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Towards a balanced growth
Macroeconomic forecast for 2014 – 2017

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In 2014, the economic growth will increase to 2.4% from 0.9% in 2013. Export performance is driven by the recovery of our trading partners, especially Germany. Growth of real wages will significantly support a recovery of households' consumption. On the other hand, the risks related to inflation at record lows remain.

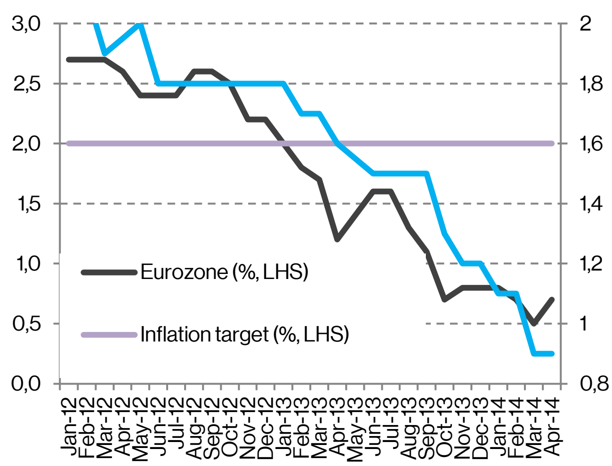
Divergent monetary policy of the ECB and the FED

The situation in financial markets remains stable; however, its impact on the real economy is lagging. In the last few months global markets have been dominated by continual recovery of developed economies and divergent monetary policy of the ECB and the FED. At the beginning of June the ECB has cut the main refinancing operations rate to a new historical minimum of 0.15%. Unprecedented among large central banks had been the set-up of negative deposit facility interest rate to -0.10%. The ECB also confirmed its commitment to improve the monetary transmission mechanism through the announcement of a new round of LTRO (€400bln) starting in September 2014 with a focus on the improvement of lending to the non-financial private sector. The FED has decided to postpone interest rate surge indefinitely. Nevertheless, it has tapered the pace of monthly asset purchases from $85bln to $45bln after the release of positive US economic data. Global equity markets have continued to rise and have reached new historical maxima.

Bond market yields reached pre-crisis levels

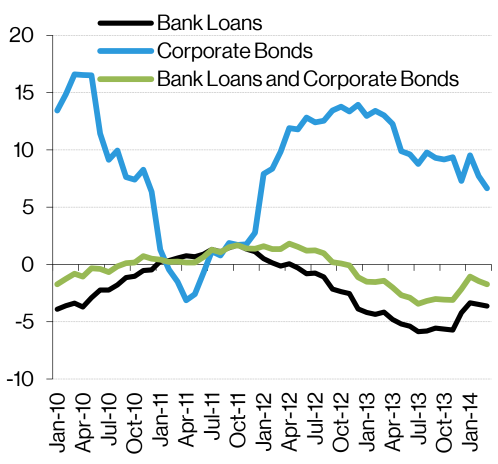
The inflation forecast below targeted 2% and promises of central bankers to keep interest rates low have contributed to the falling of government bond yields. The Eurozone peripheral bond yields have dropped to pre-crisis levels. Differences among banking sectors of euro area states and structural problems in some economies are the cause of positive financial market development reflecting unevenly in the real economy. Sluggish recovery of lending to non-financial corporations has been to some extent substituted by corporate bond issuance.

Graph 1: Current and expected inflation in Euroarea (%)



Source: Bloomberg

Graph 2: Financing of non-financial corporations (YoY, %)



Source: Bloomberg

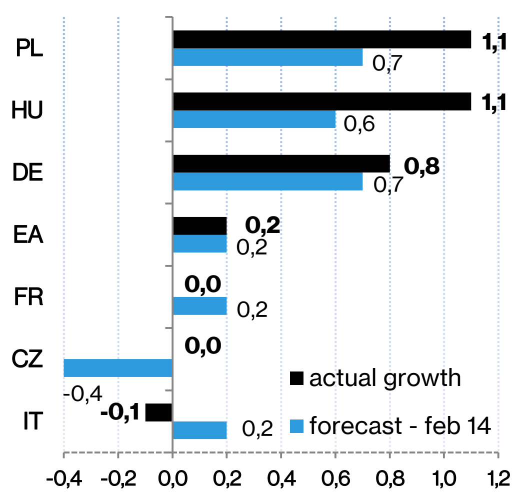
Disappointing growth of the Eurozone with the exception of Germany

The Eurozone continues in its slow economic growth, although the gains remain distributed unequally. It is mostly Germany and the new member states that are performing well. The positive message is a structural shift of the factors of the German economic growth from net export to private consumption and investments. On the other hand, the stagnation of French economy and the slump in Italy and the Netherlands (although this has been influenced by one-off factors) have been a disappointment.

Unclear effect of the ECB intervention

Despite the ECB intervention from June the inflation forecasts in the Eurozone remain low. Negative deposit rate can support a depreciation of the euro exchange rate by decreasing the portfolio flows. The announced LTRO program is expected to partially equalize the differences in the interest rates on corporate loans between the core and the periphery. ECB still expects the inflation to be under the monetary target in the medium term. Low growth of prices complicates mainly the reduction of debts of the periphery countries. On the other hand, low energy prices support private consumption.

Chart 3: Quarterly GDP growth of Slovakia's main trading partners in 2014Q1



Source: Eurostat, IFP

Chart 4: Expectations vs. actual growth in the EU member states

Source: IFP

Gradual acceleration of growth in Eurozone

Faster growth of our main trading partners led to an improvement of external assumptions. The international institutions (EC, OECD, IMF) confirmed their outlook of gradual acceleration of growth in 2014 and 2015. Leading indicators of the economic activity in the Eurozone remain on high levels despite the drop in March and April. Together with the continuing problem of the low inflation, the escalation of the geopolitical conflict in Ukraine and its impact on the foreign trade of the Eurozone countries is a main negative risk of the forecast of the external environment. On the other hand reports from the US economy create a slight positive risk.

Assumptions related to the external demand for 2014 are taken from OECD and corrected by current Bloomberg consensus estimates. The estimates for the external environment are revised upwards for the entire forecast horizon (Table 1).

Tabuľka 1: External environment in 2014-2017[1]

	GDP (% growth)				Diff. from February 2014				Import (% growth)				Diff. from February 2014			
	2014	2015	2016	2017	2014	2015	2016	2017	2014	2015	2016	2017	2014	2015	2016	2017
Main trading partners	**2,0**	**1,9**	**2,1**	**2,1**	**0,6**	**0,1**	**0,3**	**0,3**	**4,0**	**4,6**	**5,2**	**4,8**	**0,3**	**0,1**	**0,7**	**0,3**
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Eurozone	**1,7**	**1,6**	**-**	**-**	**0,5**	**0,1**	**-**	**-**	**3,9**	**3,9**	**-**	**-**	**0,3**	**0,1**	**-**	**-**
Germany	**1,7**	**1,7**	**-**	**-**	**0,1**	**-0,1**	**-**	**-**	**4,6**	**5,6**	**-**	**-**	**-0,2**	**0,1**	**-**	**-**
Czech Rep.	1,7	2,0	-	-	0,6	-0,2	-	-	4,5	5,1	-	-	0,6	0,2	-	-
Poland	3,1	3,3	-	-	0,4	0,1	-	-	3,9	6,0	-	-	-0,3	-0,4	-	-
Hungary	2,5	1,7	-	-	0,5	0,1	-	-	4,8	5,0	-	-	0,3	-0,1	-	-

Source: Bloomberg, OECD, IFP

More balanced economic growth

Slovak economic growth will accelerate to 2.4% this year. The recovery of our trading partners will have a positive impact on the export performance. The external demand has been joined by households' consumption since the start of the year. The increased confidence and purchasing power of consumers are caused mainly by improved labor market and lower inflation. Investments into new production capacities in the automotive sector as well as the motorway construction also contribute to the recovery of the domestic demand. The forecast for the government consumption includes reaching the fiscal target and the activation of the debt brake by freezing the expenditures from May of this year.

In the following years a gradual acceleration of the economy with a more balanced structure of growth is expected. Accelerating foreign demand will result in a faster growth of Slovak exports, which will continue to gain market share on the foreign markets. Households' consumption will be driven by a recovery on the labor market, as well as the improvement of the purchasing power through lower inflation. On the other hand, the government consumption will remain dampened due to fiscal consolidation on the expenditure side. The one-off impacts of automotive investments and motorway construction on the investment demand will gradually fade out. On the other hand, improvement of the conditions of financing will lead to accelerating investments in the economy.

Table 2: MF SR forecast – main economic indicators (June 2014)

indicator (growth in % unless otherwise noted)	actual	forecast				difference from February 2014			
	2013	2014	2015	2016	2017	2014	2015	2016	2017
Gross domestic product									
GDP, real	0,9	2,4	3,0	3,5	3,5	0,1	0,0	0,3	0,0
GDP, nominal (bn €)	72,1	73,8	77,0	81,1	85,6	-0,7	-0,8	-0,6	-0,6
Private consumption, real	-0,1	2,4	2,1	2,6	2,2	1,2	-0,1	0,3	-0,7
Private consumption, nominal	1,3	2,7	3,8	4,8	4,6	0,7	-0,5	0,0	-0,8
Public consumption	1,4	-0,2	-2,5	-0,8	0,1	-2,1	-1,1	-0,4	-0,8
Fixed investments	-4,3	2,8	3,3	1,5	2,0	1,0	0,9	0,7	-0,1
Export of goods and services	4,5	6,7	4,6	6,2	6,3	2,7	0,1	1,4	1,5
Import of goods and services	2,9	7,4	3,7	5,2	5,2	3,8	0,1	1,5	1,0
Labor market									
Employment (registered)	-0,7	0,5	0,6	0,6	0,7	0,2	-0,1	-0,1	-0,3
Wages, nominal	2,4	3,2	3,3	4,2	4,6	0,6	-0,2	0,1	0,1
Wages, real	0,9	2,8	1,7	2,0	2,3	1,1	0,2	0,2	0,2
Unemployment rate	14,2	13,7	13,1	12,3	11,3	-0,3	-0,1	0,0	0,0
Inflation									
CPI	1,4	0,3	1,6	2,1	2,3	-0,5	-0,5	-0,1	-0,1

Source: ŠÚ SR, IFP

[1] In an effort to use all available information on the external environment the OECD forecast from May 2014 was adjusted based on latest consensus of international financial institutions (Bloomberg consensus).

Continued recovery of the labor market

The labor market continues to recover. The first quarter showed a solid growth of employment and job vacancies, which should continue throughout 2014. Jobs will be created mainly in industry and in services, jobs in construction will grow at a slower pace. **The economic growth will push the unemployment rate below 14% this year.** In the following years the growth of employment will accelerate even further.

In 2014, real wages will grow at a fastest pace since 2008, mainly due to low inflation. In the following years the dynamics of growth will slightly weaken and its development will follow the gains in labor productivity. The fastest growth of wages should take place in industry and in market services. In construction, the dynamics of wages will be somewhat weaker. **Fast growth of nominal wages in 2014 is supported by positive data from the first quarter, which has been only partially influenced by a one-off effect of bonuses.** Strong dynamics of nominal wages should continue in the following years and will lead to an eventual narrowing of the gap between productivity and wages growth.

2014 inflation at record lows

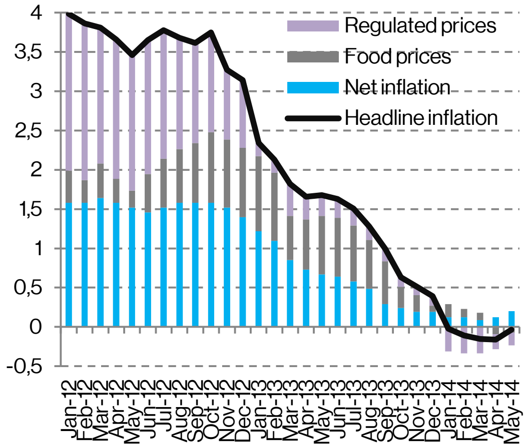
This year the price growth will reach record lows. A slowdown of inflation can be seen in all components of the consumption basket. The expected year-on-year growth of consumer prices will slow down towards 0.3%. Inflation will rise in the second half of the year, with a slight increase in the prices of food and services. The risk of deflation in the Eurozone has decreased only slightly.

Slower price growth results from both external and domestic factors. A strong euro exchange rate and a drop of energy prices and primary inputs lower production costs. Lower costs lead to slow growth of prices of goods throughout the Eurozone. Last year's abundant harvest both at home and abroad resulted in a drop of food prices at a domestic market. Their further development will be dependent on more accurate estimates of this year's harvest. The prices of services followed the general disinflationary trend. The positive results of the labor market are expected to reverse the slowdown of inflation of market services. The growth of prices of services, which is expected from the third quarter onwards, should be a sign of the recovery of domestic consumption.

Continued risk of deflation in the Eurozone

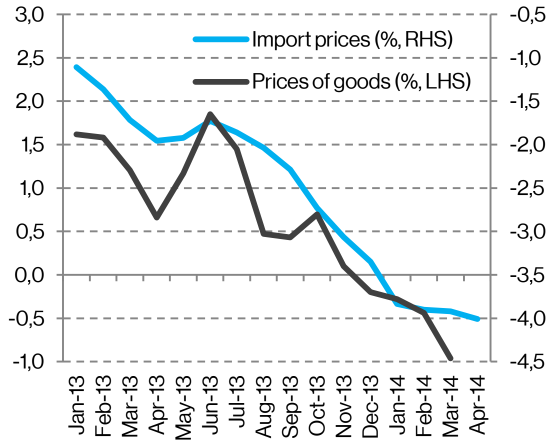
The risks for the domestic price level are concentrated mostly on the negative side. It is improbable that the current ECB intervention will lead to significantly faster inflation in the Eurozone, which will have a dampening effect on the prices of goods.

Chart 5: Year-on-year growth of CPI and contributions of individual components (p.p.)



Source: IFP

Chart 6: Year-on-year growth of import prices for producers and prices of goods

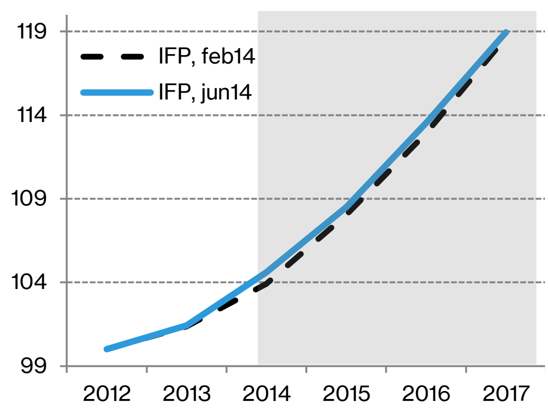


Source: IFP, Eurostat

Lower inflation slows down the growth of tax bases

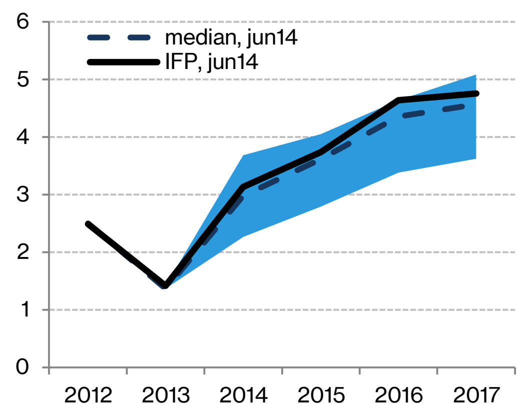
The total impact of the update of the macroeconomic forecast on the tax bases is positive compared to February. Better performance of real indicators and especially the wage base is only partially compensated by lower nominal values due to slower inflation[2]. The impact of the macroeconomic forecast on the estimate of budgetary revenues will be subject to a meeting of the Tax forecasts committee on June 20th 2014. Low inflation has a negative impact also on the public debt. Slower growth of the nominal GDP will increase the debt to GDP ratio by 0.5 p.p. in both 2014 and 2015.

Chart 7: Macroeconomic tax bases[3] compared to February forecast



Source: IFP

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



Source: IFP, Eurostat

Medium term macroeconomic **forecast** by the MoF SR **was evaluated by the majority of members of the Macroeconomic forecasts committee** (NBS, Infostat, SAV, Unicredit, ČSOB, SLSP, VÚB) **as realistic,** with the exception of Tatra banka, which evaluated it as conservative, and Sberbank, which considers the forecast as optimistic. Detailed macroeconomic forecast, as well as 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. Consolidation in 2013 took less than 0.2 p.p. from GDP growth

Due to the excessive deficit procedure, Slovak government has committed to lowering the public finance deficit in 2013 under 3% of GDP. Under the no policy change assumption the public finance deficit would reach 4.9% of GDP in 2013. According to current estimates the consolidation measures amounted to 2.2% of GDP, i.e. almost 1.6 bn. euro. **Since only a smaller part in the amount of 0.7% of GDP had a direct impact on GDP**, the impact of fiscal consolidation on growth in 2013 did not exceed 0.2 p.p.

Consolidation measures without a direct impact on GDP were excluded from the calculations. These are extraordinary revenues from the change in the second (private) pillar of the pension system and other non-tax revenues. The overview of budgetary measures with a direct impact on GDP can be found in the Stability programme of the Slovak Republic for 2014 – 2017 in the Table 1 of Annex 2.

The estimate of the impact of the fiscal consolidation on GDP growth in 2013 was quantified by several approaches, a more detailed description of which will be provided in a separate analysis. The estimates are based on fiscal multipliers[4] from the macroeconomic model of the IFP (IFPMOD), other econometric models (SVAR and ECM) and the OECD analysis. Overview of the estimated multipliers of the 2013 package and its impact on GDP can be found on the Chart B1. Based on four model approaches the estimate of the consolidation on the GDP growth in 2013 ranges from **-0.01 to -0.2 p.p.**

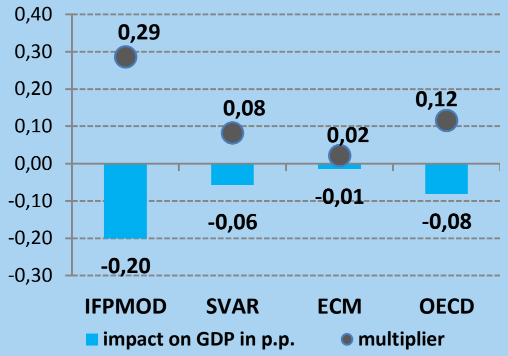
Macromodel of the IFP was used to **calculate the impact of the package on other macroeconomic variables** (see Table B1). Higher social security contributions for households lowered their compensations. In the case of higher corporate taxes and contributions we assumed savings in the wage expenditures together with an increase of prices of goods and services (GDP deflator). On the expenditure side, higher current transfers and wage expenditures in the state sector contributed positively towards households' compensations. The rest of expenditure measures stimulated government consumption and investments. The estimated fiscal multiplier reached 0.29, while the estimates from other model approaches were even lower (Chart B1).

Table B1: Impact of consolidation on the economy according to the macroeconomic model of the IFP (p.p.)

	2013
total measures (% of GDP)	**-2.2**
measures with an impact on GDP	**-0.7**
Contribution to CPI change	0.2
Employment	0.0
wages	0.3
private consumption	-0.4
public consumption	0.7
investments	0.3
import	0.0
contribution to GDP growth (y/y)	**-0.2**

Source: IFP

Chart B1: Fiscal multipliers of the 2013 package according to various approaches



Source: IFP

In the short history of the independent Slovak Republic three main periods of the public finance consolidation can be identified: 1993-1995, 2003-2005 and 2011. During 2003-2005 despite the strong consolidation effort the economic growth accelerated. Main factors behind the significant economic growth were mainly the favorable external environment, accession to the EU, start of the structural reforms and also the low starting point of the economy. Measures with a direct impact on GDP in 2011 amounted to 3.3% of GDP. We estimate the impact of consolidation on our economic growth in the interval from -1.0 p.p. to -1.8 p.p. depending on the approach used. The fiscal multiplier ranged from 0.3 to 0.54.

[4] Fiscal multiplier in effect says how much the GDP will increase (in euros) if the government raises expenditures (lowers taxes) by one euro.