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Households' consumption helps revive the economy

Macroeconomic forecast for 2013 - 2016

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Economic recovery in the Eurozone helps the Slovak economy maintain its export performance and improves its outlook. The economy will grow by 0.8% this year and 2.2% next year. In addition to growing exports, households' consumption starts to recover as well, due to improving consumer confidence and lower inflation. The updated forecast has a positive impact on tax bases.

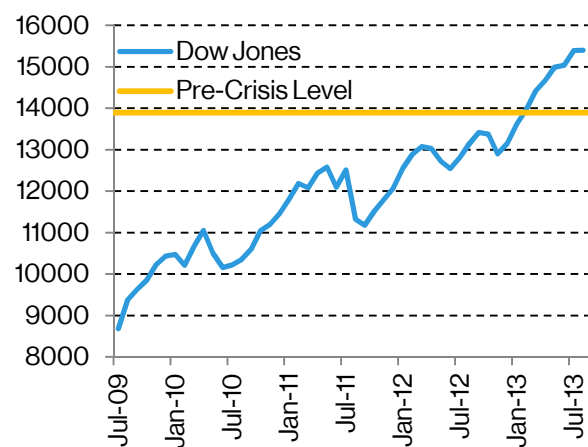
Stocks at maximums, slight increase in volatility

The developed capital markets continued to experience the liquidity surplus and the stock prices reached historical maxima. Nevertheless, the volatility has slightly increased since the last forecast. The main reasons were the fears of premature tightening of the expansive monetary policy of the Fed, which are gradually dissipating. On the bond markets there have been corrections of excessively low yields, and the yields of German and US bonds have started to rise.

Stabilization in the Eurozone transforms into business activity

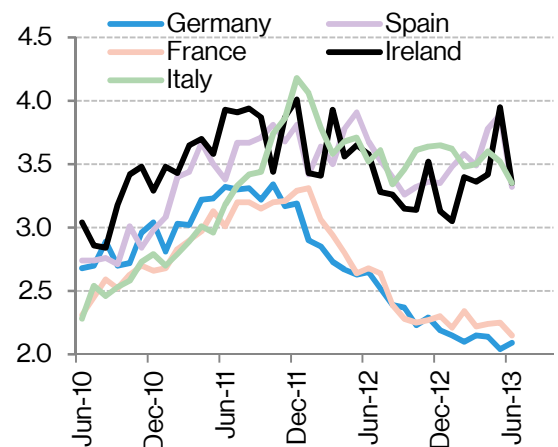
The financial markets in the Eurozone remained stable and the bonds of the peripheral countries remained on safe levels. The liquidity surplus started slowly appearing also in the real economy. The loan activity of businesses in the Eurozone has rebounded from the bottom and suggests a potential shift in trend. **However, the development remains unequal** (two-speed Eurozone, Chart 2). Small and medium businesses in the Eurozone remain in a bad situation, as profits fall and number of bankruptcies rises.

Chart 1: Dow Jones Industrial Average Index compared to pre-crisis maximum from 2007



Source: Bloomberg

Chart 2: Interest rates on corporate loans in selected Eurozone countries



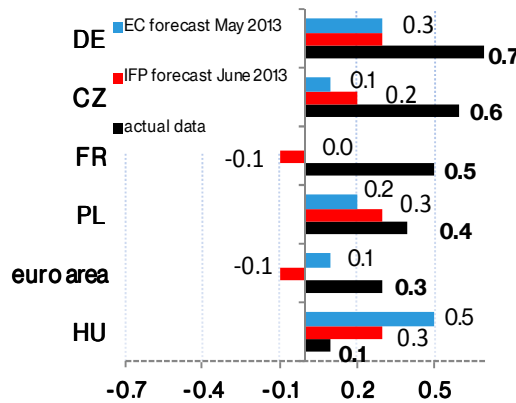
Source: Bloomberg

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Favorable external development in the second quarter

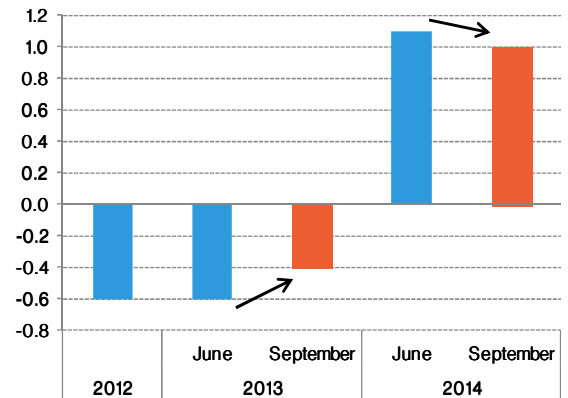
The recession in the Eurozone has ended after a year and a half. The expectations indicators show that the growth should continue in the Eurozone into the second half of the year. Germany and France have experienced an especially favorable development. Households' consumption has been a positive surprise, as it has risen for the first time since 2011. Despite the fact that part of the economic growth has been caused by one-off effects¹, the overall development has exceeded the expectations (Chart 3). Soft indicators suggest further improvement, German expectations indicators IFO and ZEW² show a probable continued growth of the German economy in the second half of 2013.

Chart 3: GDP growth in 2013Q2 (% QoQ)



Source: IFFP, EC Spring Forecast, Eurostat

Chart 4: Eurozone GDP forecast - ECB (%)



Source: ECB

Mixed Eurozone outlook for 2013-14

Expectations of the external environment for this year have improved. The favorable situation in the second quarter and the improvement of the soft indicators has resulted in the upward revision of forecast of international institutions (ECB, OECD). However, the outlook for the following years remains uncertain. High unemployment and slow redressing of the imbalances in the Eurozone, as well as slower growth of the emerging economies do not support a stronger growth of the external environment. Therefore, after consultations with IMF and OECD, we have adjusted upwards the assumptions for 2013 and slightly downwards for the following years (Table 1).

Table 1: External environment in 2013-2016³

	GDP (% growth)				Diff. from Jun 2013				Import (% growth)				Diff. from Jun 2013			
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016
Largest trading partners	-0,1	1,3	1,5	1,5	0,1	-0,1	0,0	0,0	0,7	3,4	3,7	4,0	0,7	-0,2	-0,2	0,0
Euro area	-0,5	0,9	-	-	0,1	-0,1	-	-	-0,4	2,7	-	-	-0,4	-0,3	-	-
Germany	0,5	1,5	-	-	0,1	-0,1	-	-	1,2	4,8	-	-	-0,9	-0,3	-	-
<i>Czech republic</i>	-0,9	1,7	-	-	0,1	0,4	-	-	-0,9	4,8	-	-	2,1	0,2	-	-
<i>Poland</i>	1,1	2,2	-	-	0,1	-0,1	-	-	2,8	2,3	-	-	3,2	-0,2	-	-
<i>Hungary</i>	0,4	1,2	-	-	0,2	0,0	-	-	3,2	2,9	-	-	1,1	-0,5	-	-

Source: Bloomberg, OECD, IFFP

¹ Seasonal influences of longer and colder winter and the statistical effect of Easter falling in the first quarter this year.

² Which has significantly improved in September

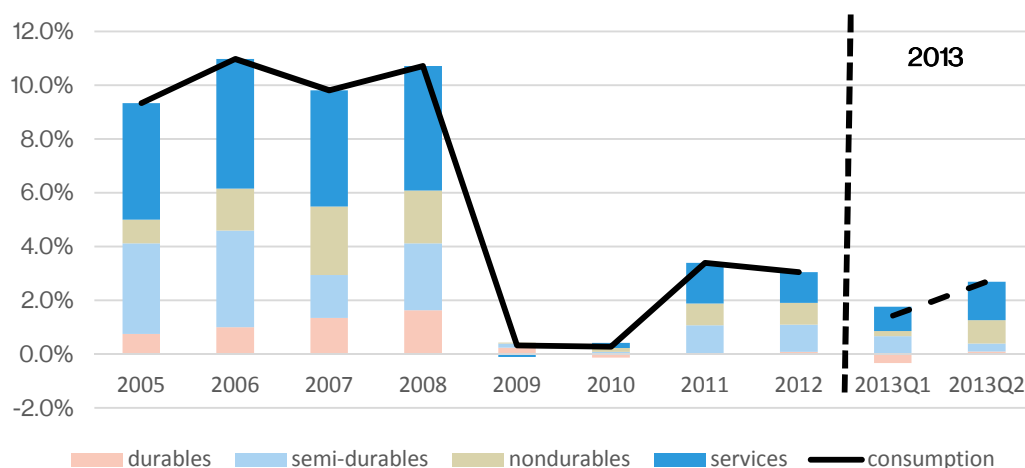
³ In order to utilize all the available information about the external environment, we adjusted the OECD May forecast with more recent consensus estimates of International Financial Institutions (Bloomberg Consensus).

Growth in 2013 driven also by households' consumption

The Slovak economy will grow this year by 0.8%. The main driver of the growth is the net export, which will accelerate also due to a more positive situation of our trading partners. The economy will be helped also by a recovery of consumption, which has increased for the first time in four years. The households increase their consumption mainly due to lower inflation and improved confidence in the future economic development⁴. However, consumer behavior remains unchanged. Households continue to postpone expenditures on durable goods and luxuries (Chart 5). Due to the unchanged structure of consumption and problems on the labor market, we expect only a moderate and gradual growth of consumption in the following years.

The economic growth will be dampened by investments and public expenditures. Continued decline in profits and corporate loans puts a brake on the investment activity. It should restart in 2014 due to motorway construction and investment projects in the automotive industry. Public consumption will continue to decline due to fiscal consolidation.

Chart 5: Contributions to changes in consumption



Source: IFP, own calculations

Gradual acceleration of the economy

The economy should gradually accelerate in the following years. Domestic demand will gradually improve with improving external environment and labor market even with continued consolidation of public finances. The economic growth should reach 2.2% in 2014 and continue to accelerate.

Table 2: MF SR FORECAST - MAIN ECONOMIC INDICATORS (September 2013)

indicator (growth in % unless otherwise noted)	actual 2012	forecast				difference from June 2013			
		2013	2014	2015	2016	2013	2014	2015	2016
Gross domestic product									
GDP, real	2.0	0.8	2.2	2.9	3.1	0.3	0.0	0.1	-0.4
GDP, nominal (bn €)	71.5	73.0	75.8	79.5	83.5	0.4	0.0	0.0	-0.3
Private consumption, real	-0.6	0.5	0.8	2.1	2.2	1.2	0.1	-0.2	-0.5
Private consumption, nominal	3.1	2.0	2.5	4.3	4.6	1.1	-0.2	-0.1	-0.2
Public consumption	-0.6	-0.7	-1.2	-2.3	-2.2	1.2	-0.8	0.8	-2.8
Fixed investments	-3.7	-5.8	2.9	-0.1	-1.5	-0.5	-0.6	-0.2	-2.1
Export of goods and services	8.6	4.8	4.3	4.5	5.1	2.3	0.0	-0.4	-0.1
Import of goods and services	2.8	1.7	3.3	2.9	3.3	1.2	-0.2	-0.4	-0.8

⁴ Savings also follow the soft indicator of consumer confidence, as their growth in the first half of 2013 lagged behind the growth of consumption.

Labor market									
Employment (registered)	-0.1	-1.0	0.2	0.6	0.7	-0.3	-0.1	-0.1	-0.1
Wages, nominal	2.4	2.6	2.8	3.4	3.5	0.6	0.2	-0.3	-0.6
Wages, real	-1.2	0.9	1.1	1.3	1.2	0.6	0.4	-0.4	-0.8
Unemployment rate	14.0	14.5	14.3	13.6	12.7	0.0	0.1	0.1	0.1
Inflation									
CPI	3.6	1.6	1.7	2.1	2.3	-0.1	-0.2	0.1	0.3

Source: ŠÚ SR, IFP

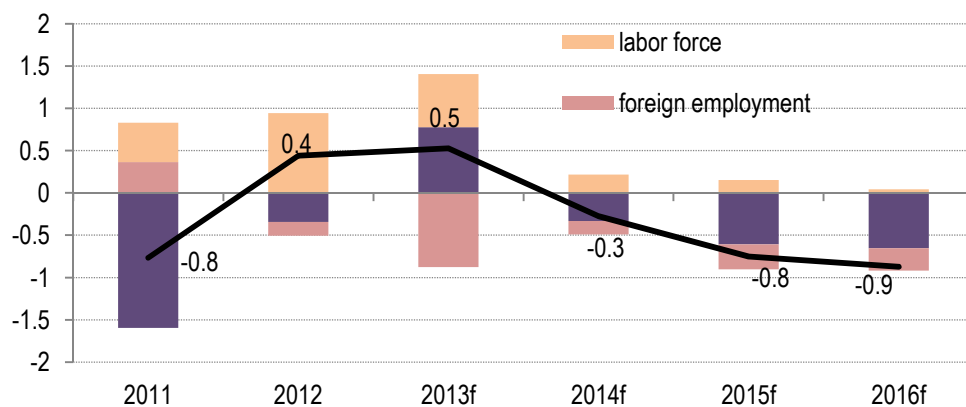
Labor market turnaround in 2014

The employment according to the ESA95 methodology fell in the second quarter of 2013, mainly in small businesses and in the construction and industry sectors. Despite the improving economic development the average unemployment rate should reach 14.5% (labor force survey) in 2013.

The unemployment rate starts to fall in 2014. The decline in unemployment is even during the recovery burdened by a high rate of structural unemployment (see box). More significant growth of employment and decline of unemployment should arrive in 2015 together with faster economic recovery.

Real wages will grow this year after two years of decline. Higher productivity growth pushes nominal wages upwards. Furthermore, gradual decline in inflation has a positive impact on real wage and purchasing power of households. **Real wages should grow in the following years as well.** Generally the wage growth will be faster in the private sector, while in the public service it will be dampened by the consolidation of public finances.

Chart 6: Contributions to change in the unemployment rate



Source: ŠÚ SR, IFP, own calculations

Inflation continues to decline

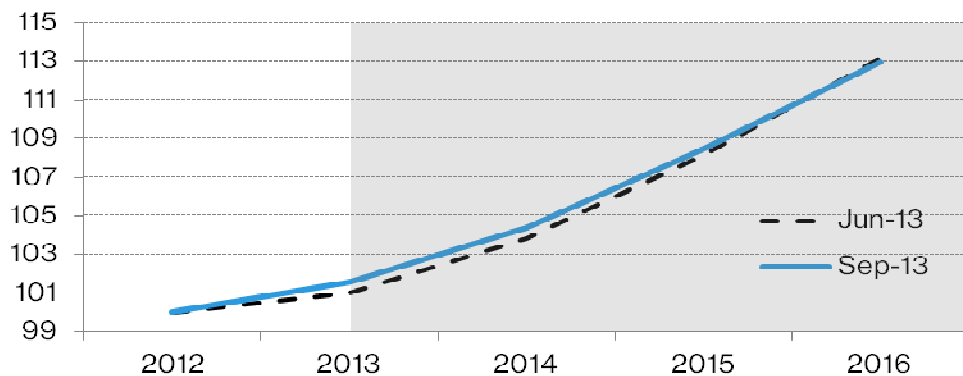
The growth of price level in 2013 will be considerably lower than in the previous two years. The expected annual growth of consumer prices is 1.6%. The main reason behind the slowdown of price increase is a significantly slower growth of regulated prices and low values of net inflation. The growth of regulated prices is approximately one sixth of the average of previous years. We expect that the announced good harvest will end the period of above average food prices growth. **The households' electricity prices will fall starting in January 2014** and total regulated prices will record only a moderate growth. The net inflation will recover only slowly. We therefore forecast the inflation for 2014 at approximately the level of this year. In the following years the inflation will slowly accelerate above 2%.

Positive impact on the tax bases

The total impact of the updated macroeconomic forecast on the tax bases is positive on the entire horizon of the forecast with the exception of 2016, which will be marked by a higher fiscal consolidation. Nominal level of GDP and households' consumption exceeds our June expectations. The wage base remains practically unchanged, lower outlook for employment is compensated by higher nominal wages, which reflects the development from this year.

Table 3: Macroeconomic bases – comparison with June 2013												
2012	2013			2014			2015			2016		
Act..	Jun-13	Sep-13	Δ	Jun-13	Sep-13	Δ	Jun-13	Sep-13	Δ	Jun-13	Sep-13	Δ
100	101	101.6	0.6	103.8	104.4	0.5	108.1	108.5	0.3	113.2	112.9	-0.2

Chart 7: Macroeconomic bases⁶ compared to June forecast

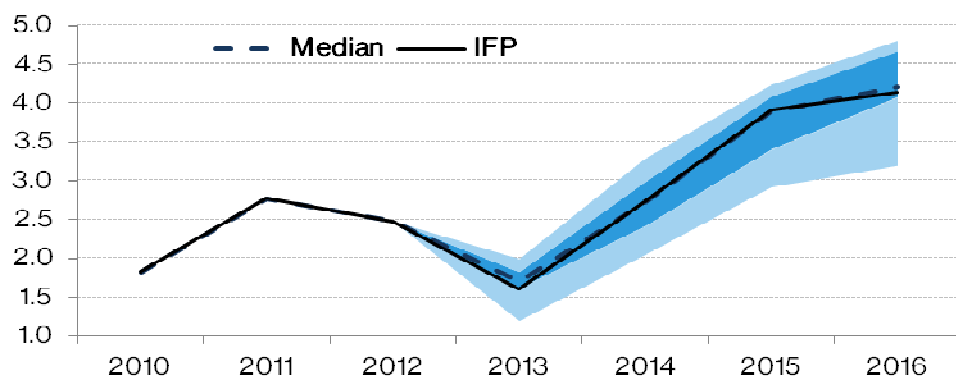


Source: IFP, own calculations

Realistic forecast

Medium term **forecast** of the macroeconomic development prepared by the MoF **was evaluated by the majority of the Committee** (NBS, Infostat, Tatra Banka, Unicredit, SLSP, VUB and Sberbank) **as realistic**, with the exception of CSOB, which has characterized it as optimistic. The detailed macroeconomic forecast, as well as the minutes from the meeting of the Macroeconomic Forecasting Committee and supporting materials, can be found on the IFP website.

Chart 8: Comparison of forecast of weighted macroeconomic bases⁵ for budgetary revenues with the MFC members⁶



Source: IFP, own calculations

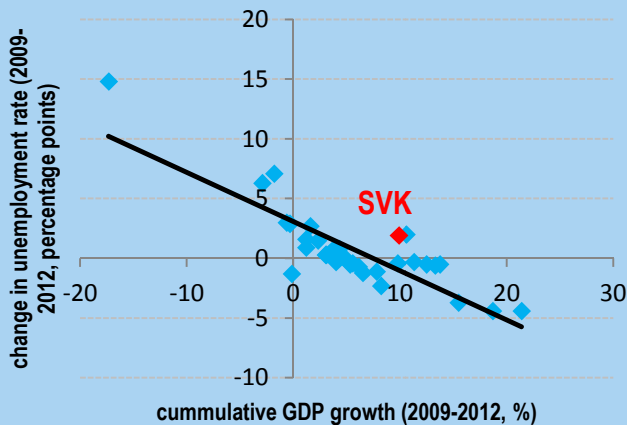
⁵ Macroeconomic basis for the budget revenues (weight of indicators depends on the proportional share of the particular tax on the total tax revenues); Wage base (employment x nominal wage) – 51,1%; Nominal private consumption – 25,7%; Real private consumption – 6,6%; Nominal GDP growth – 9,9%; Real GDP growth – 6,7%.

⁶ Darker blue represents 50% of MFC members.

BOX: How difficult is to sustainably reduce the unemployment in Slovakia?

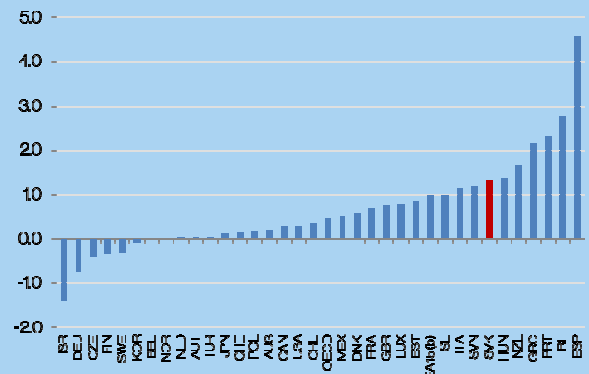
The unemployment rate according to LFS reached 14% in the second quarter of 2013. For a long time it has exceeded the average of the OECD (8%). It reacts weakly to the economic performance. Even though the Slovak economy grew above EU and OECD average between 2009 - 2012, the change in the unemployment rate has been during the same period below average (Chart A). This suggest that **its cause is rather structural than cyclical**.

Graph A: GDP growth and unemployment rate comparison in OECD countries



Source: OECD, IFP, own calculations

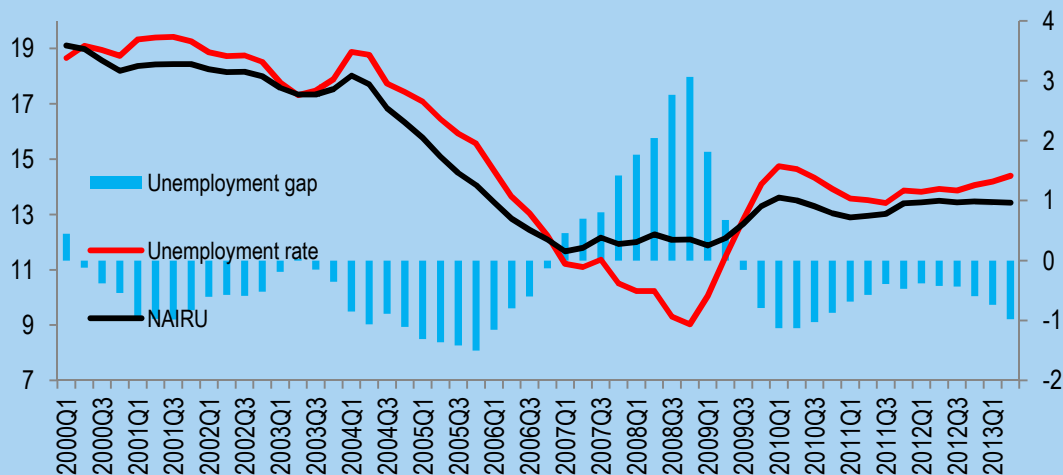
Graph B: Change in NAIRU in OECD between 2008-2012 (p.p.)



Source: OECD

IFP tried to estimate the structural rate of unemployment using the so-called NAIRU estimate (non-accelerating inflation rate of unemployment), i.e. the rate of unemployment consistent with the stable inflation in the economy. **The NAIRU estimate for Slovakia in 2013 is 13.5%, which is 1 p.p. below the actual LFS unemployment rate (Chart C) and high above the OECD average (7.0%).**

Graph C: NAIRU and unemployment gap



Source: IFP, own calculations

Our NAIRU estimate results in the following:

- A larger part of the unemployment in Slovakia is structural. Lowering the unemployment rate in Slovakia will be more difficult, and even a significant recovery of the foreign demand might not lead to its sustainable decline.
- Permanent and sustainable decline of unemployment must rely on the improvement of the structure of the labor market, mostly in the area of active labor market policies, education and mobility of the labor force.
- Cyclical unemployment caused by the crisis can over time transform into growing structural unemployment, if the jobless start to lose contact with the labor market, job skills, etc. A solution can be e.g. social security allowance for the long term unemployed ([IFP brief no. 10/2013](#)).

**IFP relied on the “gap” model of the Slovak and Eurozone economies inspired by the IMF methodology (Carabenciov et al..2008). In it a large closed economy (Eurozone) influences the economy of Slovakia, but Slovakia, as a small open economy, does not influence the economy of Eurozone. The model then estimates, using the Kalman filter, the structural and cyclical component of the unemployment and the GDP.*