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Institute for Financial Policy
Ministry of Finance SR
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Policy Brief 2012/03

23 March 2012

NEW FLASH ESTIMATE – Updated macroeconomic forecast for 2012

Growth may accelerate due to exports and private investments

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In reaction to more positive results of the Slovak economy in the fourth quarter of 2011 and improved expectations of growth in Eurozone in 1H12A, IFP has prepared a new macroeconomic "flash" forecast for 2012. The main positive driver has been Slovak exports, which, despite the decline of the economies of our two biggest trading partners, have recorded significant growth in Q4 2011. The latest Eurozone forecast indicates the possibility that its economy will not decline in 2012 on QoQ basis. Based on these updates, IFP has revised its forecast of the growth of the Slovak economy for 2012 upwards from 1.1% to 2.3%. At the same time, the high degree of uncertainty increases the estimate interval. The current estimate is in the range of 1.9% - 2.6%, while the most probable scenario sees growth at 2.3%. Faster economic growth in 2012 will have only minimal impact on the public balance, after taking into account weaker than expected employment and lower collection estimates of exice taxes.

Eurozone should not fall into recession in 2012

Since the publication of the last Slovak MinFin forecast (February 9th 2012), economies of USA and the Eurozone have been showing signs of stabilization. The stock market, reacting mainly to future expectations, has continued to grow. The uncertainty (traded through VIX) reached the lowest levels since June 2007. Sovereign bond markets have experienced a loosening in the wake of a large liquidity offers from the ECB. European and, more significantly, German leading indicators, continue their growing trend. The February IFP forecast assumed a recession of EU economy in the first half of 2012. The latest monthly data (industrial production, retail sales and business sentiment indicators) however offer several reasons to revise these dynamics upwards. **As a result, IFP has revised its growth forecast of Eurozone economies for the first two quarters of 2012. GDP was revised from an expected decrease of -0.31% to an increase of 0.04% in the first quarter and from -0.09% to 0.15% in the second quarter.** These assumptions come from the forecasts of the Now-casting[1] portal, which provides forecasts updated for foreign soft and hard data on a daily basis. **Our current assumption is that in 2012, the Eurozone GDP will grow by 0.2%, whereas the February forecast assumed a decline of 0.5%.** However, high degree of uncertainty caused by the risk of acceleration of the debt crisis and freezing of the banking system in the Eurozone remains. This is coupled with a possible risk of a slowdown in the emerging markets, especially in China.

Slovak economy grew quicker in the fourth quarter of 2011 than was expected in the February forecast

In addition to the assumption of improved external environment, the new flash estimate of Slovak GDP in 2012 also takes into account the newly published data for economic growth in the fourth quarter of 2011, when the Slovak economy grew by surprising 0.9% (3.4% y/y). If the same quarter on quarter growth was applied as in the February forecast, the 2012 GDP growth would reach 1.6%. However, a closer look at the structure of the growth reveals several inconsistencies. On the production side[2] a significant **contribution (1.2 p.p.)** to the y/y growth has been provided by higher collection of net taxes on products, i.e. VAT and excise taxes net of subsidies. A significant contribution to this was the VAT of 173.6 m EUR for a delivery of a section of the R1 motorway financed by PPP project. During the construction of the motorway portion the subcontractors continuously included VAT in their invoices, i.e. output VAT was charged to the concessionaire. At the same time the concessionaire accrued excessive input VAT and as a result the net impact to tax collection was nullified during this period. At the moment of the delivery of the motorway to the state (4q2011), the concessionaire paid the total VAT in full. According to the accrual principle of national accounting the VAT is included in the GDP at the moment of the formation of the tax liability, i.e. the delivery of the motorway. **Statistically, quarterly GDP has been likely lowered during PPP construction, whereas in the last quarter the GDP growth could have been overestimated.** In this case a theoretically more "accurate" real GDP growth could be obtained by spreading the VAT in time according to the realized construction. However this data is not currently available. Another option for obtaining more accurate GDP values would be to look at the **value added,** which represents

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[1] More in the FPI paper: http://www.finance.gov.sk/Components/CategoryDocuments/s_LoadDocument.aspx?categoryId=8163&documentId=7066

[2] GDP is a sum of a gross value added (difference between gross production and intermediary consumption) and net taxes on products.

more than 90% of GDP and does not contain taxes. VA increased by 0.6% in the last quarter of 2011, which nonetheless still does not point to a significant slowdown.

A view of the structure of GDP in 2011Q4 from the expenditure side also brings up several questions. The main driver of the growth was net foreign trade, was been driven by a significant increase in exports. These have surprisingly increased quarterly by 4.5%, while the economies of the Eurozone and the EU countries, as well as our two most important trading partners (Germany, Czech Republic) have experienced a decline. Another surprise was a strong growth of investments (quarterly growth of 3%), driven by purchases of machinery probably related to the launch of production of new models in automotive factories. The stock of goods and materials contributed most negatively to the growth. This may indicate either the continuing uncertainty of firms about the future development and thus lower willingness to build stocks, or a high demand in the fourth quarter, for which the production was not prepared. Currently we are leaning towards the more optimistic explanation. At the same time the sum of individual components of the GDP (in previous year prices[3]) also indicates higher GDP growth, because statistical discrepancy was significantly negative, at the level of -1.6% of the quarterly GDP. **The structure of the expenditure side of GDP growth has brought a positive surprise and does not indicate future slowdown.**

Slovak economy should grow faster in 2012 due to higher exports and investments

In 2012 Slovak economy should grow faster than originally expected. **IFP has revised the estimate of its growth to 2.3% from 1.1%. Higher growth stems from more positive development in the last quarter of 2011 and higher expectations of growth of export and investments caused by more positive outlook of external environment.** Even though the growth in the fourth quarter of 2011 was positively influenced by the contribution of taxes, value added without taxes did not indicate signs of slowing and was better than expected in the February forecast. On the expenditure side the exports and investments grew faster than expected. Even assuming no further growth, their increase in 2012 would be higher than originally expected. The forecast assumes a slight correction of quarterly growth rates in the following quarters, as they are relatively volatile due to short time series marked by several structural changes. Furthermore, exports are expected to be driven by better Eurozone development in the first half of 2012, and an annual growth of 0.2% compared to the originally expected decline of 0.5%. More positive development of exports is also indicated by the January data on industrial production, export of goods and new industrial orders.

The rest of domestic demand remains subdued. Private consumption is expected to stagnate. Public consumption should continue to decrease in accordance with the consolidation measures of the government. **The situation in the labour market is not significantly different from the February forecast.** A slight worsening of the employment growth is due to **worse labour market developments in 4Q11**. The increase of nominal wages will be driven by wages in public sector, notably by the increases of doctors', nurses' and teachers' wages. The slightly higher inflation forecast reflects a higher weight of the regulated prices in the consumer basket.

MF SR FORECAST – MAIN ECONOMIC INDICATORS (March 2012)

Forecast version:	Nov 2011	Feb 2012	Mar 2012	*Difference*	
Period:	2012	2012	2012	*mar_12 - nov_11*	*mar_12 - feb_12*
GDP – nominal growth	3.7	3.3	**4.6**	*0.9*	*1.3*
GDP – real growth	1.7	1.1	**2.3**	*0.6*	*1.2*
Private consumption – nominal growth	2.9	3.3	**3.0**	*0.1*	*-0.3*
Private consumption – real growth	0.6	0.0	**0.0**	*-0.6*	*0.0*
Investments – real growth	2.0	1.6	**4.3**	*2.3*	*2.7*
Exports – real growth	6.1	2.2	**3.8**	*-2.3*	*1.6*
Average nominal wages (growth)	3.4	3.4	**3.5**	*0.1*	*0.1*
Average real wages (growth)	0.8	0.6	**0.5**	*-0.3*	*-0.1*
ESA employment (growth)	-0.2	-0.2	**-0.3**	*-0.1*	*-0.1*
Nominal wage base (ESA, growth)	3.2	3.2	**3.2**	*0.0*	*0.0*
Unemployment rate	13.7	13.8	**14.1**	*0.4*	*0.3*
Inflation (CPI)	2.6	2.8	**3.0**	*0.4*	*0.2*

[3] Where components of real GDP are shown in previous year prices additivity holds.

The GDP growth estimate moves in the interval 1,9% - 2,6%

The forecast of GDP for 2012 assumes a correction of growth in the first quarter, related to a strong growth in the last quarter of 2011. In the following quarters growth is expected to accelerate. Current period is marked by a high uncertainty about future development. Combined with several uncertainties about the 2011Q4 GDP, this increases the interval of the GDP growth estimates in 2012. In case of the **more negative scenario**, assuming a stronger correction in the first quarter and slower acceleration of growth, the 2012 growth estimate is **1.9%**. On the contrary, according to the more optimistic scenario of higher growth in the second half of the year the annual growth should reach **2.6%.** The 2012 growth estimate can be therefore found in the interval **1.9% - 2.6%**.

BOX: FLASH ESTIMATE OF SLOVAK MINFIN FOR THE CURRENT YEAR

The budget and the budgetary framework (including EU documents such as the Stability programme) are always based on a standard forecasting procedure. This procedure assumes that the macroeconomic and tax forecasts are produced by committees composed of independent experts. The forecasting process takes place over approximately 3 weeks and is available for the next 3 years.

In case of significant changes (currently this is for example 4q2011 data and global growth soft indicators), **IFP can use flash estimates throughout the year to update the forecast for the current period. This estimate cannot be used for budgetary purposes and serves mainly for risk estimation and communication toward the external environment. The forecast process usually takes up to one week and is available for the current year only. It is not subject to discussion or approval of the independent macroeconomic committee.**

The current budgetary framework assumes 1.1% growth for the current year. The next standard forecast of the macroeconomic committee will be published in **June**. It will reflect information about the economy of Slovakia and its main trading partners for the first months of 2012, and it will also include latest estimates of the external environment from international institutions.

The impact of the flash macroeconomic forecast on the balance of public finances was estimated using a simplified model of the impacts of the macroeconomic assumptions on public finances[4]. In addition to fully applying the changes in the macroeconomic forecast to the model, the balance estimate **includes subsequent ad-hoc adjustments of government revenues** based on the best currently available information. Compared to the results from the model, i.e. taking into account only the impact of the change of the GDP forecast and its structure, there were negative adjustments to excise taxes in the amount of 24.6 m EUR:

- The model expects positive influence of macroeconomic development amounting to a change of 9.6 m EUR in excise taxes (mainly through businesses fuel consumption). However higher prices and the possibility of shopping tourism mean lower demand from households, therefore that the forecast of consumption is unchanged compared to February.
- In case of cigarettes the 2012 model estimate does not include a one-off loss of revenue of 15 m EUR caused by the sale of the last year's surplus stocks. In this case the estimate is quite conservative, however, the higher risk of cross-border purchases justifies the cautiousness.

The higher macroeconomic forecast in 2012 will therefore result in only minimal increase of revenues. **The total positive effect on public finances is in the amount of 53.8 m EUR.**

Total effect on public finance (thousands EUR)

	2012	2013	2014	2015
Total effect compared to February forecast	**53 810**	**66 088**	**74 881**	**77 154**
Change in revenues	11 882	29 043	31 305	33 481
Change in expenditures	0	-6 307	-4 179	-4 081
Impact of the change of nominal GDP on the balance	**41 929**	**43 352**	**47 754**	**47 754**
Impact of the change of nominal GDP on the balance as % of GDP	**0,06**	**0,06**	**0,06**	**0,06**
Total effect compared to the 2012 – 2014 budget	**-107 837**	**-133 510**	**-189 321**	-
Change in revenues	-122 462	-237 329	-372 665	-
Change in expenditures	-11 872	74 897	170 724	-
Impact of the change of nominal GDP on the balance	**26 497**	**28 922**	**12 620**	-
Impact of the change of nominal GDP on the balance as % of GDP	**0,04**	**0,04**	**0,02**	-

[4] http://www.finance.gov.sk/Default.aspx?CatID=8011