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Slovak economy will gallop at a faster pace

Macroeconomic forecast for 2014 – 2018

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Primarily owing to the robust private consumption, economic growth is expected to pick up to 2.9% YoY this year. Consumers´spending will be driven by continuing improvement on the labor market, but the inflation stagnation will be a key to solid real wage growth. Collapsing oil prices will support economic growth of key trading partners as well, and that will help export to recover from last year´s negative trend.

ECB kicks off QE program lasting until September 2016

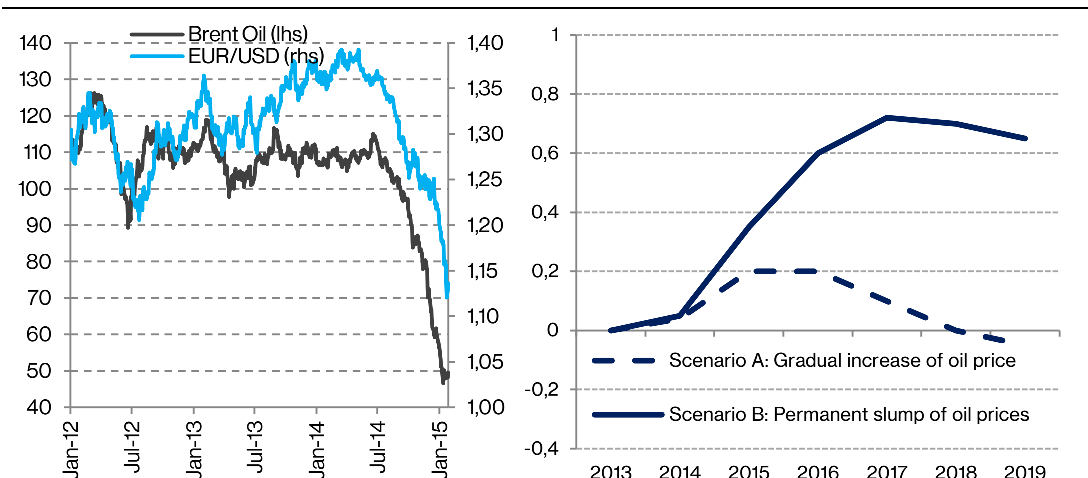
Central banks´monetary policies, geopilitical tensions and an eye-catching slump of oil prices determined the financial markets´trends in the last months. The ECB revealed its long awaited expansion of bond buying program in January. From March on, the ECB will be buying asset backed securities in the amount of 60 bln. Eur per month. This decision should help the bank to meet its medium-term inflation target. In the reaction, the euro depreciated to 12-month lows. On the other hand, the FED exitted its bond buying program, mostly due to positive development of the US economy. Market observers expect the first interest rate hike in 3Q. The ongoing Russian-Ukraine geopolitical conflict has induced an increase of the stock market volatility. Nevertheless, the major stock indices continued posting strong gains.

Oil prices fall sharply mainly on the supply factors

The US dollar appreciated against the basket of currencies. The US economic recovery, expected FED interest rate hike and the monetary policy easing in the Euro Area and Japan have been the main drivers of this development. In contrast, the oil price has slumped dramatically in the last two quarters. The drop in oil prices has been caused by the combination of factors: increase in the US production, drop in demand from Asia and fear of OPEC members about losing their market share in case of supply cuts. The fall in oil prices accelerated after OPEC meeting in Vienna, where decision about not cutting the production had been made.

Chart 1: Bearish trend in EUR/USD and collapsing oil prices

Chart 2: Contribution of decrease in oil prices to GDP growth (%, level)



Source: Bloomberg

Source: IMF

Growth in Euro Area is stable but slow

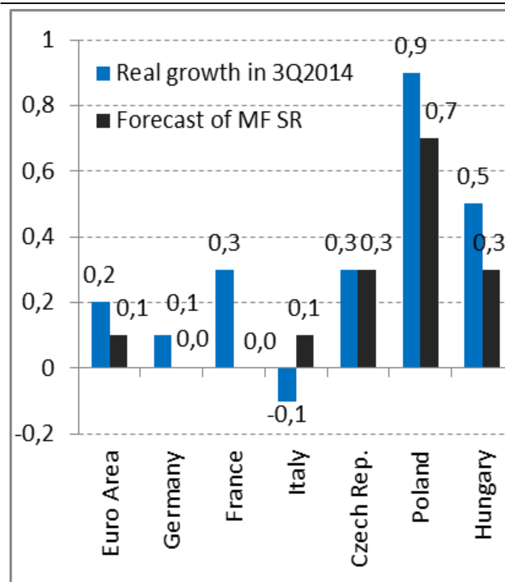
Economic growth in Eurozone is stable but slow. Euro Area grew by 0.2% on quarterly basis in the third quarter of 2014. Full-year annual GDP growth is expected to end up at 0.8% annually in 2014. The dynamic growth of German economy from the beginning of 2014 has faded away. German economy also suffers from the lack of the investment. The other major economies of the Eurozone are in even more difficult position. France is balancing on the edge of the recession while Italian economy has not grown since 2011. The gradual decline in inflation was observed during the whole previous year. In December the Eurozone slid into deflation for the first time in the history. Slow economic growth together with deflationary trend limits the strategy of fiscal consolidation and debt deleveraging.

Collapse of oil prices will support recovery in the Euro Area

Collapse of the oil prices and depreciation of euro currency will stimulate European economies. The sudden fall of oil prices decreases production costs and increases real wealth of consumers in the oil importing countries. The secondary-round effects include also an increase in investment and employment. The euro depreciation supports the export competitiveness and partially curb the deflationary trend in the Eurozone. **Decline of the oil prices and euro depreciation would contribute positively to the overall GDP growth in the Eurozone in range from 0.2% to 0.8% in current year.**[1]

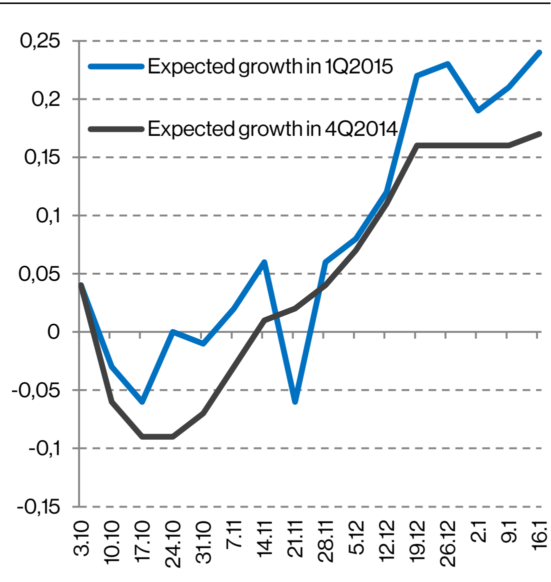
Euro Area will grow above 1% in 2015. Leading indicators bounced back from the lows witnessed in autumn and currently suggest a space for gradual acceleration of economic growth. More visible improvement of the soft indicators was observed in Germany.

Chart 3: q-o-q GDP growth of Slovakia's main trading partners in 3Q2014



Source: Eurostat, IFP

Chart 4: Rebound of leading indicators (Q-o-Q GDP growth in Euro Area)



Source: IFP

Foreign demand indicator revised upwards in 2015

The estimate of the aggregate economic growth of our main trading partners in 2015 remains unchanged. Neighboring central European countries are expected to grow faster than the Euro Area. Their mild slowdown in 2016 will be fully offset by acceleration of the Euro Area economies. **The weighted import estimate for 2015 was revised upwards due to a more positive structure of GDP growth in economies of our main trading partners.** The forecast for period 2016-2018 remains almost unchanged. The forecast of foreign prices and deflators was significantly revised downwards with

[1] Based on the estimation of the IMF published in recent WEO Outlook

respect to disinflationary trend in the Euro Area. The assumptions related to the external demand are taken from the OECD Autumn forecast and IMF WEO outlook and corrected for the growth observed in 3Q of the past year and a very short forecast (nowcasting) of the Eurozone. Assumptions related to the external environment, interest rates and commodity prices are based on information available at the of January 20.

Table 1: Development of external enviroment in 2014-2018

	GDP (% growth)					Diff. from Sept. 2014				Import (% growth)					Diff. from Sept. 2014			
	2014	2015	2016	2017	2018	2014	2015	2016	2017	2014	2015	2016	2017	2018	2014	2015	2016	2017
Main trading partners	**2.1**	**1.8**	**2.1**	**2.2**	**2.3**	**0.1**	**0.0**	**-0.1**	**0.0**	**6.4**	**4.5**	**5.1**	**4.8**	**4.9**	**1.3**	**0.4**	**-0.1**	**-0.1**
of that ***Eurozone***	0.8	1.2	1.5	-		0.0	-0.1	-	-	3.0	3.5	4.0	-	-	0.1	1.3	-	-
Germany	1.4	1.2	1.6	-		0.1	-0.3	-	-	3.5	4.2	5.7	-	-	-0.5	-0.1	-	-
Czech Rep.	2.4	2.6	2.6	-		0.0	0.1	-	-	8.1	6.5	6.2	-	-	1.2	1.8	-	-
Poland	3.3	3.2	3.0	-		-0.1	-0.1	-	-	7.3	5.0	6.5	-	-	0.0	0.3	-	-
Hungary	3.0	2.3	2.1	-		0.3	0.2	-	-	7.8	5.3	4.8	-	-	2.0	0.3	-	-

Source OECD , Bloomberg, IFP

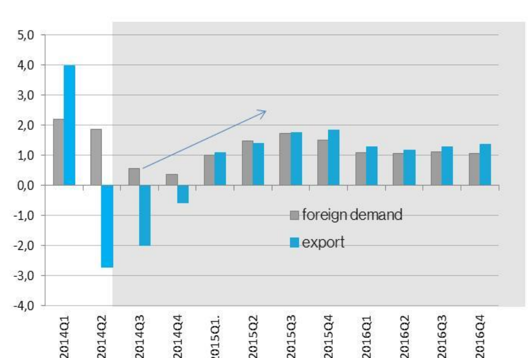
The economy in 2014 was driven only by domestic demand

Slovak economy should grow by 2.4% in the previous year. After five years of growth driven mainly by the foreign demand, purely domestic demand was in the role of the locomotive last year. Positive surprise in the development of retail sales at the end of the year indicates a strong growth in consumer spending. Nevertheless, the household saving rate should reach a new post-crisis peak. The recovery in bank lending along with assumptions about the public investment signals acceleration of the investment in 4Q. On the other hand, exports are likely to decline for the third consecutive quarter, mostly due to the weak automotive industry performance. Overall, we expect only a slight slowdown of the growth at the end of the year on the quarterly base.

Chart 5: Contributions of GDP components to growth (in ppt.)

Source: SÚ SR, IFP

Chart 6: Gradual recovery of the export performance (QoQ growth in %)



Source: ŠÚSR, IFP

Supply shock positively affects the economic growth in 2015

In 2015 the economic growth should accelerate and reach 2.9%. Forecast for 2015 is positively influenced by the supply shock. The fall in oil prices through lower inflation translates into acceleration in domestic demand, which will continue to be the main growth driver. Higher growth in household consumption reflects the ongoing positive

development in the labor market, positive consumer sentiment and only a gradual decline in the saving rate in the second half of the year. Investment growth will be driven mainly by the private sector. Growth of exports should return to positive numbers on quarterly base with the recovery of gaining market shares in the second half of the year

In the following years we expect an acceleration of growth to 3.6% in 2016 and 2017 and 3.7% in 2018. The positive effect of the oil shock and its direct impact on household consumption will gradually wan. However, export performance should recover, which should contribute to a more balanced growth structure. The rate of investment should ease due to the negative contribution of waning one-off factors in the automotive industry.

Table 2: MF SR forecast – main economic indicators (January 2015)

indicator (growth in % unless otherwise noted)	actual	forecast					Diff. from Sept. 2014				
	2013	2014	2015	2016	2017	2018	2014	2015	2016	2017	2018
Gross domestic product											
GDP, real	1.4	2.4	2.9	3.6	3.6	3.7	0.0	0.3	0.1	0.1	
GDP, nominal (bn €)	73.6	75.1	77.3	81.3	85.7	90.6	0.0	-0.6	-0.9	-0.9	
GDP, nominal (bn €), ESA 2010	-0.8	2.4	2.8	2.7	2.8	2.9	-0.5	0.4	0.0	0.6	
Private consumption, real	0.6	1.9	2.7	4.4	4.5	4.9	-0.9	-0.7	-0.2	0.2	
Private consumption, nominal	2.4	3.7	2.1	1.1	1.2	1.3	1.7	5.9	1.4	1.4	
Public consumption	-2.7	4.6	3.7	1.8	1.7	2.1	-0.2	1.0	0.4	-0.2	
Fixed investments											
	5.2	4.1	1.4	5.9	6.0	6.1	-0.4	-2.8	-0.1	-0.1	
Export of goods and services	3.8	4.7	1.0	4.5	4.9	4.8	-1.0	-2.4	-0.2	-0.2	
Import of goods and services											
Labor market	-0.7	1.1	0.6	0.7	0.7	0.8	0.1	0.2	0.2	0.2	
Employment (stat. evidence)	2.4	4.4	2.6	3.9	4.4	4.6	0.1	-0.7	-0.3	-0.1	
Wages, nominal	0.9	4.4	2.6	2.3	2.6	2.6	0.3	0.5	0.0	0.3	
Wages, real	14.2	13.4	12.9	12.2	11.4	10.5	-0.1	-0.2	0.0	0.1	
Unemployment rate											
Inflation	1.4	-0.1	0.0	1.6	1.8	2.0	-0.2	-1.0	-0.3	-0.3	

Source: ŠÚ SR, IFP

Faster recovery of the labor market

The labour market improvement should continue. Economic growth driven mainly by domestic demand will result in solid growth of employment. Approximately 14 thousand of new jobs should be created, primarily in the service sector. Construction will rebound after deteriorating in 2014, while employment growth in the industry will slow down. Instead, the manufacturing will witness accelerating labor productivity growth again. These developments result into a decrease in the **unemployment rate slightly below 13 %**. Gradual acceleration of employment growth implies approaching almost 10% level of unemployment at the end of the forecasted period.

Real wage growth above productivity again this year

Real wages will continue in solid growth. Though slower than in the previous year, the pace of wage growth will be the second fastest growth in the post-crisis period. The reason is predominantly stagnation of inflation. Scissors between the real wages growth and labor productivity will close only partially. Zero inflation should affect wage bargaining in the private sector only in part: we assume that a third of the inflation

surprise will have a positive impact on the growth of real wages, which will be supported by faster growth in labor productivity as well. Looking at the sectors, we expect similar growth rates in all sectors, except the construction which should witness only a anemic growth. The average nominal wage in 2015 should reach 882 euros.

Prices will not grow in 2015

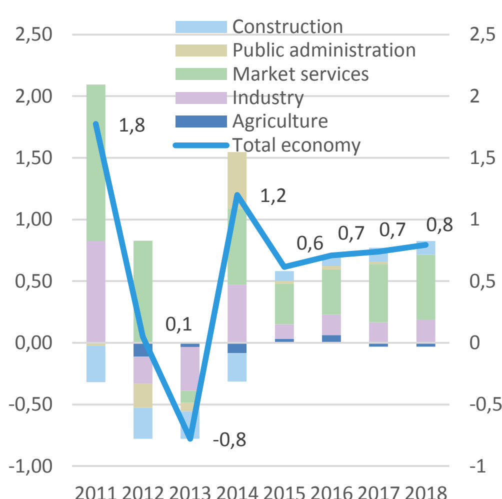
Consumer prices will stagnate in 2015. The deflationary trend observed in previous months will be supported by the fall of oil prices during the first half of the current year. Decrease of gas, electricity and heat prices also contributes to non-inflationary dynamics. The domestic inflation pressures arising from strong labor market performance combined with weak euro and monetary policy easing will lead to gradual acceleration of the net inflation in the second half of the year. Despite the gradual rise in consumer price dynamics, inflation will be hover well below the rates corresponding to the expected economic economic growth and it will reach the standard levels only at the end of forecasted period in 2018.

Inflation dampened by the collapse of oil prices

Stagnation of consumer prices is a result of a positive impact of the cost factors amplified by global disinflationary trend. Disinflationary impulse from the cost side arises mainly from the collapse of the oil prices which is followed by the decrease of other energy commodities. The secondary effects of the decline in energy prices will transmit into slower growth of prices of the tradable goods. Domestic demand pressures have not yet visibly translated into price dynamics of market services. The dynamics of the latter has remained subdued vis-à-vis the pace of household consumption.

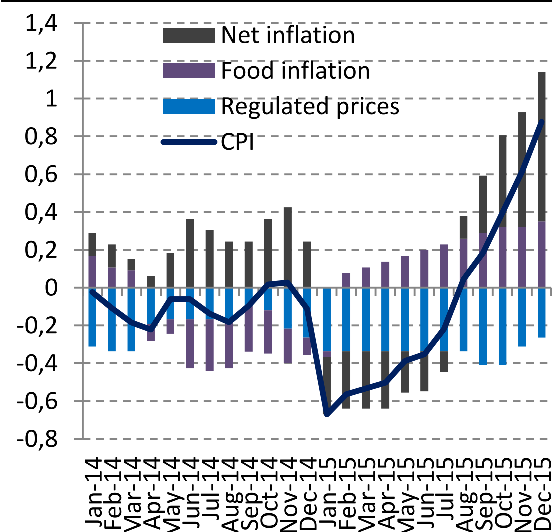
Risks for the domestic price development are balanced. Currently observed fall of oil and gas prices can be potentially mirrored in additional decrease of the regulated prices during this year (particularly gas prices). On the other hand, loose monetary policy together with weak euro and strong domestic wage growth might result in a faster acceleration of the prices of market services and industrial goods.

Chart 5: Contributions of sectors to employment growth (in p.p.)



Source: SÚ SR, IFP

Chart 6: y-o-y growth of CPI and contributions of individual components (p.p.)

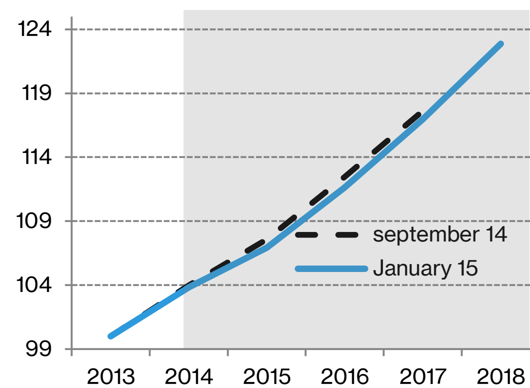


Source: IFP

Low inflation environment curbs the growth of tax bases

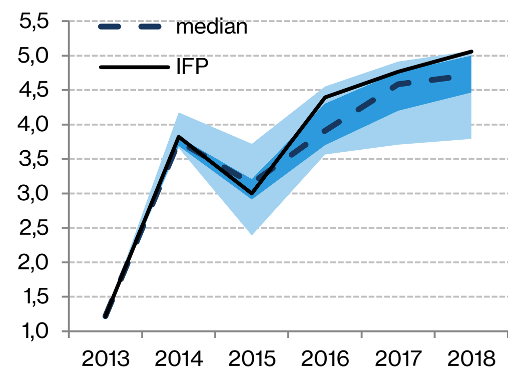
Despite the upward revision of real economic indicators, the overall impact of the update of the macroeconomic forecast on the tax bases is negative compared to September. The negative gap opens particularly in 2016. Improvement of the labor market outlook and the upward revision of the economic growth is more than offset by slower inflation on the whole forecasted period[2]. The impact of the macroeconomic forecast on the estimate of taxes and contributions will be discussed on the Tax forecast committee on February 10th 2015.

Chart 7: Macroeconomic tax bases compared to September forecast



Source: IFP

Chart 8: Comparison of forecasts of macroeconomic bases[3] with the members of the committee



Source: IFP

The medium-term macroeconomic **forecast** by the MF SR has been the subject of discussion of the Macroeconomic forecasts committee on January 29th 2015 and it **has been evaluated by the majority of committee members as realistic** (NBS, Infostat, SLSP, Unicredit VÚB a Sberbank), while Tatrabanka marked it as optimistic. Detailed macroeconomic forecast, together with the minutes from the meeting of the Committee and supporting materials, is available on the IFP website.

[2] Changes in the price level are not automatically reflected in the fiscal framework and the government budget balance. Lower growth of prices automatically results in lower growth of certain government expenditures.

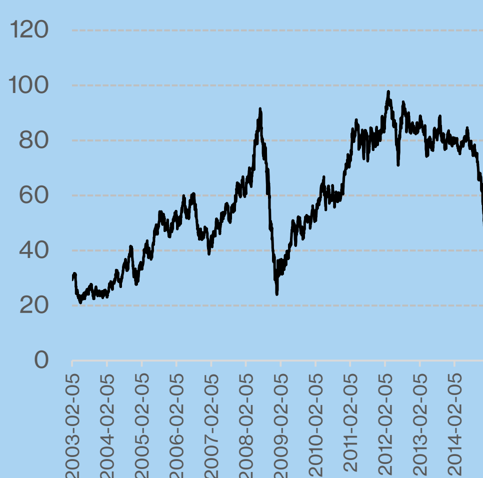
[3] Macroeconomic basis for the budget revenues (weight of indicators depends on the proportional share of the particular tax on the total tax revenues); Wage base (employment x nominal wage) – 51,1%; Nominal private consumption – 25,7%; Real private consumption – 6.6%; Nominal GDP growth – 9.9%; Real GDP growth – 6.7%.

BOX. The True Black Gold

The oil price drop will increase Slovak GDP by 0.3 percent within the next two years. Most of the positive effect for the economy will be delivered in 2015, while the effect will gradually vanish in 2016. Higher growth will be accompanied by lower inflation.

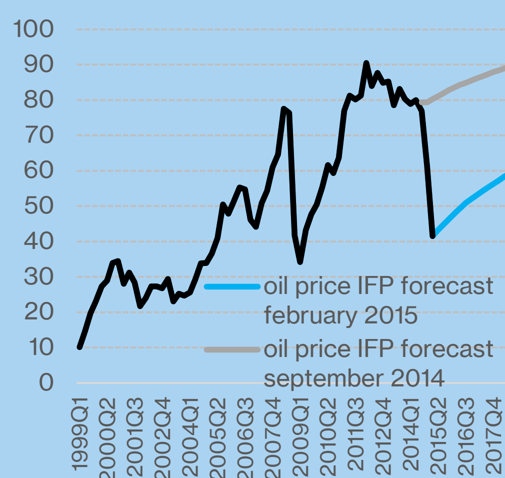
BRENT price fell in the last quarter of 2014 from eur 80 to almost eur 40 per barrel. This shock will likely influence Slovak economy in the medium-term. Oil price expectations based on future contracts suggest that the shock might be rather persistent and that price might increase only gradually towards eur 60 per barrel in 2018.

Graf A: BRENT price sunk ...



Source: FRED

Graf B: ... and could possibly stay lower throughout the whole forecasting period



Source: FRED, IFP

To evaluate the effects of the oil price drop, the nature of the shock must be first identified. In case of the demand shock, the price of oil falls due to lower economic activity in the world economy. In case of the supply shock, the oil price decreases due to improvements in the oil market itself (tough competition, technological progress, new oil fields discoveries, etc.). The IMF estimates[4] that most of the current price drop stems from supply side, while only 20 to 35 percent is a result of the demand factors. Other estimates, however, suggest that the ratio could be 1:1[5]. Thus, the overall effects on the economy should be rather positive.

Two scenarios are compared when evaluating the effect of the oil price shock on the economy[6]. In the baseline scenario the oil price follows the IFP forecast from

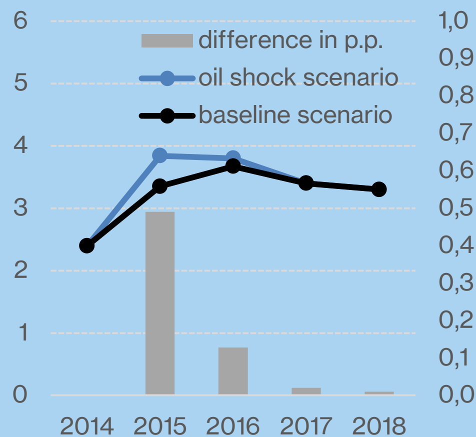
[4] http://blog-imfdirect.imf.org/2014/12/22/seven-questions-about-the-recent-oil-price-slump/

[5] http://econbrowser.com/archives/2015/01/whats-driving-the-price-of-oil-down

[6] The IFP estimate is based on the simulation from the two-country GAP model: Slovakia and Eurozone. Both economies are characterized by sevaral behavioral relations (dynamic IS curve, New-Keynesian Phillips Curve, Taylor rule) and together they are tied with the uncovered interest parity. While the Slovak economy is influenced by the development in the Eurozone, the Eurozone is not affected by the Slovak economy. The price of oil affects the Phillips curve and potential output. Parameters of the model for the Eurozone were calibrated according to Carabenciov, et al.: *A Small Multi-Country Global Projection Model with Financial-Real Linkages and Oil Prices*, IMF Working Paper No. 08/280, 2008, while the experts' calibration was used for the rest of the parameters.

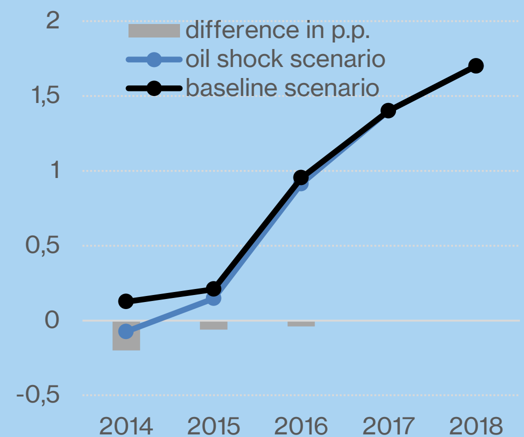
September 2014. The oil shock scenario assumes the oil price dip as witnessed in 4Q-1Q and then expects a rebound towards eur 60 per barrel as the future contracts suggest. Results of the oil shock scenario should be viewed as the most optimistic outcome as the shock is modelled fully as a supply shock in the model.

Graf C: Lower prices of oil affects economic growth mainly in 2015 (in %)



Source: IFP

Graf D: Inflation is expected to be lower in 2015 and 2016 (in %)



Source: IFP

Comparing the two scenarios show that a fully supply shock would increase Slovak GDP by 0.5 percent by the end of the forecasting period in 2018. However, assuming that part of the decline in price should be attributed to the lower demand in the world economy, the overall effect is expected to be only approx. 0.3 percent. This benefit will be visible in the economy mostly in 2015, while it will gradually fade away in 2016. The oil shock will curb inflation rate as well, approaching to zero in 2015.

Results from the simulation in GAP model implies slightly larger effect of the oil shock on the economic growth when compared to the model IFPmod, which is used by IFP for the comprehensive macroeconomic forecasting. On the other hand, the effect on the inflation has smaller amplitude in 2015 and it suggest slower inflation pick-up in following years (compared with IFPmod). Hence, the new IFP macroeconomic forecast may have some upside risks with regards to the transmission of the oil price shock to the real economic indicators.