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The economy will slightly accelerate, the prices will slow down

Macroeconomic forecast for the period 2013 – 2017

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The sound working economic development in the euro area helps the Slovak economy to maintain the export performance and improves its prospects. In addition to the growth in exports, the domestic consumption will revive thanks to the significant drop in price growth. The economic growth will increase to 2.3% this year from 0.9% in 2013. Lower inflation will affect the growth of tax base which are linked to nominal indicators.

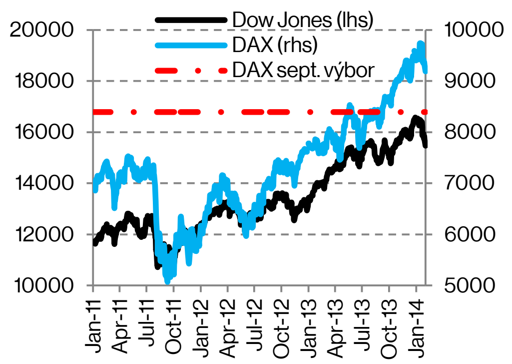
ECB reduced the interest rate, FED started tapering

The situation in financial markets remains stable; however its impact on the real economy continues to be differentiated. Global markets were dominated by monetary policy recently. Due to the low inflation reports, ECB reduced the key interest rate by 25 basis points to a historical minimum of 0.25%. Conversely, the FED after the positive signs from the U.S. economy began to restrict purchases of assets (called tapering) from 85 billion USD to 65 billion USD monthly. Stock markets of emerging economies experienced announced tapering through capital outflows. Shares of developed countries, on the other hand, have continued to grow and overcome the historic highs. During the recent weeks, there was a slight correction in the equity markets, for example DAX values returned to those of the middle of December 2013.

Expectation of improvement in the periphery of the euro area

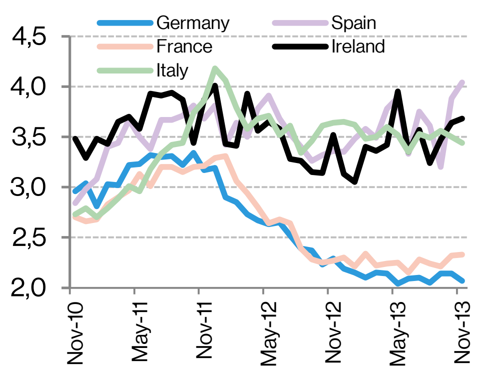
Opposing action of the two largest central banks stirred up the situation on the bond markets. Yields on U.S. 10-year bonds rose above 3%, while yields on 10-year bonds of peripheral countries of the euro area continued to decline. Positive development in the financial markets in the euro area has not been reflected in the real economy of all countries equally. Interest rates on corporate loans remain uneven in the core and the peripheral countries of the euro area. However, the policies to reduce these disparities were adopted both in the short term (lending businesses through EIB and EIF) and the medium term (stabilization of the banking sector through a single surveillance).

Chart 1: Index Dow Jones Industrial Average and DAX reached historic highs



Source: Bloomberg

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

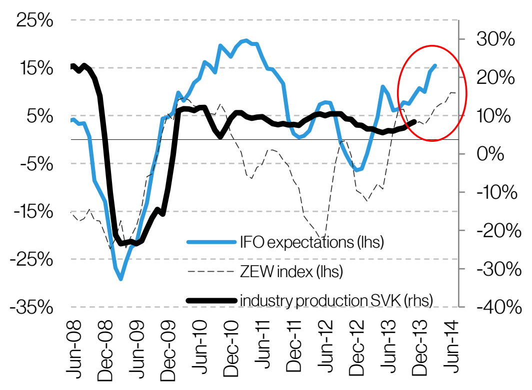


Source: Bloomberg

Continued growth in the third quarter of the year

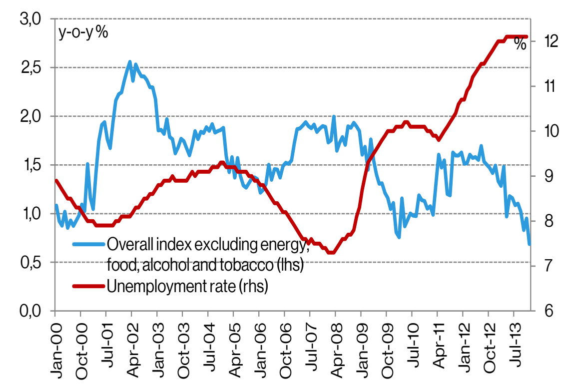
Euro area economy continues to grow. Moreover, the indicators of expectations suggest that its growth should gradually accelerate. The favorable development is primarily driven by German economy. While in the past, the growth in the euro area was driven by export growth, nowadays the domestic consumption is gradually reviving too. Purchases of automobiles and results of industrial production in the euro area confirmed the gradual recovery in economic activity. Expectations about the future continue to grow, reaching the highest value since 2011. It suggests the acceleration of economic activity in 2014.

Chart 3: Expectations in Germany vs. reality in Slovakia (3M moving average, SA)



Source: CESifo, ZEW, ŠÚ SR

Chart 4: Euro area high unemployment rate coupled with too-low inflation



Source: Eurostat

Moderate improvement in Eurozone for 2014-17

Assumptions about the external environment have improved only slightly so far. Continuous recovery and improvement of soft indicators are reflected in the forecasts of international institutions which expect an acceleration of growth in 2014 (ECB, OECD, IMF). Economic growth should be moderate and risks remain. High unemployment and the threat of deflation in the euro area, as well as slower growth in emerging countries, counteract stronger growth of our external environment. (Chart 4). Low inflation makes it difficult to reduce the debt of the peripheral countries.

Assumptions related to external demand in 2014 have been slightly improved in comparison with the previous forecast. The changes were based on OECD forecasts adjusted by Bloomberg consensus estimate. The increase occurs in the following years as well (Table 1).

The growth in 2013 was driven by domestic demand as well

Table 1: External environment in 2013 - 2017[1]

	GDP (% growth)				Diff. from Sep 2013				Import (% growth)				Diff. from Sep 2013			
	2013	2014	2015	2016 2017	2013	2014	2015	2016	2013	2014	2015	2016 2017	2013	2014	2015	2016
Main trading partners	-0.1	1.4	1.8	1.8	0.0	0.1	0.3	0.3	1.1	3.7	4.5	4.5	0.4	0.3	0.5	0.5
Euro area	-0.4	1.0	1.3	-	0.1	0.1	-	-	0.0	3.4	4.0	-	0.2	0.3	-	-
Germany	0.4	1.6	1.8	-	-0.1	0.3	-	-	1.1	4.8	5.5	-	0.1	0.2	-	-
Czech republic	-1.5	1.1	2.2	-	-0.6	-0.6	-	-	-0.9	3.9	4.9	-	0.1	-1.0	-	-
Poland	1.4	2.7	3.2	-	0.3	0.4	-	-	1.9	4.2	6.4	-	-0.9	1.4	-	-
Hungary	1.2	2.0	1.6	-	0.8	0.8	-	-	4.6	4.5	5.1	-	1.4	1.6	-	-

Source: Bloomberg, OECD, IFP

Slovak economy will grow this year by 2.3%. Gradual recovery in the Eurozone improves prospects of Slovak exports. Industrial production is already growing at a robust pace.

[1] 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).

In addition, the domestic demand slowly begins to revive. Lower price growth stimulates the household consumption raise. Total investment growth will gradually accelerate. The main reason for that is expected growth of major investment projects in the automotive industry and the anticipated construction of motorways. On the other hand, stagnant corporate lending after previous decline indicates a lackluster investment activity this year.

The economy should gradually accelerate in the next years. The main reason for the economic activity growth should be faster growth in the exports, as well as the stronger consumption growth.

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

indicator	actual	forecast					diff. from September 2013				
(growth in % unles otherwise noted)	2012	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017
Gross domestic product											
GDP, real	1,8	0,9	2,3	3,0	3,2	3,4	0,1	0,1	0,0	0,1	
GDP, nominal (bn €)	71,1	72,1	74,5	77,8	81,7	86,2	-0,8	-1,3	-1,7	-1,8	
Private consumption, real	-0,2	-0,1	1,2	2,2	2,4	2,9	-0,6	0,3	0,1	0,1	
Private consumption, nominal	3,3	1,2	2,0	4,3	4,7	5,4	-0,8	-0,5	0,1	0,1	
Public consumption	-1,1	0,1	1,9	-1,4	-0,4	0,9	0,8	3,1	0,9	1,9	
Fixed investments	-10,5	-7,0	1,8	2,4	0,8	2,1	-1,2	-1,1	2,4	2,3	
Export of goods and services	9,9	3,6	4,0	4,5	4,8	4,8	-1,2	-0,3	0,0	-0,3	
Import of goods and services	3,3	1,9	3,6	3,6	3,7	4,1	0,2	0,3	0,7	0,4	
Labor market											
Employment (registered)	-0,1	-0,9	0,3	0,6	0,7	0,9	0,1	0,1	0,0	0,1	
Wages, nominal	2,4	2,6	2,5	3,5	4,1	4,5	0,1	-0,3	0,1	0,6	
Wages, real	-1,2	1,1	1,7	1,5	1,8	2,1	0,2	0,6	0,2	0,6	
Unemployment rate	14,0	14,3	14,0	13,2	12,3	11,3	-0,1	-0,3	-0,3	-0,3	
Inflation											
CPI	3,6	1,4	0,8	2,1	2,3	2,4	-0,2	-0,9	0,0	0,0	

Source: ŠÚ SR, IFP

The gradual recovery in the labor market

The labor market starts to revive. Growth in job vacancies in the last quarter and the monthly statistics show that the bottom of the labor market has been overcome. Economic growth should be reflected even in moderate employment growth this year. The main source of employment growth will be the industry sector and the market services. The unemployment rate will be reduced. In the following years, the employment growth should gradually accelerate.

Real wage growth will accelerate this year due to the lower inflation and a more favorable situation on the labor market. In subsequent years, the real wages growth will gradually accelerate to above 2% due to the labor productivity growth. In terms of sectoral structure, the wages should mainly grow in the industry sector and the market services, while wages in the public sector and the construction industry sector will grow at a slower pace. **Conversely, nominal wages will grow more slowly than in the last year.** Productivity growth and faster economic growth this year will act in favor of faster wage growth. New Year's valorization will be slower because some of the firms may during the wage negotiations take into consideration the lower price growth.

Inflation is historically low

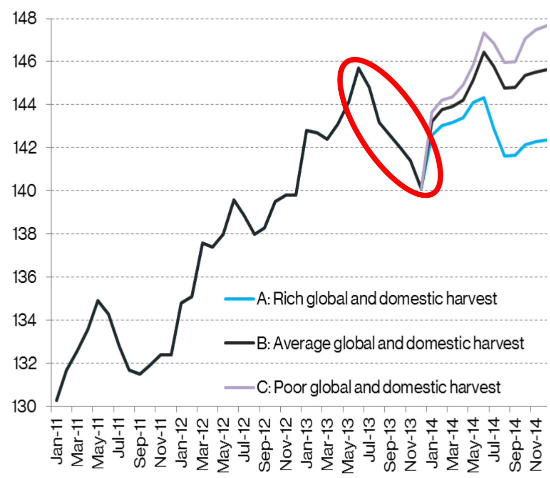
Prices will grow slower in 2014. The expected annual growth in consumer prices is 0.8%. The lowest price growth will be observed in the first quarter of the year. Moreover, the risk that there is a short fall in the price level is increasing. During the year, the growth rate of the prices will gradually increase.

Electricity will be cheaper; the food prices will slowly rise

Slower growth in prices is a result of both, domestic and foreign factors. Households will save on energy costs, most of which thanks to the fall in price of electricity. In response to the above-average harvest at home and abroad in the past six months, food prices plunged (see Chart 5). The continuing favorable market situation for agricultural commodities will be reflected in the low growth in food prices this year as well. Decline in energy prices and low prices of other inputs eliminate the risk of price increase due to higher production costs.

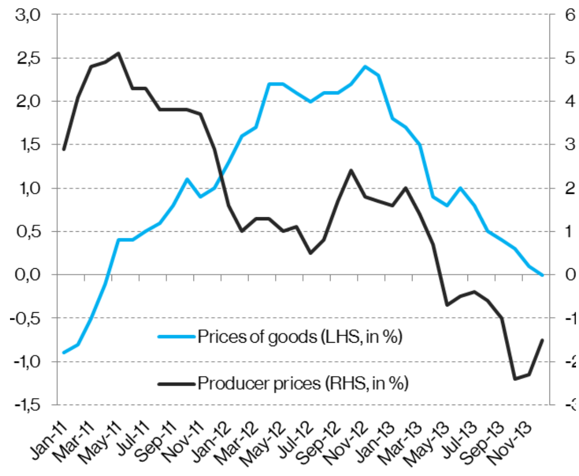
Net inflation is kept at low levels in the first half of the year. (Chart 6). The risk of demand-pull inflation is low due to continuous slow growth in private consumption and nominal wages. In the first half of the year the impetus to the significant increase in net inflation is lacking. Gradual acceleration of inflation is expected in the second half of the year.

Chart 5: Domestic food price index – past development and projections



Source: IFP

Chart 6: Annual growth of prices of goods and producer prices



Source: IFP, Eurostat

ECB intervention would lead to higher prices

The euro area inflation slows down and currently it is well below the monetary policy objective. There are multiple considerations about the possible intervention of the ECB in order to accelerate growth rates and revive economic growth. **Possible ECB intervention would likely increase the estimated price growth in Slovakia already in the middle of 2014.**

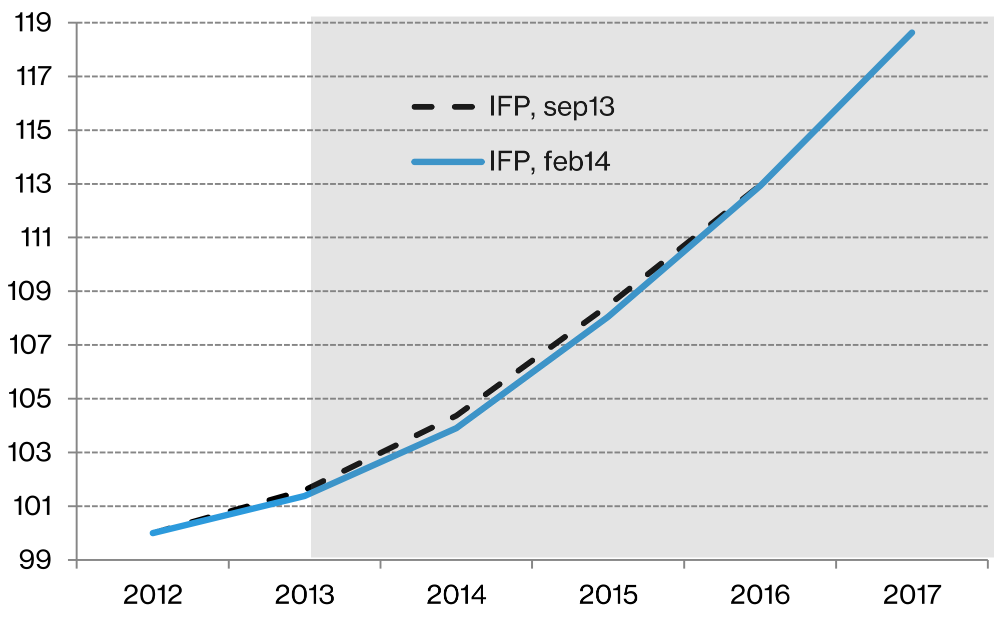
The overall impact of macroeconomic forecasts on tax base is slightly negative. Better development of real variables only partly offsets the reduction in nominal values due to a slower rise in prices[2]. The impact of macroeconomic forecasts on tax revenue

[2] Changes in the price level are not reflected automatically in the fiscal framework and the government budget balance. Lower price growth means automatically a lower growth of some public spending.

Slightly negative impact on tax base

estimation will be discussed during the Tax Revenue Forecasts Committee on February 12, 2014.

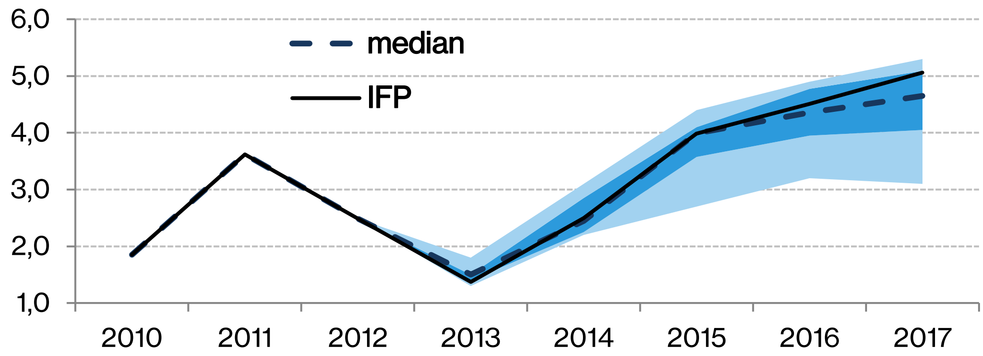
Chart 7: Macroeconomic bases compared to September forecast



Source: IFP, own calculations

Medium term forecast of the macroeconomic development prepared by the MoF was evaluated by the majority of the Committee (NBS, Infostat, Tatra Banka, CSOB, SLSP, VUB and Sberbank) as realistic, with the exception of Unicredit, which has characterized it as conservative. 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 bases[3] for budgetary revenues with the MFC members[4]



Source: IFP, own calculations

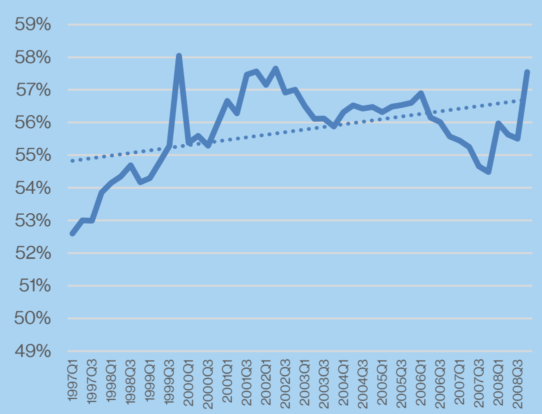
[3] Macroeconomic basis for the budget revenues (weight of indicators depends on the proportional share of the particular tax on the total tax revenues); Wage base (employment x nominal wage) – 51,1%; Nominal private consumption – 25,7%; Real private consumption – 6.6%; Nominal GDP growth – 9.9%; Real GDP growth – 6.7%.
[4] Darker blue represents 50% of MFC members.

BOX: We save more than we should

Before the crisis, households were spending more and saving less. High income growth before 2009 was also supported by higher willingness to fall into debt. Share of consumption in GDP was increasing gradually (see Chart A). Since the crisis, however, there was a turning point in consumer behavior, which affects the economy today. While before the crisis, the average real consumption growth was around 4%, since 2009 the share of consumption to production is steadily declining (Chart B).

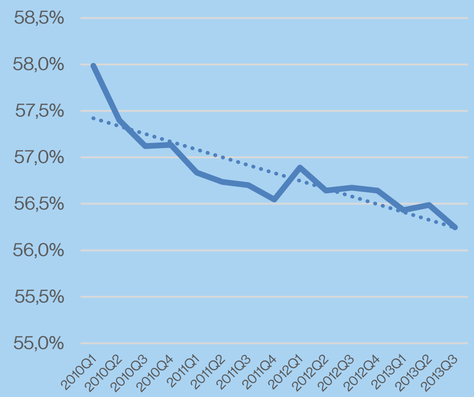
The fall in the consumption is now higher than the economic fundamentals suggest. The consumption remains stagnant despite the rise in incomes. Our estimate* suggests that the relationship between consumption and income is weaker compared to the past.

Chart A: Consumption to GDP ratio before year 2009



Source: ŠÚSR, own calculations

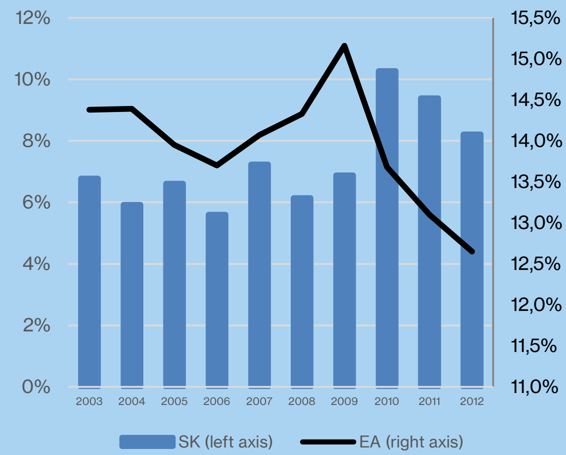
Chart B: Consumption to GDP ratio after year 2009



Source: ŠÚSR, own calculations

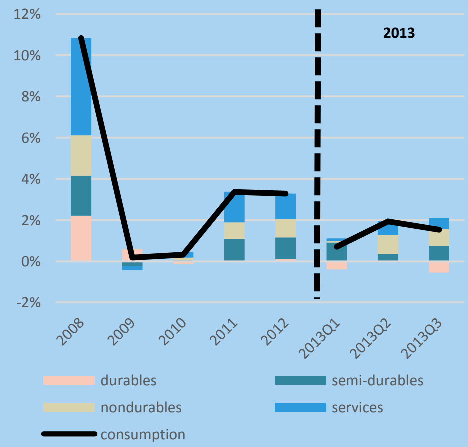
Slovak households continue to save despite higher income and better overall economic situation. The propensity to save is lower in the countries of euro area than it was before the crisis. Slovakia remains above the pre-crisis levels. While in 2008 the households were saving 6.8% of their income, in 2012 it was almost 9%. **If the rate of savings rate in our country restored to its pre-crisis level, GDP in 2013 would grow faster by 0.6 percentage points.**

Chart C: Dynamics of saving rate in Eurozone and Slovakia



Source: Eurostat, own calculations

Chart D: Contributions to changes in consumption



Source: ŠÚSR, own calculations

The change in consumer behavior is also reflected in the structural changes of household expenditure (Chart D). Consumption of durable goods, which variation is not vital, plunged and since then it has stagnated. Decrease in consumption is observed particularly among households

with the highest income. These households cut their spending mostly on long-term goods. Conversely, low-income households did not experience significant changes in consumption patterns.
Real household consumption will grow in 2014. However, the savings rate will remain at high levels, which will prevent stronger growth. We expect it to decline from 2015.

**IFP estimation is based on a linear regression model among consumption growth and income change, uncertainty and household wealth and mutual interaction between the post-crisis period and the explanatory variables.*