IFP
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New macro forecasts put Slovak 2012 growth at 1.7% with the negative impact on public finances at 0.9% of GDP

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Turbulences in financial markets and the resulting uncertainty worsen the economic outlook of the Eurozone, including Germany, which will inevitably affect the Slovak economy. The German economic growth is expected post a mild recession in 4Q11-1Q12. IFP has therefore again revised its forecast of GDP growth in Slovakia in 2012 downwards to 1.7%. The slowdown is more pronounced this time and will therefore have an impact on the Slovak labor market. This will mean a negative shortfall of 0.9% of GDP for the public finances in 2012.

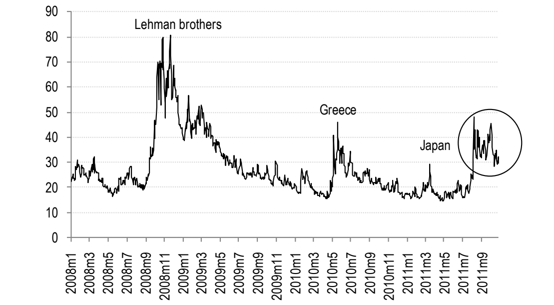
IFP has published its macroeconomic forecast in August and was among the first finance ministries in the EU to officially adjust its forecasts due to the sudden developments in financial markets in August. The estimate of real GDP growth has been lowered by 1% to **3.4%**, so that the upcoming state budget discussions would already reflect the worsened state of the global economy. This goal was achieved and Slovakia, in contrast to the majority of EU countries, has passed a budget in the government that reflected (at least partially) the changed global conditions. Three weeks later the **IMF** "confirmed" the IFP forecast (with 3.3% growth forecast). And a month later **NBS** has published a forecast of **3.8%** growth for 2012, which indicated that the IFP forecast might have been on the conservative side.

Slowdown of the external environment

However, since the end of August the situation on the financial markets has not calmed down and according to the leading soft indicators it is spilling over to the real economy of our trading partners. The debt crisis in the Eurozone requires additional tightening of fiscal policy of large countries such as Italy and France. Moreover, as a result of this nervousness, the risk premia of these countries' debt remain at the long-term maximums. This in turn makes financing their debts more expensive and increases the pressures for austerity. The investors' mistrust gradually impacts the Eurozone banking sector. Difficult financing through stock markets and the need for recapitalization contributes to the spillover of the debt crisis from the financial market into the real economy.

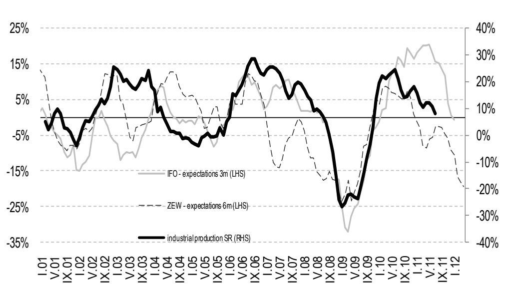
The soft indicators measuring the mood towards the future economic development are falling. The confidence indicators in the EU and in the Eurozone have fallen below the long-term average. The German businesses' expectations (IFO index) suggest a pronounced slowdown of the economic activity in our most important trading partner. "Less reliable" index of German analysts (ZEW) indicates even the threat of the deeper recession. At this point, the question is whether these negative expectations will translate into hard figures (which so far remain positive), or whether this is an overreaction.

Chart 1: Unpredictable development – Stock volatility index VIX



Source: Reuters

Chart 2: Expectations in Germany and industrial production in Slovakia



Source: Reuters

IFP has updated the estimate of future development of our trading partners and at the moment expects **a very mild recession in Germany in 4q11 and 1q12**, and subsequent rebound in the second half of next year. **The assumption behind the new forecast** therefore is that the **debt crisis will not accelerate** towards the large economies and the banking sector in the Eurozone will not freeze. The second assumption is that despite the complicated political situation, the **USA will manage to come to a compromise regarding the fiscal consolidation**. The third main assumption is that the main political parties **will not cast doubt on the goal of**

bringing the deficit below 3% of GDP in 2013, and thus avoiding the loss of confidence in the Slovak economic policy in financial markets, which would require immediate and extensive austerity measures.

The current forecast expects a large slowdown of foreign demand in 2012, the economic growth in the countries of our largest trading partners should reach **0.8%** (previously 1.8%). We still do not expect that the current debt crisis will result in the recession in the Eurozone

Table 1: External environment 2011 – 2014

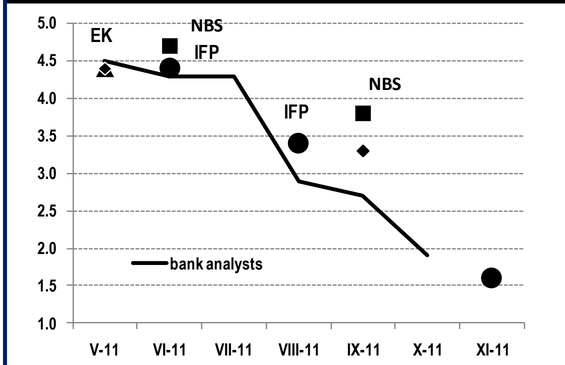
	GDP (% growth)				Difference from August 2011				Import (% growth)				Difference from August 2011			
	2011	**2012**	**2013**	**2014**	**2011**	**2012**	**2013**	**2014**	**2011**	**2012**	**2013**	**2014**	**2011**	**2012**	**2013**	**2014**
Largest trading partners of Slovakia	**2.2**	**0.8**	**1.8**	**2.0**	**-0.1**	**-1.0**	**-0.5**	**-0.4**	**6.3**	**3.4**	**5.6**	**6.3**	**-0.9**	**-2.1**	**-1.4**	**-1.0**
*incl. **Germany***	*2.9*	***0.7***	*2.0*	-	*-0.3*	***-0.7***	-	-	*7.9*	*4.2*	*6.2*	-	*1.7*	*0.0*	-	-
France	*1.6*	*0.5*	*1.5*	-	*-0.4*	*-0.3*	-	-	*5.6*	*3.0*	*5.9*	-	*-1.7*	*-1.0*	-	-
Czech Rep.	*2.1*	*1.0*	*2.0*	-	*0.1*	*-0.9*	-	-	*6.9*	*3.5*	*5.9*	-	*-0.3*	*-3.5*	-	-
other	*2.0*	*0.8*	*1.7*	-	*-0.1*	*-1.2*	-	-	*5.6*	*3.1*	*5.3*	-	*-2.1*	*-2.7*	-	-

Source: IFP

Gradual revisions of the economic growth

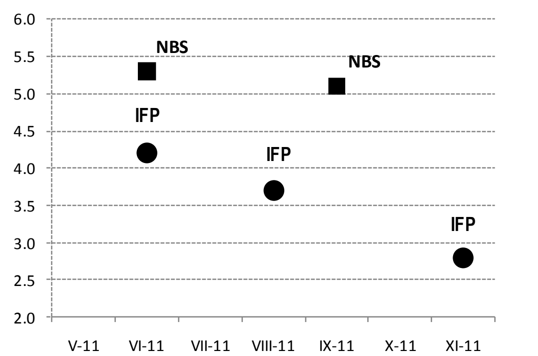
Forecasts of the growth of the Slovak economy have been gradually lowered since May, and the IFP flash forecast from August has been at the time more or less in accordance with the consensus of the bank analysts. The IFP forecast has almost always been below the forecasts of the central bank and international institutions. The actual forecast for 2012 is slightly lower than the consensus of the bank analysts in October

Chart 3: Forecasts in time – Slovak GDP growth in 2012



Source: IFP, NBS, IMF, OECD, EC

Chart 4: Forecasts in time – Slovak GDP growth in 2013



Source: IFP, NBS

Economic slowdown

Estimates of real GDP growth have been revised downwards for the whole forecasting period. In 2011 we expect the GDP growth to decrease by 0.3% to 3.0%. The slight worsening reflects the negative monthly indicators of sales, wages and employment in selected sectors, as well as the falling trend of the soft indicators in Slovakia as well as abroad. **In 2012 the economic growth is expected to fall to 1.7%.** Worsened development of the external demand for Slovak goods will slow the growth of exports, investments and employment, although the slowdown of the growth of exports will be dampened by the launch of the new production in the automotive and electronics industry. Lower demand for labor, slower productivity growth and high uncertainty will lower the pressure on wage growth, which will result in slower growth of the consumption of Slovak households. However, in real terms they should still spent 0.6% more than in 2011, due to the sharper drop of inflation. Continuing uncertainty about future development will keep the saving rate at this year’s high level. Public consumption is the only decreasing component of the GDP due to consolidation fiscal measures.

In the following years the growth of the economy is expected to gradually accelerate to 3.6% in 2014. The economy will be positively influenced by the faster growth of our trading partners, the recovery of the private consumption, and infrastructure investment partially due to higher EU funds absorption.

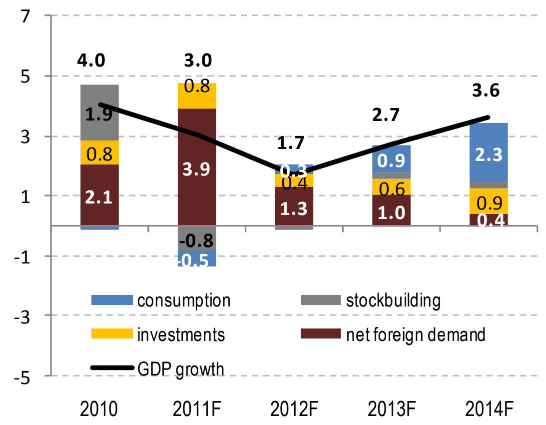
MF SR FORECAST – MAIN ECONOMIC INDICATORS (November 2011)									
Indicator (%)	**Actual**	**Forecast**				**Diff. from August flash**			
	2010	**2011**	**2012**	**2013**	**2014**	**2011**	**2012**	**2013**	**2014**
GDP, real growth	**4.2**	**3.0**	**1.7**	**2.7**	**3.6**	**-0.3**	**-1.7**	**-1.0**	**-0.3**
Private consumption, real growth	-0.7	0.0	0.6	2.5	3.0	-0.1	-2.0	-1.0	-0.6
Government consumption, real growth	1.5	-3.1	-0.1	-2.4	2.3	1.5	-1.1	-3.2	1.9
Investments, real growth	12.4	3.8	2.0	2.5	4.0	0.0	-3.1	-0.5	-0.4
Export of goods and services, real growth	16.5	8.8	6.1	6.5	7.2	-0.6	-0.4	-1.3	-0.9
Import of goods and services, real growth	14.9	5.0	5.3	6.2	7.7	-1.2	-0.9	-1.2	-0.7
Inflation, annual average; CPI	1.0	3.9	2.6	3.0	3.5	-0.1	-0.8	-0.5	-0.2
Inflation, annual average; HICP	0.7	4.0	2.6	3.0	3.5	-0.1	-0.8	-0.5	-0.2
Nominal wages, growth	3.2	3.1	3.4	4.6	5.2	-0.4	-1.9	-1.1	-1.1
Nominal wages, change in EUR	24	24.1	27.2	37.6	44.5	-3.1	-15.1	-9.9	-11.5
Real wages, growth	2.2	-0.8	0.8	1.5	1.6	-0.3	-1.0	-0.6	-0.9
Employment (ESA), growth	-1.4	1.5	-0.2	0.3	0.5	-0.1	-0.5	-0.2	0.0
Employment (thous. persons)	-30.1	31.9	-3.5	7.3	11.9	-1.2	-9.6	-4.8	-0.2
Unemployment rate (LFS)	14.4	13.5	13.7	13.4	13.1	0.5	1.1	1.5	1.9
Real wage base	0.8	0.7	0.6	1.8	2.1	-0.3	-1.5	-0.8	-0.8
Current account, % of GDP	-3.5	-1.1	-1.7	-1.0	-1.2	0.6	0.4	0.7	0.7

Source: ŠÚ SR, MF SR

Industry still the main driver of the economy

In 2012 the GDP growth should be driven mainly by the launch of new investments in the automotive and electronics industry, as well as higher EU funds absorption outside the general government. In the following years all components should contribute to the GDP growth positively. The contribution of foreign demand should gradually diminish due to higher domestic demand caused by the recovery of the private consumption.

Chart 5: Contributions to real GDP growth (p.p.)



Source: MF SR

Stagnation in the labor market

The slowdown of economic activity will cause stagnation in the labor market. The economic growth of 1.7% will not be sufficient to generate new jobs. Moreover, in 2012 the fiscal consolidation will result in layoffs in general government and railways. Starting with 2013, the employment growth will resume, although at a very limited pace. Worse employment prospect will automatically result in the unemployment forecast. The unemployment rate should increase in 2012 by 0.2 p.p. to 13.7% and since 2013 should again decrease to 13.1% in 2014.

Wages should grow slower than it was expected in the August forecast. The expected wage growth in 2012 has been lowered, although it is still higher than in 2011. The wages development in 2012 will be influenced by several opposing factors. Higher inflation in 2011 will increase the wages due to the indexation. Fiscal restriction, which has in 2011 lowered the salaries in the public administration, should be much milder as the salaries of civil servants are frozen and teachers' salaries will grow. The general government salaries should therefore nominally grow in 2012. On the other hand, the uncertainty about future development, which could significantly influence wage negotiations in 2012, will dampen the pressures on the growth of wages. The wages in the private sector are therefore assumed to grow at the same pace as this year, despite higher inflation. Real wages in the public sector should decrease in 2011 by 0.8% due to the savings in public sector and higher inflation (in the private sector the real wages should increase, whereas in the public sector they should fall by almost 5%). In the following years they should annually grow on average by 1.3%. However, real wages in the public sector will decrease in the entire forecasted period.

Table 2 : Real wages forecast in the selected sectors

	2010	2011	2012	2013	2014
Public administration + railways	***2.5***	***-4.7***	***-0.8***	***-0.7***	***-1.2***
Private sector	***2.4***	***0.3***	***1.6***	***2.0***	***2.1***
Market services	*1.4*	*0*	*1.6*	*2.1*	*2.1*
Industry	*4.5*	*0.4*	*1.6*	*1.6*	*2.1*
Construction	*1.1*	*0.6*	*1.4*	*2.1*	*1.9*
Real wages growth	***2.2***	***-0.8***	***0.8***	***1.5***	***1.6***

Source. IFP

BOX: Labor market development without the effect of fiscal consolidation

The labor market development is significantly influenced by austerity measures in public administration wages. Nominal wage expenditures of the general government in 2011 decrease by 10%, while at the same time there have been increases in efficiency in state-owned businesses (e.g. railways) with the impact on the employment. Assuming no changes in the public sector employment (i.e. no need to reduce deficit), the labor market development would look as follows (see table). **The employment would grow faster this year and would not decrease next year. Real wages would grow during the entire period.**

Labor market, assuming no savings on wage expenditures

	2010	2011	2012	2013	2014
Employment growth ESA95 (%)	-1.4	1.9	0.1	0.5	0.5
Employment growth ESA95 (thous. persons)	-30.1	**40.0**	**1.8**	**10.0**	**11.7**
Unemployment rate (%)	14.4	13.2	13.1	12.8	12.5
Nominal wages growth	3.4	4.2	4.2	5.0	5.6
Real wages growth	2.4	**0.3**	**1.6**	**2.0**	**2.1**

Source: IFP

Inflation should decelerate

Due to the slowdown in the economic activity we expect slower inflation in the entire forecasted period. In 2011 the main factors are external, such as lower increase of food prices on the global markets, but also delayed increase in heat prices. The following table suggests that compared to the forecast from the beginning of 2011 there have been **no changes in direct impact of government measures or secondary effects** (0.9% and 1.2%, respectively). Compared to the February forecast the only increase has been the contribution of gas, heat and fuel prices, mainly due to unusual July growth of gas and heat prices, caused by increased oil prices (unrest in North Africa). Lower foreign demand and related lower energy and commodities' prices result in 2012 lower inflation in the next year to 2.6%. Moreover in January 2012 we don't expect the increase of the regulated energy prices in such extent as in the August forecast. The food prices in 2012 should follow this year's good harvest, which should result in their slower growth.

Table 3: Contribution to CPI inflation in 2011 (p.b.)				
	Feb forecast	**Jun forecast**	**Aug estimate**	**Nov forecast**
External factors				
Food	0.9	1.0	1.0	0.9
Gas, heat and fuel	0.5	1.0	0.9	0.9
Internal economy				
Government measures	**0.9**	0.9	0.9	**0.9**
Rest	**1.2**	1.3	1.2	**1.2**
Total	**3.5**	**4.1**	**4.0**	**3.9**

Impact on public finance

The spillover effects of the crisis on our domestic economy (in the form of employment and wages) **represent a higher impact on public finance. The shortage of 640m EUR** includes, on the top of the revenue shortfall, also the impact on expenditures and change in nominal GDP[1]. The savings on the expenditures stem mainly from the savings on interest payments due to lower interest rates which offset the impact of higher than expected deficit and savings on pension benefits and other transfers due to lower indexation. Further shortages may be caused by changes in legislature (if the tax mix for municipalities and social security, pension, and home savings reforms are not passed).

Impact of the new macroeconomic forecast on public finances (thous. EUR)				
	2011	2012	2013	2014
A. Impact on revenues (updated)	-72 068	-577 225	-924 363	-1 098 997
% of GDP	**-0,1**	**-0,8**	**-1,2**	**-1,4**
B. Impact on expenditures	-1 347	-17 118	-96 758	-136 618
% of GDP	**0,0**	**0,0**	**-0,1**	**-0,2**
C. Impact of change of nominal GDP	-22 249	-80 349	-103 527	-108 159
Total impact on general government balance (A-B+C)	**-92 970**	**-640 456**	**-931 132**	**-1 070 537**
Total (% of HDP)	**-0,1**	**-0,9**	**-1,2**	**-1,3**

Medium-term macroeconomic **forecast** has been termed **realistic by most members of the** independent watchdog **Committee for Macroeconomic Forecasts** (Infostat, SLSP, ING, VUB). Tatra Banka and CSOB have termed the forecast as optimistic while the central bank and UniCredit as conservative. Detailed macroeconomic forecast is available on the IFP website.

[1] Since fiscal target is defined as a % of GDP.