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Recession in the Euro Area impacts the Slovak economy

Macroeconomic forecast 2013 – 2016 (June 2013)

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The annual economic growth should reach 0.5% this year. The rate of economic growth decelerates due to economic slowdown of our most important trading partners and due to lack of domestic demand. The unfavorable situation in Europe will negatively affect exports and the investment activity in Slovakia. Fiscal consolidation and weak labor market will further dampen domestic consumption. Because of the expected recovery of the world economy, we expect a gradual increase in the rate of economic growth in Slovakia by the end of 2013, which will approach 2.2% in 2014. By the end of the forecasted period the economic growth in Slovakia should return to 3%.

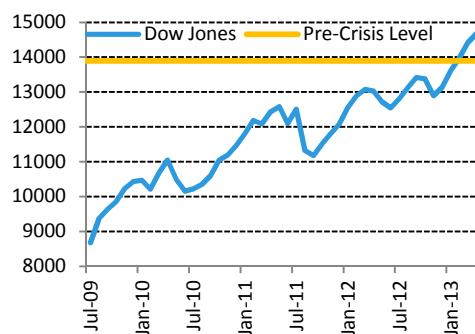
Financial markets' stabilization ...

The situation on the international financial markets improved when compared to the last IFP forecast. Stock markets gained (see Chart 1) and there was an excess of liquidity on financial markets due to QE programs of central banks in the US, Euro Area and Japan. Euro Area periphery bond yields fell to lowest levels since the beginning of 2011. Italy and Spain, the two largest at-risk economies in the Euro Area, sold their 10-year debt as yields decreased to 4.2% and 4.5%, respectively. This is a major improvement when compared to the yields' maxima (7.1% and 7.6% resp.) in 2012. Yields on Slovak debt fell significantly as well: 10-year government bond yield dropped from 5% in December 2011 to current 2.5%.

... does not affect the real economy evenly

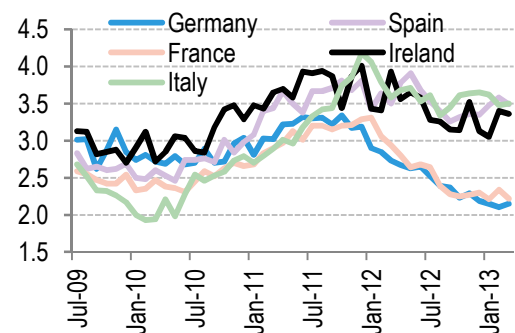
However, the stabilization of the financial market and the excess of liquidity is only modestly affecting the real economy. The activity of non-financial corporations in the credit market is declining; credit to households is rising only slightly. **Moreover, the credit development is not balanced within the Euro Area** (the so-called two-speed Euro Area, Chart 2). Falling interest rates in the core Euro Area countries reflect the excess liquidity and easier access to capital markets. Conversely, the interest rates on periphery stagnate because of high delinquency rates on loans and because of the ongoing fragile confidence in the financial system. Given the high indebtedness and elevated volatility on the financial markets in the periphery, the improvement in the real economy will be subdued.

Graph 1: Dow Jones Industrial Average compared to the pre-crisis maximum



Source: Bloomberg

Graph 2: Interest rates on corporate loans in selected euro area countries



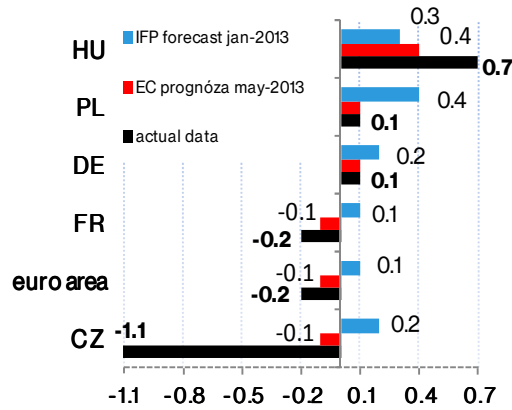
Source: Bloomberg

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Inhospitable external environment at the beginning of the year

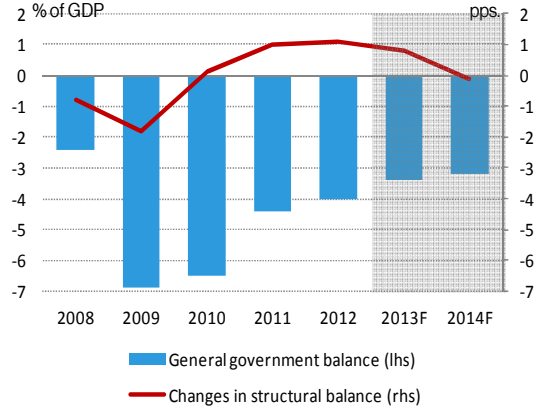
The performance of our main trading partners has been worsening. **The recession in Euro Area deepened, its economy is shrinking for six consecutive quarters.** The unemployment in the EMU reached the maximum in the last 20 years. The development in the first quarter of 2013 was worse than we expected in January, and it was even worse compared to the EC spring forecast from May (Chart 3). Market expectations suggest that the situation should improve in the second half of 2013. Expectation indices IFO and ZEW predict the economic recovery mainly in Germany.

Graph 3: Real GDP growth 1Q 2013 (% QoQ)



Source: IFP, EC spring forecast, Eurostat

Graph 4: Consolidation in EU27 (% pps.)



Source: EC spring forecast

EU expectations worsened

The expected external environment worsened throughout the whole forecasted period. The economic activity of our trading partners should be weaker in 2013 compared to 2012. The main reasons are a high public and private debt, an ongoing fiscal consolidation and a weak labor market. **The reconsideration of fiscal tightening in the Euro Area and the expected growth in the world trade should increase the demand in the Euro Area in the near future.**

Table 1: Foreign environment in 2013 – 2016¹

	GDP (% growth)				Diff. from Jan 2013				Import (% growth)				Diff. from Jan 2013			
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016
Largest trading partners	-0,2	1,4	1,5	1,5	-0,7	-0,4	-0,2	-0,2	0,0	3,6	4,0	4,0	-2,4	-0,9	-0,3	-0,3
Euro area	-0,6	1,0	-	-	-0,5	-0,2	-	-	0,0	3,1	-	-	-2,0	-1,9	-	-
<i>Germany</i>	0,4	1,6	-	-	-0,1	-0,2	-	-	2,1	5,4	-	-	-1,3	-0,4	-	-
<i>Czech republic</i>	-1,0	1,3	-	-	-1,8	-1,1	-	-	-3,0	4,6	-	-	-5,9	-1,0	-	-
<i>Poland</i>	1,0	2,3	-	-	-0,6	-0,2	-	-	-0,4	2,5	-	-	-3,8	-3,1	-	-
<i>Hungary</i>	0,2	1,2	-	-	-0,3	-0,2	-	-	2,1	3,4	-	-	0,6	0,2	-	-

Source: Bloomberg, OECD, IFP

Reduction in GDP growth throughout the forecasted horizon

For the current year, the IFP forecast predicts a slowdown for the Slovak economy to an annual increase of 0.5%. Our export driven economy did not receive any impulse from the foreign demand in the first quarter 2013. Worsening external environment accompanied by the diminishing corporate profits resulted in significant reduction of the investment activity. Furthermore, conditions on the labor market drove the households to cut their spending.

Though the exporters' situation may improve in the second half of the year, the foreign demand recovery might be postponed. The real wage will continue to grow, yet the households spending will be subdued due to labor market conditions. The ongoing fall in credit activity does not indicate any positive reverse with the exception

¹In 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).

of the investments in automotive industry (VW and Continental) and planned highway construction.

Assuming a stable foreign demand, the domestic consumption in Slovakia should continue to recover, even though the fiscal consolidation will persist. **The economic growth should gradually accelerate towards 3.5% in 2016.**

MF SR FORECAST - MAIN ECONOMIC INDICATORS (June 2013)

indicator (growth in % unless otherwise noted)	actual 2012	forecast				difference from January 2013			
		2013	2014	2015	2016	2013	2014	2015	2016
Gross domestic product									
GDP, real	2.0	0.5	2.2	2.9	3.5	-0.7	-0.7	-0.5	-0.1
GDP, nominal (bn €)	71.5	72.6	75.8	79.5	83.8	-1.2	-1.7	-2.2	-2.5
Private consumption, real	-0.6	-0.7	0.8	2.3	2.8	-0.5	-0.7	-0.3	-0.5
Private consumption, nominal	3.1	0.9	2.7	4.4	4.9	-1.1	-1.2	-0.6	-0.8
Public consumption	-0.6	-1.9	-0.4	-3.2	0.5	-1.0	1.0	-3.6	-0.2
Fixed investments	-3.7	-5.3	3.5	0.1	0.6	-7.6	0.2	-2.3	-1.4
Export of goods and services	8.6	2.6	4.3	4.9	5.2	-0.8	-0.7	0.1	0.4
Import of goods and services	2.8	0.5	3.5	3.3	4.0	-3.1	-0.6	-0.7	-0.2
Labor market									
Employment (registered)	-0.1	-0.7	0.4	0.7	0.8	-0.4	-0.2	0.0	0.0
Wages, nominal	2.5	2.0	2.6	3.7	4.1	-0.4	-0.9	-0.6	-0.6
Wages, real	-1.1	0.3	0.7	1.7	2.0	0.2	-0.4	-0.2	-0.3
Unemployment rate	13.9	14.5	14.2	13.4	12.5	0.1	0.4	0.4	0.5
Inflation									
CPI	3.6	1.7	1.9	2.0	2.1	-0.5	-0.5	-0.4	-0.3

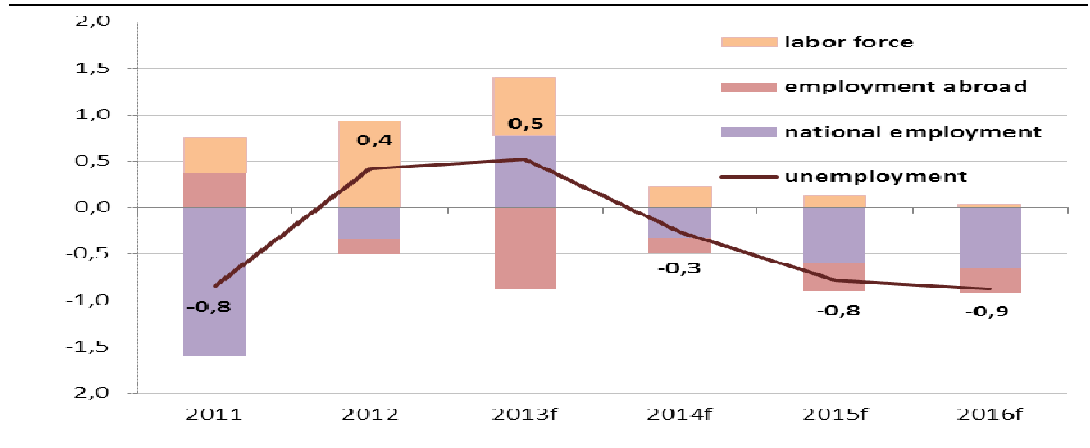
Source: ŠÚ SR, IFP

Labor market recovery
delayed

The labor market will improve at a slower pace. The reduction in economic growth impedes the job creation. The amount of employed persons may fall in 2013 by 16 thousand. From the sectoral perspective, the main decline is expected to happen in construction and industry. The unemployment rate will rise to 14.5% in 2013. In the second and third quarter the unemployment rate will be 14.1% and 14.4% respectively due to seasonal factors. The unemployment rate will be negatively influenced by declining domestic employment and rising labor force. On the other hand, the unemployment will be positively affected by the foreign employment of Slovak citizens, which increased from the beginning of the year (Chart 5). More significant rise in employment and decline in unemployment should arrive in 2014 on the back of accelerating GDP.

The energy prices and net inflation decelerates, thus the real wage will grow mildly in 2013. The nominal wage increase of 2% in 2013 is a result of two opposing forces. Wages are negatively influenced by the weak economy and a wage freeze in the public sector. On the other hand, wages in the health sector contributed significantly positively to the general wage level. In 2014 the wages should accelerate as a consequence of the growth in productivity.

Graph 5: Contributions to unemployment growth



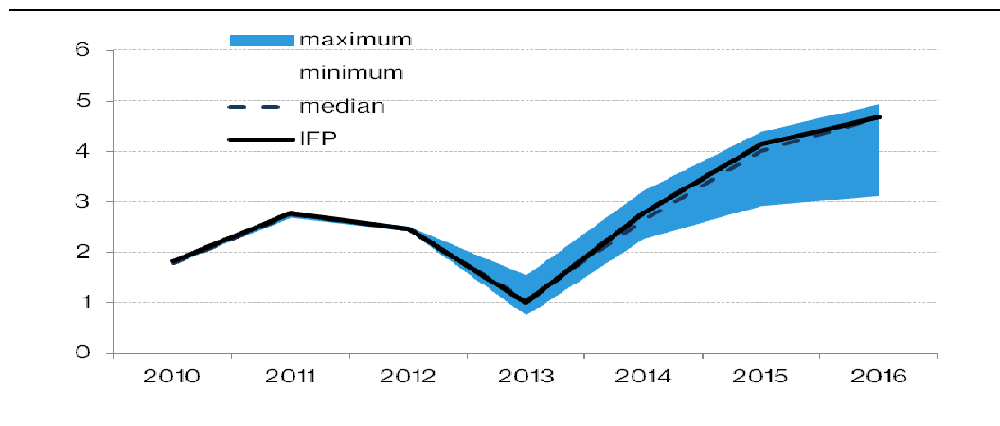
Source: IFP, own calculations,

Inflation pressure subdued

Inflation will be considerably lower in 2013 compared to 2012. We expect the annual consumer inflation to reach 1.7%. The main reason for the lower inflation is the slow growth of the regulated prices and net inflation. The net inflation reflects the anemic domestic demand. The regulated prices grow only modestly due to regulation policies and stagnating energy and commodity prices on the world markets. The restrained price development can be illustrated on the domestic price of electricity, which follows the path of the wholesale electricity price on the European market. Similarly, the 2% growth in gas prices this year will be considerably lower when compared to 10% growth from the last year. We expect that food prices will peak in the middle of this year and afterwards, in the third quarter, the food inflation will start to decelerate. The inflation will stabilize around 2% in the 2014-2016 horizon.

The mid-term macroeconomic **forecast** by IFP **was considered to be realistic by a vast majority of the Macroeconomic Forecasting Committee** (NBS, Infostat, SAV, CSOB, Tatra banka, UniCredit, SLSP, VUB) with the exception of Sberbank which considered it to be optimistic. Detailed macroeconomic forecast, supporting materials as well as the Minutes from Macroeconomic Forecasting Committee meeting are available on the IFP web page.

Graph 6: Comparison of weighted bases² for budget revenues with the committee



Source: IFP, own calculations

² 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: Current changes in the employment structure

The recession in Euro Area as well as the fiscal consolidation significantly influences the structure of the labor market and forms of employment.

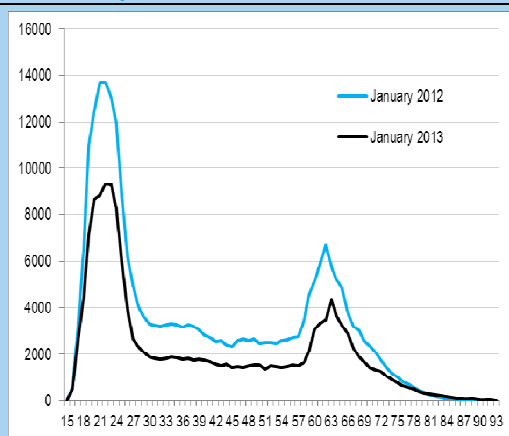
We analyzed the changes in the employment structure using the individual data from Social Insurance Agency in Slovakia (SIA). Note that the estimations below are very preliminary, due to changes in methodology regarding the data on insurance contracts.

- **The number of performance contracts declined approx. by 57% y-o-y.** The number of all performance contracts (i.e. the number of insurance contracts) in January 2013 dropped to 207,000 from 487,000 in January 2012. Compared to December 2012, the number of performance contracts slumped approx. by 63%. This insurance contracts concerned persons working only on performance contract as well as persons working concurrently on performance contract and on the standard employment agreement.
- **The number of persons working only on performance contract declined by a third (y-o-y).** The number of persons whose main and only job is on the performance contract declined in January 2013 by 37% (y-o-y) and by 50% (m-o-m). Re-calculating the numbers to the full-time equivalents, the number of persons working with only on the performance contract fell approx. from 40,000 to 26,000. These numbers are confirmed by the Labor Force Survey, which estimated the fall from 30,000 to 21,000. IFP estimated that the number of the performance workers slipped by 9 to 14 thousand.

Quarter of the decline in the number of the performance workers is because of the shift to the standard employment agreement while three-quarters dropped out from the SIA database (i.e. they could have become self-employed, inactive or unemployed). The change affected all age groups (Chart A). Persons who dropped out are mostly young cohorts and old cohorts, which could mean that those cohorts became inactive.

Long-term trend of switching from self-employed contract to "Company Limited" continues. The rise in the number of Companies Limited in recent years offset the fall of the number of self-employed persons (Chart B). This trend was confirmed in the first quarter of 2013 when the number of self-employed persons declined by approx. 14,000 and simultaneously the number of Companies Limited rose by 17,000. **The reason why workers switch from self-employment to start the Company Limited is mainly due to the tax avoidance and not because they cease to be entrepreneurs.**

Graph A: Change in the employment structure: performance workers



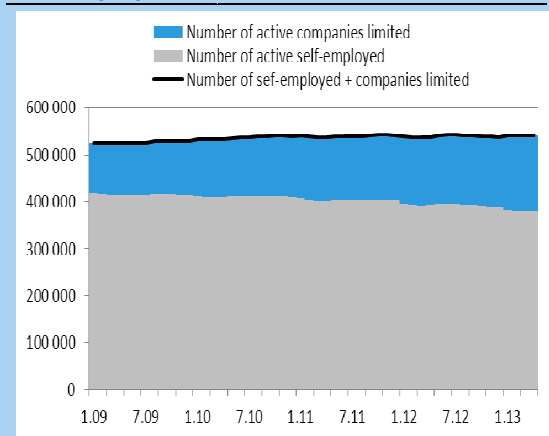
Source: SIA, own calculations

Notes:

¹ The number of performance contracts in January 2013 is net of contracts with zero labor cost. The number of performance contracts in January 2012 is net of contracts which mean labor cost in the whole year 2012 is zero.

² Full-time equivalent calculation is based on the assumption that the hourly labor cost in particular month is the same for performance workers and for standard employees.

Graf B: Change in the employment structure: self-employed



Source: ŠÚ SR,