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The economy is likely to slow down due to the weak euro area performace

Macroeconomic forecast for 2012 – 2016

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The effects of the debt crisis have been intensified and the economies of our main trading partners have slowed significantly. In 2012, its impact was cushioned by the new production capacities in the automotive sector. In 2013 the Slovak economy will be fully exposed to the weak foreign demand and growth should slow to 1.2%. Household consumption will be dampened by the slow wage growth and rising unemployment. In the following years, as the global recovery will speed up, the economy should be slowly getting back to growth around 3%.

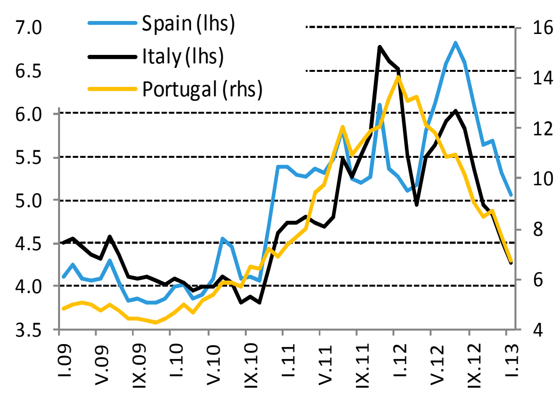
Financial conditions have improved...

Situation on the international financial markets has significantly improved since the latest forecast. Stock markets have responded favorably to the statements made by the ECB. The governor has publicly supported the unity of the common currency and stressed out the commitment to do the necessary steps to resolve the crisis. Moreover, the ECB announced further purchases of government debt on the secondary market. The euro has strengthened against the dollar and has reached the strongest position in the recent past at 1.3 against dollar. The sovereign bond yields of the peripheral countries of the euro area have continued to decrease. Spanish bond yields were down at 5.1% and Italian got to 4.1%.

...with delayed effect on the real economy

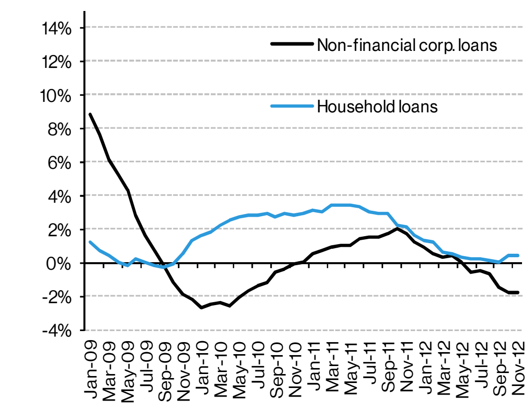
Despite the stabilization, the financial conditions remain fragile and the boost to the real economy is likely to be delayed and weaker compared to past developments. This reflects unresolved problems of the euro area periphery – high public debt and continued large imbalances within the monetary union. Improved financial conditions would not therefore automatically lead to an increase in the economic activity due to the ongoing deleveraging and uncertainty.

Graph 1: Bond yields of selected countries (%)



Source: Bloomberg

Graph 2: Credit growth in euro area (y/y, %)



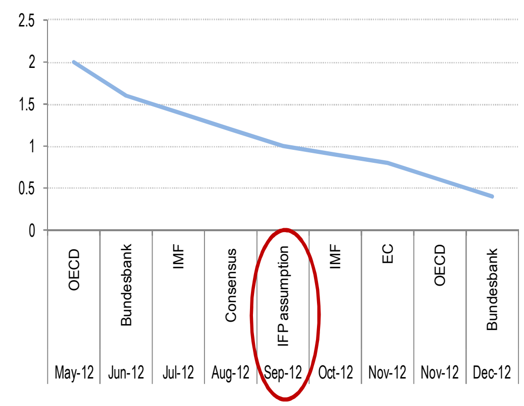
Source: ECB

Recent development confirms that the financial market stabilization is not reflected in the economic development. The economies of our main trading partners have slowed significantly. The economy of the euro area decreased in the third quarter of 2012, when the debt crisis has started to affect the core countries of the euro area as well. Germany has slowed to 0.2%, and according to the flash estimates for the fourth quarter, the German economy shrank by 0.5%.

Consolidation and deleveraging in the euro area

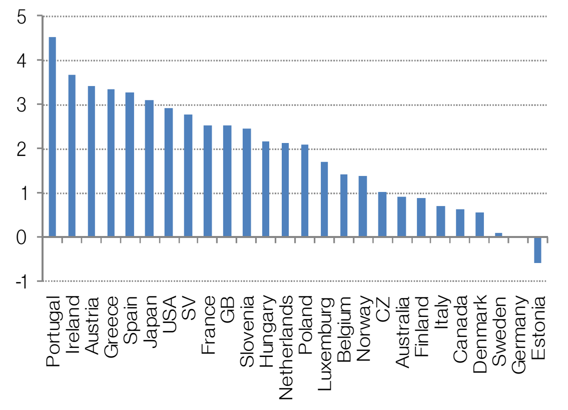
Despite the estimated pick up of the German economy, the GDP forecast for 2013 experienced a significant downward revision (graph 3). Estimates for the rest of the euro area countries have been revised as well, reflecting simultaneous consolidation effort. Moreover, economic activity should be affected by the deleveraging process and uncertainty.

Graph 3: Forecast of the German real GDP growth (%)



Source: Bloomberg

Graph 4: Consolidation plans of selected countries for 2013 and 2014 (% HDP)



Source: OECD

Lowered expectations for foreign demand

The external assumptions were based upon the latest OECD forecast and updated according to the latest forecast of the financial institutions (Bloomberg consensus). The growth of the German economy should slow by 0.6 p.p. and the euro area GDP should decrease GDP by 0.1%. Due to these changes the external environment should be significantly lower compared to the September forecast. The recent exceptional growth of the IFO index (January 2013) has not been included in the forecast. In line with other leading indicators it suggests that the drop of the German economy should be temporary and the economy should be stronger from the second half of the year onwards.

Table 1: Foreign environment in 2013 – 2016

	GDP (% growth)				Diff. from Sep 2012				Import (% growth)				Diff. from Sep 2012			
	2013	**2014**	**2015**	**2016**	**2013**	**2014**	**2015**	**2016**	**2013**	**2014**	**2015**	**2016**	**2013**	**2014**	**2015**	**2016**
Largest trading partners	**0.5**	**1.8**	**1.7**	**1.7**	**-0.6**	**0.4**	**0.2**	**-**	**2.4**	**4.5**	**4.3**	**4.3**	**-1.4**	**0.7**	**0.5**	**-**
Euro area	**-0.1**	1.2	-	-	-0.5	-	-	-	2.0	5.0	-	-	0.7	-	-	-
Germany	**0.5**	1.8	-	-	-0.6	-	-	-	3.4	5.8	-	-	-1.4	-	-	-
Czech republic	0.8	2.4	-	-	-0.2	-	-	-	2.9	5.6	-	-	-0.3	-	-	-
Poland	1.6	2.5	-	-	-0.9	-	-	-	3.4	5.6	-	-	-1.1	-	-	-
Hungary	0.5	1.4	-	-	-0.5	-	-	-	1.5	3.2	-	-	-3.5	-	-	-

Source: Bloomberg, MMF, IFP

Lower GDP growth throughout the forecast horizon

Slovak economy should slow down to 1.2% in 2013. After a significant production increase the automotive sector reached its full capacities, and thus it won't provide an impulse to the GDP growth similar to the one in 2012. Weak foreign and domestic demand should therefore fully affect the GDP growth at the end of 2012 and in 2013. In the 4th quarter of 2012 the economy probably slightly contracted by 0.2%. The drop in the 4th quarter is indicated also by our short-term model[1].

The economy in this year should again benefit from the net export, although less than in 2012. The consumption should slightly decrease due to the unfavorable situation on the labor market. The deficit reduction in the amount of 3.3% of GDP (compared to the no policy change scenario) should lead to the decrease in the public spending. Moreover, low economic sentiment and uncertainty should have a negative impact on investment.

MF SR FORECAST –MAIN ECONOMIC INDICATORS (Januaru 2013)

Indicator (%)	Actual	Forecast					Difference from September 2012			
	2011	2012	2013	2014	2015	2016	2012	2013	2014	2015
GDP, real growth	**3.2**	**2.3**	**1.2**	**2.9**	**3.3**	**3.6**	**-0.2**	**-0.9**	**-0.6**	**-0.3**
Inflation, annual average; CPI	3.9	3.6	2.3	2.4	2.4	2.3	-0.1	-0.8	0.3	0.2
Inflation, annual average; HICP	4.1	3.7	2.4	2.5	2.5	2.3	-0.2	-0.7	0.4	0.3
Nominal wages, growth	2.2	2.3	2.3	3.5	4.4	4.7	-0.1	-1.1	-0.9	-0.6
Nominal wages, change in EUR	17.0	18.0	18.8	29.0	37.1	41.7	-0.8	-8.8	-7.7	-5.9
Real wages, growth	-1.6	-1.3	0.1	1.1	1.9	2.3	0.0	-0.3	-1.1	-0.8
Employment (ESA), growth	1.8	0.1	-0.5	0.5	0.7	0.8	-0.1	-0.6	-0.1	0.0
Employment (thous. persons)	38.5	2.6	-11.6	12.0	16.0	18.0	-2.0	-13.4	-3.0	-1.2
Unemployment rate (LFS)	13.5	13.9	14.3	13.8	13.0	12.1	-0.1	0.4	0.3	0.0
Real wage base	0.1	-1.2	-0.4	1.3	2.5	3.1	-0.2	-0.7	-1.6	-0.9
Government consumption, real growth	-0.5	-0.4	-0.1	1.5	2.6	3.2	-0.3	-0.8	-1.7	-1.3
Investments, real growth	14.2	-3.7	2.3	3.3	2.4	2.0	-1.6	-4.3	5.2	0.4
Export of goods and services, real growth	12.7	8.9	3.3	4.9	4.8	4.7	1.4	-1.3	0.4	0.2
Current account, % of GDP	-2.1	1.8	1.2	1.7	2.4	2.8	0.9	0.0	-0.1	0.0

Source: ŠÚ SR, MF SR

Underperforming labor market

The expectations regarding the labor market development remained bleak. Economic growth in the previous year has been driven mainly by the productivity increase and has not produced a significant number of new jobs. However, the slowdown of the economic activity at the end of the last year has been coupled with the worsening of the labor market. Most of all, workers in manufacturing and construction have been laid off. Fiscal consolidation should also negatively affect the labor market. The number of workers should decrease by 0.5%. Significant rise in the employment should come with a stronger GDP growth in 2014 and in 2016 the employment should reach the pre-crisis level. Unemployment rate should increase to 14% in 2013, but in the following years it should slowly decrease due to the growth employment development down to 12% in 2016.

[1] Our dynamic factor model of GDP takes as inputs German IFO index, Slovak economic sentiment indicator, sales of tradable goods, retail sales and health insurance contributions of economically active population.

Inflation slows down

The wage growth should slow down as well compared to the previous forecast. Besides the slowdown of the foreign demand, there is an expected cut in the public sector wage bill (with the exception of the education). Nominal average wage should reach 823 eur, which is a 2.3% increase compared to 2012. Nominal growth is the same as in, but due to the lower inflation, the real wage should increase. In the following years the nominal wage should grow more in line with the productivity increase. In 2016 the real wage growth should be above 2%.

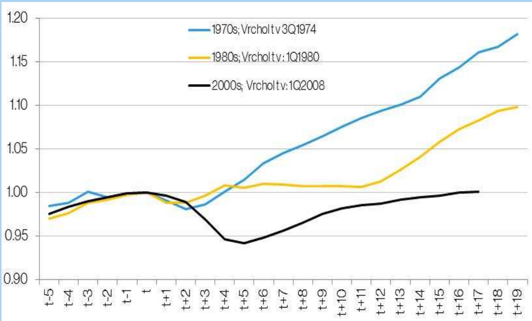
Inflation in 2013 should be lower than in the previous year. The prices are expected to increase by 2.3%. The downward revision of the inflation is related to all its components. The regulated prices should grow at a moderate pace and the energy prices remain stable. The growth of food prices have been revised downwards to 3.5% due to the stabilization of the world commodity prices. However, the food prices should be still the highest contributor to the inflation. The net inflation should be lower due to the weak domestic demand.

The medium-term macroeconomic forecast by the MF SR has been characterized as realistic by the majority of the members of the Committee (ČSOB, Tatra banka, UniCredit, NBS, Infostat). Volksbank, SLSP and VUB evaluated the forecast as optimistic. The detailed macroeconomic forecast, as well as minutes from the session of the Committee for the macroeconomic forecasts and supplementary materials, is available on the IFP website.

BOX. How does foreign uncertainty affect economic performance in Slovakia?

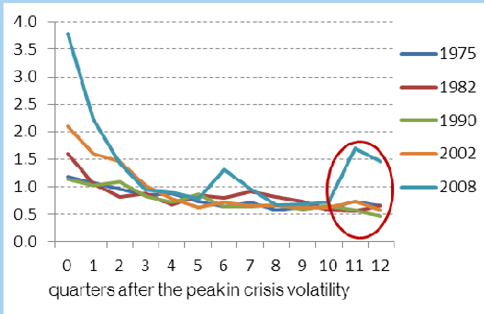
Recent global recovery is one of the slowest compared to the recessions in the past (left graph). One of the reasons is a significant and prolonged uncertainty. While in the past the uncertainty has gradually vanished, the recent development is characterized by high volatility (right graph). The situation on the financial markets has been stabilized for now, although the risk remains and the overall uncertainty can suddenly shift.

Domestic demand of OECD countries before and after recessions (% change since quarter t)



Source: OECD

Volatility of daily returns on Dow Jones IA stock index in recessions



Source: Bloomberg

Global uncertainty is affecting the Slovak economy through the channel of expectations. The increase of the uncertainty to the level from the end 2011, when the debt crisis peaked, could lead to the decrease of the GDP by 0.9 p.p. Uncertainty has the largest impact on the investments, due to the negative expectations. The same amount of global uncertainty could decrease the overall investment by 2%. Likewise, consumers are likely to postpone purchases of durable goods. The overall consumption should react to the changes in uncertainty with the lag of one quarter. Therefore the recent stabilization of the financial markets could have an effect with some delay.

The uncertainty has been measured with different indicators in order to track proper changes in the global uncertainty. Correlation between different indices and Slovak data is the strongest in a case of global volatility factor (first column). Our estimates are in line with the IMF results [2].

Effect on: (real growth rates y-o-y)	Indicator of uncertainty: Global uncertainty on financial markets 1)	VIX index of volatility 2)	Policy uncertainty index in the EU 3)	Policy uncertainty in the EU - media 4)
GDP	-0.94***	-0.13***	-0.02*	-0.01
	(0.34)	(0.04)	(0.01)	(0.01)
Household consumption	-0.41*	-0.06**	-0.01	-0.00
	(0.21)	(0.02)	(0.01)	(0.01)
Fixed investment	-2.09**	-0.28**	-0.05	-0.01
	(1.04)	(0.12)	(0.03)	(0.02)
Employment (ESA)	-0.07	-0.02**	-0.003**	-0.00
	(0.12)	(0.01)	(0.001)	(0.00)

Notes: 1) Common factor in monthly std. dev.-s of daily returns on stock indexes DJIA, Euro Stoxx 50 and Nikkei.
2) Volatility index of the Chicago Board Options Exchange Market.
3), 4) Index constructed by S. R. Baker, N. Bloom and S. J. Davis, www.policyuncertainty.com
*,** and *** denote significance at the 90, 95 and 99% levels. Standard errors of coefficients in brackets.

[2] IMF World Economic Outlook, október 2012, Box 1.3, str. 49.

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