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Labor market recovery will help public budgets

Macroeconomic forecast for 2014 – 2017

Lucia Šrámková, Libor Melioris, Peter Tóth

Improving domestic demand in 2014 will support the economic growth and compensate for the weaker foreign demand caused by the uncertainty resulting from the current geopolitical conflict. This year's development is marked by good news coming from the labor market confirming a robust growth of employment and wages. Thanks to this recovery, the economic growth by 2.4% is the most favorable for tax revenues in the whole post-crisis period. The rate of economic growth should slightly accelerate in the following year, although with a lower impact on the growth of tax bases.

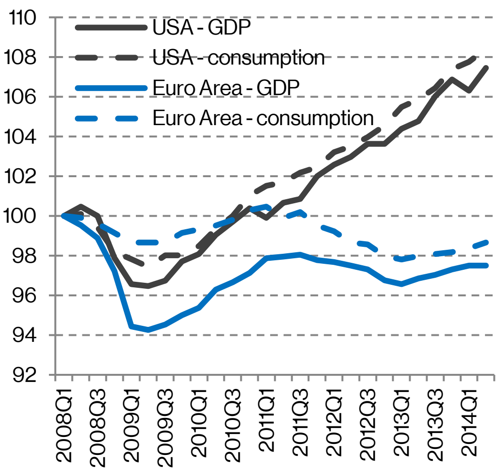
ECB surprises markets with new easing measures

In recent months global markets have been affected by rising differences in the monetary policy cycle between major advanced economies and the ongoing geopolitical tensions. The ECB in an environment of declining inflation expectations in euro area decided to lower interest rates in the early September by 0.1 b. p. to historical lows (main refinancing 0.05%, deposit -0.2% and marginal lending 0.3%). New programs were announced to purchase asset-backed securities with underlying assets consisting of claims against the euro area non-financial private sector and covered bonds issued by financial institutions domiciled in the euro area. Aforementioned programs together with targeted LTRO should improve the monetary policy transmission mechanism and support higher inflation expectations in the future. Euro dropped against the US dollar after the ECB announcements. The FED encouraged by positive news from the American economy continued in tapering. Financial markets expect increase of the FED rate in the second quarter of 2015. Conflict between Russia and Ukraine has significantly increased market volatility on several occasions.

Interest rates convergence still distant

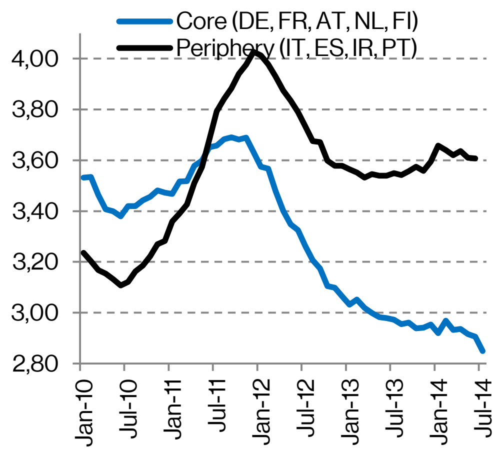
Expected inflation well below the target level of 2% and ECB's easing of monetary policy contributed to the reduction of government bond yields. Nevertheless, divergence of interest rates on loans in the core and the periphery still persists.

Chart 1: Comparison of post-crisis development of the USA and the Eurozone



Source: Bloomberg

Chart 2: Comparison of interest rates in the core and the periperhy (%, level)



Source: MF SR, ECB

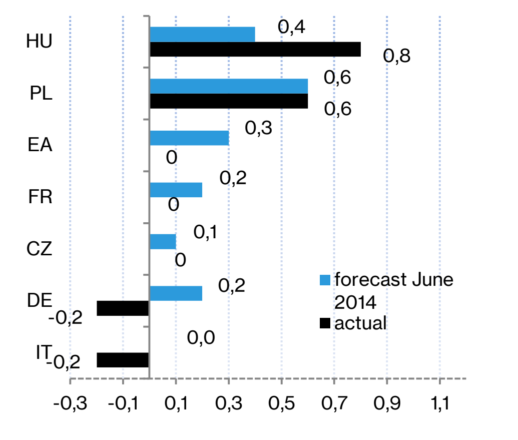
Slow growth is becoming a tradition in the Eurozone

Even after five years since the crisis the Eurozone has not managed to reach the pre-crisis growth dynamics. The optimistic expectations from the end of the last year were not fulfilled and the bad news peaked with the stagnation of GDP in the second quarter. The continuing recession in large countries such as France and Italy signals persistent structural problems of these economies. The second quarter has surprisingly brought also the drop of the economy of the Eurozone's engine – Germany. The stagnation in the Czech Republic has been, similarly to Germany, influenced by one-off factors, which should not repeat[1] in the following periods. Out of our main trading partners only Poland and Hungary have maintained, similarly to Slovakia, strong quarter-on-quarter growth.

Worsened outlook due to Ukraine and persistently low inflation

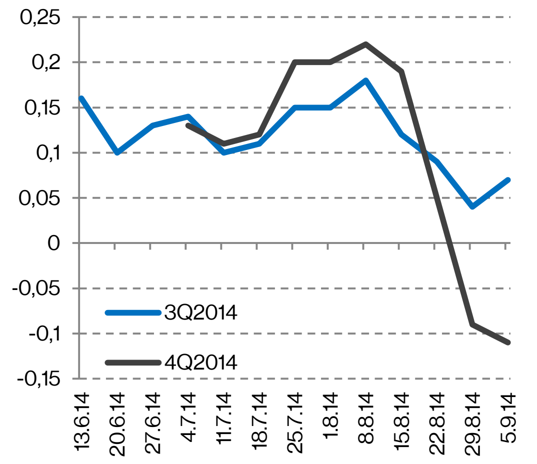
The outlook of economic growth in the Eurozone has worsened. The expectations in the Eurozone are negatively influenced mainly by the uncertainty related to the conflict in Ukraine and the anchoring of the inflation at low levels. Lower business and consumer confidence due to uncertain outlook of future development has a more pronounced impact on the economies of the Eurozone than the direct restrictions in the financial sector and the ban of the export of a currently relatively narrow spectrum of products. Negative outlook in the Eurozone is reflected in the drop of the forward-looking indicators since April of this year. Current levels indicate a possible stagnation of the Eurozone in the second half of this year. The non-inflationary trend in the Eurozone remains a risk as well.

Chart 3: Q-o-q GDP growth of Slovakia's main trading partners in 2Q2014



Source: Eurostat, IFP

Chart 4: Drop of estimated q-o-q growth in the Eurozone



Source: IFP

Worse performance of the Eurozone is compensated by an improvement of our neighbors

Despite all this, the estimates of the economic growth of our main trading partners in 2014 remain unchanged. Lower estimated growth of the Eurozone is fully compensated by a positive outlook of growth of the neighboring countries. High import growth of our trading partners in the first half of the year has had a positive impact on the forecast of the foreign demand for this year and has outweighed the estimated slowdown in the second half. The deterioration of the foreign demand will therefore be fully apparent only in 2015. The assumptions related to the external demand are taken from the OECD Spring forecast and corrected for the growth observed in the first half of the year and a very short forecast (nowcasting) of the Eurozone. Assumptions related to external environment, interest rates and commodity prices are based on information available by the end of August 2014.

[1] Impact of number of working days and an atypical weather which influenced economic activity in the first and second quarter of this year.

Table 1: External environment in 2014-2017

	GDP (% growth)				Diff. from June 2014				Import (% growth)				Diff. from June 2014			
	2014	2015	2016	2017	2014	2015	2016	2017	2014	2015	2016	2017	2014	2015	2016	2017
Main trading partners	2.0	1.8	2.2	2.2	0.0	-0.1	0.1	0.1	5.1	4.1	5.2	4.9	1.1	-0.5	0.0	0.1
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Eurozone	0.7	1.3	-	-	-0.5	-0.2	-	-	2.9	2.2	-	-	-1.0	-1.7	-	-
Germany	1.3	1.5	-	-	-0.4	-0.2	-	-	4.0	4.3	-	-	-0.6	-1.3	-	-
Czech Rep.	2.4	2.5	-	-	0.7	0.5	-	-	6.9	4.7	-	-	2.4	-0.4	-	-
Poland	3.4	3.3	-	-	0.3	0	-	-	7.3	4.7	-	-	3.4	-1.3	-	-
Hungary	2.7	2.1	-	-	0.2	0.4	-	-	5.8	5.0	-	-	1.0	0.0	-	-

Source: Bloomberg, OECD, IFP

Domestic demand is the main driver of growth in 2014

Slovak economy will grow this year by 2.4%. The growth will be driven mainly by a faster than expected growth of consumption and investments in the first half of this year, while in the second half we expect a slowdown of both domestic and foreign demand. The main factors behind the positive outlook for consumption are the growth of real wages and the ongoing recovery of employment. The growth of investments will accelerate mainly in the non-financial sector. The public consumption will contribute positively to growth as well, even after the expected slowdown in the second half of the year in line with the expenditure limits. Export performed worse than expected in the first half, indicating a moderate slowdown of the pace of gaining export shares.

Slow acceleration of growth in 2015

In 2015 the economic growth should slightly accelerate and reach 2.6%. Forecast for 2015 is influenced by a worse outlook of the foreign demand, as well as by a drop in public consumption (fastest since 2011) reflecting the expected additional consolidation. The investment growth will slowly recover from the worsened sentiment in the second half of 2014. Slowdown of the domestic demand will make space for a positive contribution of the net export. The structure of growth will be somewhat less tax favorable compared to 2014.

Balanced structure of growth by the end of the forecasted period

2016 and 2017 should bring a balanced structure of growth, with a slight prevalence of net export over the components of domestic demand. Strengthened performance of our main trading partners will drive Slovak export growth. Stable environment of orders will support private investments, although there will be a negative influence of waning one-off factors in the automotive industry and motorway construction. Stable growth of real wages and continued recovery of employment will have a pro-growth impact on private consumption. Public consumption will be kept at 2015 levels due to the effects of the debt brake.

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

indicator (growth in % unless otherwise noted)	actual 2013	forecast 2014	2015	2016	2017	Diff. from June 2014 2014	2015	2016	2017
Gross domestic product									
GDP, real	0.9	2.4	2.6	3.5	3.5	0.0	-0.4	0.1	0.0
GDP, nominal (bn €)	72.1	73.6	76.4	80.5	84.9	-0.2	-0.7	-0.6	-0.7
GDP, nominal (bn €), ESA 2010		75.1	77.9	82.2	86.6				
Private consumption, real	-0.1	2.9	2.4	2.7	2.2	0.5	0.2	0.1	0.0
Private consumption, nominal	1.3	2.9	3.4	4.6	4.3	0.2	-0.4	-0.1	-0.3
Public consumption	1.4	2.0	-3.8	-0.2	-0.2	2.1	-1.4	0.6	-0.3
Fixed investments	-4.3	4.8	2.7	1.4	1.9	2.0	-0.5	-0.1	-0.2
Export of goods and services	4.5	4.6	4.3	6.0	6.1	-2.1	-0.4	-0.3	-0.2
Import of goods and services	2.9	5.7	3.4	4.7	5.0	-1.7	-0.4	-0.5	-0.1
Labor market									
Employment (stat. evidence)	-0.7	1.0	0.4	0.5	0.6	0.5	-0.1	-0.1	-0.1
Wages, nominal	2.4	4.2	3.3	4.2	4.4	1.1	0.0	0.0	-0.2
Wages, real	0.9	4.1	2.1	2.2	2.3	1.3	0.4	0.2	0.0
Unemployment rate	14.2	13.5	13.0	12.2	11.3	-0.2	-0.1	-0.1	0.0
Inflation									
CPI	1.4	0.1	1.0	1.9	2.1	-0.1	-0.5	-0.2	-0.2

Source: ŠÚ SR, IFP

Faster recovery of the labor market

The labor market will recover significantly this year. First half of the year brought a significant growth of employment and job vacancies, which should result in an increase of employed by 22 thousand in the whole 2014[2]. New jobs will be created mostly in industry and in the public administration, in construction we expect stagnation. **Economic growth will push the unemployment rate down to 13.5% this year.** In 2015 the employment growth will slow down due to weaker foreign demand and public consumption. By the end of the forecast horizon the employment growth will reach a sustainable pace.

Growth of real wages above productivity

In 2014, the pace of real wages growth will be the fastest since 2007. The reason behind the fast growth of real wages is mostly a low price growth. After several years, the growth of real wages will exceed the growth of labor productivity and close a part of the scissors opened in the past. In the following years the dynamic of real wages will be slightly weaker in line with the growth of productivity. Wage growth should be the fastest in industry and market services (Chart 5). In construction the dynamic will be slightly weaker. Strong growth of nominal wages from 2014[3] should continue in the following years and will lead to an increased share of wages on GDP.

Inflation is positively influenced by food and energy prices

This year we'll observe the lowest inflation in Slovak history. This development is consistent with the non-inflationary trend observed across the Eurozone. Annual growth of consumer prices will reach only 0.1%. Among individual component we see a significant decrease of food prices, slight decrease of regulated prices and only weak net inflation. The rate of inflation should slowly accelerate in the last quarter of this year and the first half of 2015. The inflation will reach the levels usually corresponding to the expected levels of the economic activity only by the end of the forecasted period.

2014 inflation at record lows

Slow increase of prices is a result of a positive impact of the cost factors and a weak reaction to the demand impulses. Disinflationary impulse from the cost side follows mainly the decrease of prices of energies and primary inputs on the global markets observed in the first half of the year. This drop will influence the price level in the

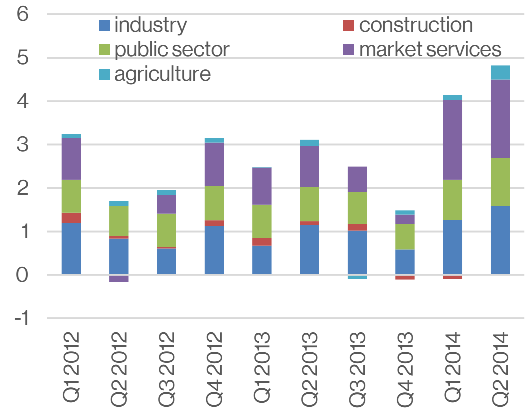
[2] From 2 176 thousand to 2 198 thousand workers
[3] Average nominal wages will rise by EUR 35 with a negligible inflation

second half as well. The dynamics of the cost factors result in a decrease of prices of goods, food and energies. Domestic demand pressures in the form of improved results of the labor market have not yet translated into price dynamics. Prices of services therefore continue only in a moderate growth.

Demand pressures will slowly increase

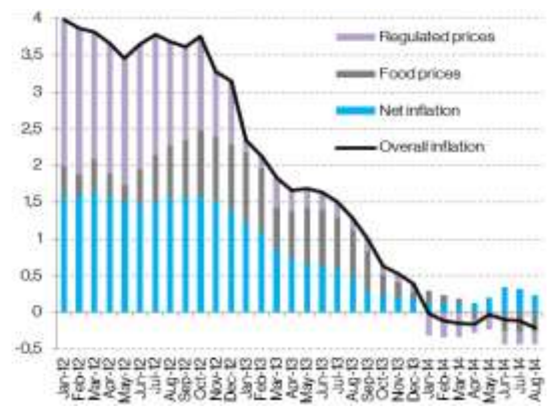
Risks for the domestic price development are balanced. Currently observed fall of energy prices will have a dampening effect on the inflation even in 2015. On the other hand, strong wage growth in this year should result in a gradual acceleration of the prices of services. Relaxed monetary conditions make space for a faster growth of prices of goods next year. By the end of the forecast horizon the inflation will gradually accelerate due to the demand pressures from the recovery of growth.

Chart 5: Contributions of individual components of wage growth (p.p.)



Source: SÚ SR, IFP

Chart 6: Y-o-y growth of CPI and contributions of individual components (p.p.)



Source: IFP

Labor market recovery supports tax base growth

The overall impact of the update of the macroeconomic forecast on the tax bases is positive compared to June, especially in 2014. Improvement of the wage base and private consumption is only partially carried over to following years, mainly due to slower growth of nominal values[4]. The impact of the macroeconomic forecast on the estimate of taxes and contributions will be discussed on the Tax forecast committee on September 24th 2014.

Chart 7: Macroeconomic tax bases compared to June forecast

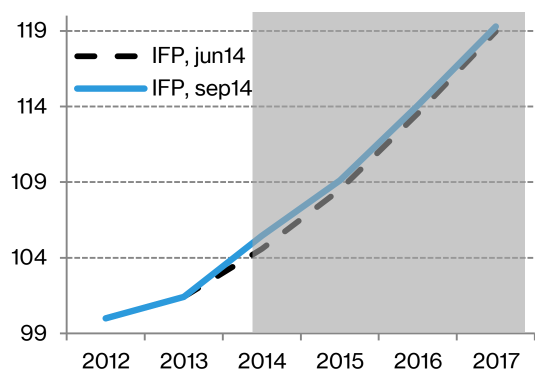
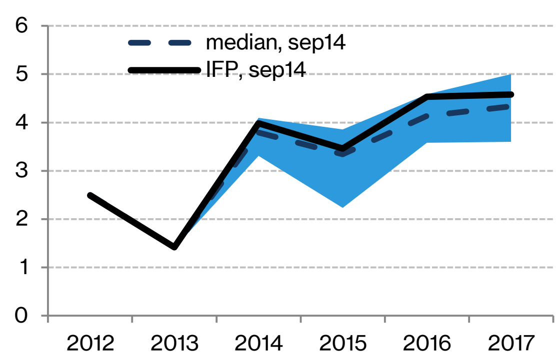


Chart 8: Comparison of forecasts of macroeconomic bases[5] with the members of the committee



[4] 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.
[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%.

Source: IFP

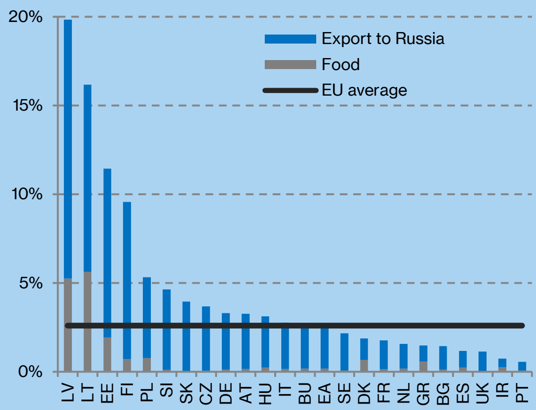
Source: IFP

The medium-term macroeconomic **forecast** by the MF SR has been the subject of discussion of the Macroeconomic forecasts committee on September 16th 2014 and it has been evaluated by all members as realistic. Detailed macroeconomic forecast, together with the minutes from the meeting of the Committee and supporting materials, is available on the IFP website.

BOX. Geopolitical conflict will lower growth by 0.2 – 0.3 p.p.

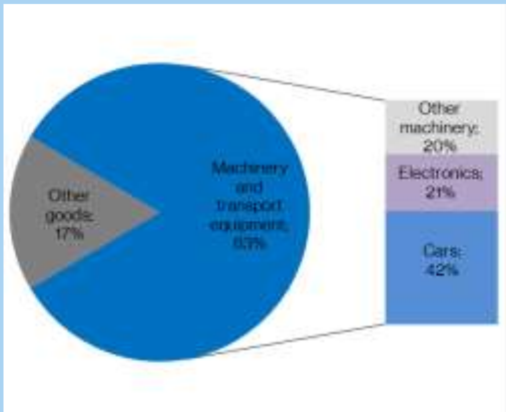
Slovakia is not among the countries dependent on exports to Russia. The share of export to the Russian Federation on total export is less than 4% and continually drops since 2012. It's even less in case of Slovakia's main trading partners with the exception of Poland (Chart B1), as our share is above the EU average. The dominant part of our exports to RF consists of automobiles and products of the automotive industry, followed by the products of the electronics industry (Chart B2). The direct impact of sanctions from both sided as of September 10th 2014 on Slovakia's foreign trade is negligible according to IFP's calculations. The estimated drop of exports due to sanctions will amount to a maximum of 0.05% of the total volume of exports.[6] The ban on export of European food to RF creates a surplus of food in the Eurozone, which leads to a decrease of food prices in addition to the global decrease of prices of agricultural commodities.

Chart B1: Share of exports to Russia on total exports of individual countries



Source: IFP

Chart B2: Structure of Slovak export to Russia



Source: IFP

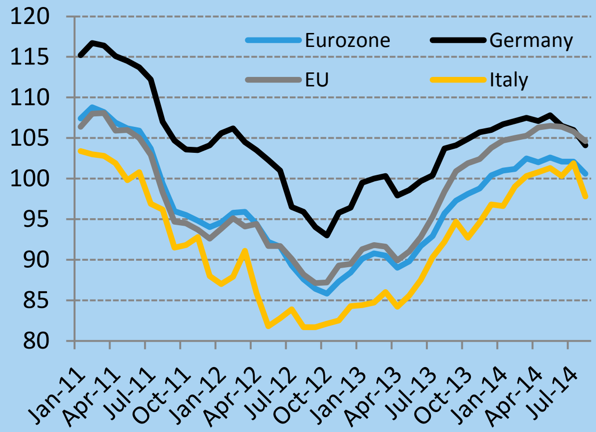
The indirect impact of sanctions poses a more serious risk for our economy. This effect arises from the weakening of business and consumer confidence in Europe due to the uncertainty related to the conflict in Ukraine. Heightened vigilance discourages businesses from the implementation of their investment projects and job creation. Weaker labor market prospect are transmitted into household consumption. It is quite difficult to quantify the impact of this transmission channel, as it is difficult to separate the effects of the conflict in Ukraine on the economy of our major trading partners from other current events affecting their development. However, it is clear that from the beginning of April there has been a continuous deterioration in leading indicators in the Eurozone (Chart B3). Given its timing, it is very likely that the dominant part of this decline is due to the conflict in Ukraine.

We quantified the impact of the worsening Eurozone outlook on the forecast of the Slovak economy using the IFP's macroeconomic model. We have taken into account actual foreign and domestic GDP figures for the first half of 2014. Assumptions for the further development are based on the September international consensus of analysts surveyed by Bloomberg[7], which already reflects the deterioration in the confidence indicators in the euro area. The baseline scenario takes into account the assumptions of analysts regarding growth and foreign demand from June 2014, in which the geopolitical conflict has not yet manifested. The geopolitics should start showing in the euro area GDP figures starting in the third quarter of this year and its effect on the performance of our major trading partners should according to the analysts' estimates gradually recede during 2015. The assumptions of the exercise and their impact on the forecast

[6] This is an upper bound due to the volume of export of dual-use goods identified on the basis of HS6 classification of foreign trade.
[7] Updated projections of the external environment according to the foreign institutions (OECD, European Commission, IMF) are not yet available.

of our economy are summarized in Table B1. **The results show that the uncertainty surrounding the conflict in Ukraine will lower the expected growth of Slovak GDP by 0.2 and 0.3 p.p. in 2014 and 2015 respectively.** The decline in orders directly affects the export performance, which translates into lower investment. Slowdown of the labor market is more significant in 2015 and slightly dampens the growth rate of private consumption, but without an increase in the savings rate.

Chart B3: Confidence indicators in the Eurozone countries



Source: IFP

Table B1: Effect of the change of the Eurozone Outlook on the Slovak economy

Impact on growth in p.p.	2014	2015
Eurozone GDP	**-0.1**	**0.0**
Foreign demand	-0.4	-0.3
Slovak economy:		
CPI	0.0	-0.2
employment	0.0	-0.1
wages	-0.2	-0.4
household consumption	-0.1	-0.2
fixed investment	-0.2	-0.3
export	-0.4	-0.4
import	-0.4	-0.4
GDP growth	**-0.2**	**-0.3**

Source: IFP

BOX. MF SR forecast in the new ESA2010 national accounts methodology

In view of the preparation of the general government budget for the years 2015-2017 and the draft budgetary plan already in the new ESA2010 national accounts methodology, **IFP submitted to the Macroeconomic Forecast Committee for approval also the macroeconomic forecast prepared on the basis on preliminary ESA2010 data.** The Statistical Office will publish the quarterly GDP data only in early December, however **in October this year there will be a notification of the deficit and the debt of the general government in the new ESA2010 methodology.** At the time of the preparation of the forecast IFP had only preliminary annual national accounts data available from the Statistical Office. It is therefore likely that, based on further details from the Statistical Office and the Eurostat, IFP will undertake further methodological changes in the next update of the forecast in January.

The basis of the ESA2010 forecast was the forecast developed by the standard model approach in the ESA95 methodology. Due to unavailability of the quarterly profiles the annual growth of GDP and its components (in both constant and current prices) were carried over to the new (preliminary) levels of those indicators in ESA2010. The results of this simplified approach are therefore the estimated new levels of GDP and its components, while their annual growths are identical to the ESA95 estimates.

The projected level of GDP is higher in the new methodology (Table 2), which also affects the ratios of the deficit and the debt of the general government to GDP. Due to the sectoral reclassification of certain entities which previously did not belong to public administration, however, there will be also changes to the deficit and the debt of the general government. These changes will be known only after the notification process in October.