the slight slowdown in capital accumulation (caused by lower investments) or stagnating potential employment. However, none of these production factors are expected to record a negative pace of growth, and the drop in total factor productivity (TFP) is also seen as modest and temporary. As a result, potential GDP continues to grow without any drop in its level. The situation is different on the demand side, of course, where owing to the glo-

bal drop in trade, real GDP is declining sharply in 2009, causing the negative output gap to widen significantly.

As a consequence of the substantial inflow of foreign investments in Slovakia over the course of previous years, the average annual growth of TFP reached around 4%. It is assumed that this phase of dynamic growth will be replaced during 2009 with a slight decline in TFP (an average quarter-on-quarter fall of 0.2% is estimated) due to unutilized production capacities and the falling profits of companies struggling with declining demand. Following stagnation in 2010, a recovery is expected in 2011 (with TFP recording quarter-on-quarter growth of 0.5% by the year-end), and this should, in the medium term, lead to an annual rate of TFP growth slightly in excess of 2%.

The outlook for annual TFP data is distorted by the so-called carry-over effect, which is also reflected in the total growth of potential GDP (owing to the high quarter-on-quarter increases of TFP in 2008, the contribution of total factor productivity to the potential growth in 2009 is positive; TFP's quarter-on-quarter declines in 2009 will consequently be reflected in a negative annual contribution in 2010). Although the situation seems to be different in view of annual aggregates, the largest drop in TFP (as well as the most marked slowdown in potential) is being recorded in the first half of 2009. Beyond this horizon, the pace of growth is expected to rise and the supply side to consolidate. The same applies for the demand side of the economy, but the initial asymmetry in the impact of the economic crisis on the supply and demand sides is so large, and the widening of the negative output gap so pronounced, that even though real GDP growth slightly outpaces the rise in GDP potential on the projection horizon, it will not ensure, in the medium term, anything more than a very slow return of the economy to the level of its capacities.

HICP

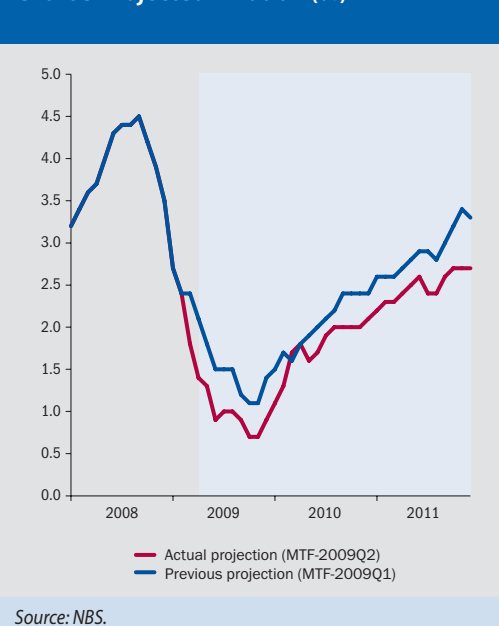
HICP inflation recorded a steady decline in the first months of the current year, slowing from 3.5% in December 2008 to 1.4% in April 2009



– a more favourable development than was projected in MTF-2009Q1. The drop in the year-on-year inflation rate largely reflected a slowdown in the dynamics of food and energy prices. The year-on-year rise in food prices was affected by the base effect of high increases in the same period of the previous year and by this year's sharper fall in prices of food commodities on the European market. World oil prices had a dampening effect on energy prices, particularly fuel prices, and at the same time enabled the Regulatory Office for Network Industries (ÚRSO) to reduce certain energy prices (heat) for households. The fall in import prices was also reflected in a slower rise in prices of non-energy industrial goods. The slower increase in the prices of services resulted from price developments in transport, recreation, and personal services.

The current forecast assumes that inflation will gradually decline and reach its lowest level in October 2009 (0.7%). Thereafter, it is expected to accelerate to 0.9% at the end of 2009, to 2.1% in December 2010, and to 2.7% in December 2011. This trend is driven by all inflation components. The main factor, however, is the slowdown in economic activity in 2009, both domestically and globally, and its gradual revival over the period 2010-2011, which may be reflected in more sharply rising consumer prices.

Chart 3 Projected inflation (%)



Compared with the previous forecast (MTF-2009Q1), the current forecasts for both year-end inflation and average annual inflation over the whole projection horizon are lower. In 2009, this is expected to be affected by a slower increase in prices of food and non-energy industrial goods and by a sharper decline in economic activity. In-

Table 3 Comparison of HICP inflation forecasts (year-on-year changes in %; average for the period)

	2008	2009	2010	2011
MTF-2008Q4	3.9	2.7	3.2	–
MTF-2009Q1	3.9	1.7	2.0	2.9
MTF-2009Q2	3.9	1.3	1.8	2.5

Source: NBS.

Table 4 Comparison of HICP inflation forecasts (year-on-year changes in %; end-of-year figures)

	2008	2009	2010	2011
MTF-2008Q4	3.4	2.8	2.8	–
MTF-2009Q1	3.5	1.4	2.4	3.3
MTF-2009Q2	3.5	0.9	2.1	2.7

Source: NBS.



flation in the medium-term horizon is expected to rise at a more moderate rate than that projected in MTF-2009Q1, owing to the slower revival in the world economy.

Regulated prices could rise by an average of 5.0% in 2009 and 2.7% in 2010 and 2011 (MTF-2009Q1 projected 4.2% for 2009, 3.1% for 2010 and 2.7% for 2011).

Overall inflation excluding energy and unprocessed foods (core inflation) is expected to average 2.1% in 2009, 2.2% in 2010, and 3.1% in 2011.

In the current inflation forecast for 2009, the risks are predominantly on the downside, since the decline in global economic activity may lead

to another greater-than-expected fall in foreign demand for Slovak products and services. At the same time, the decline so far recorded in energy commodity prices (second half of 2008 and first quarter of 2009) may create scope for a reduction in certain regulated energy prices (gas and heat) during 2009. In the medium-term horizon, however, upward risks predominate, especially in energy commodity prices. This is also indicated by current developments, with the price of oil now higher than projected.

Deflation remains a risk, albeit a small one, during 2009, partly because of the ongoing nominal convergence of Slovakia. If regulated prices were to be reduced as early as this year (the secondary effects of which would be seen in prices of services), inflation could approach zero.



Table 5 Medium-term forecast (MTF-2009Q2) – main macroeconomic indicators

	2008	2009	2010	2011	2009	2010	2011
	Actual	Forecast			Difference versus MTF-2009Q1		
Prices (annual percentage changes)							
HICP inflation (average)	3,9	1,3	1,8	2,5	-0,4	-0,2	-0,4
CPI inflation (average)	4,6	2,1	2,5	2,9	-0,3	-0,2	-0,4
ULC (compensation per employee at current prices / labour productivity ESA95 at constant prices)	5,3	6,0	0,0	1,6	1,7	-0,9	-0,8
Labour productivity ESA95 (GDP at constant prices / employment ESA95)	3,5	-2,7	2,5	3,7	-1,6	0,6	0,6
Compensation per employee (current prices)	9,0	3,1	2,5	5,4	0,0	-0,3	-0,2
Economic activity (annual percentage change; unless otherwise indicated)							
Real GDP	6,4	-4,2	2,4	4,1	-1,8	0,4	0,9
Final consumption of households	6,1	1,0	0,3	3,6	0,0	-1,1	0,5
Final consumption of general government	4,3	2,2	2,1	2,8	-2,2	0,2	0,5
Gross fixed capital formation	6,8	-8,8	3,2	2,0	-8,4	0,7	-1,5
Exports of goods and services	3,2	-18,4	0,8	6,7	-10,1	0,5	3,3
Imports of goods and services	3,3	-17,0	0,3	5,2	-12,2	0,4	1,9
Gross real disposable income of households	7,2	2,9	0,8	3,2	-0,4	-0,3	0,5
Output gap (% of the potential output)	0,5	-7,6	-7,3	-7,1	-1,7	-1,0	-1,0
Labour market							
Employment, based on ESA95 (annual percentage change)	2,8	-1,6	-0,1	0,3	-0,3	-0,3	0,2
Unemployment rate, LFSS-based (%)	9,6	11,5	12,0	12,1	0,4	0,3	0,4
Balance of payments							
Economic openness (% of GDP)	166,8	137,6	134,2	135,3	-11,9	-11,4	-9,0
Balance of trade (% of GDP)	-1,1	-3,0	-2,5	-1,5	0,2	0,4	1,0
Balance of services (% of GDP)	-0,7	-1,1	-1,0	-0,8	-0,3	-0,3	-0,2
Current account (% of GDP)	-6,5	-7,5	-6,4	-4,8	-0,2	0,0	0,8
Current and capital account (% of GDP)	-5,3	-5,9	-4,3	-2,8	-0,2	0,1	0,8

Source: NBS.

Note: LFSS stands for Labour Force Sample Survey.

