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Foreign trade improved the outlook of the Slovak economy

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MF SR raised its estimate of the GDP growth for 2012 to 2.5% due to higher growth in the first quarter and moderate improvement of the external environment. However, the structure of the economic growth will have little impact on tax revenues, as the growth will be driven mainly by the foreign trade. The labor market and the households' consumption should recover only gradually. The forecast for the next year includes the consolidation measures necessary to achieve the public finance deficit below 3% of GDP. Even then the GDP in 2013 should grow by 2.6%. The uncertainty surrounding the debt crisis in the euro area increased the negative risks of the forecast.

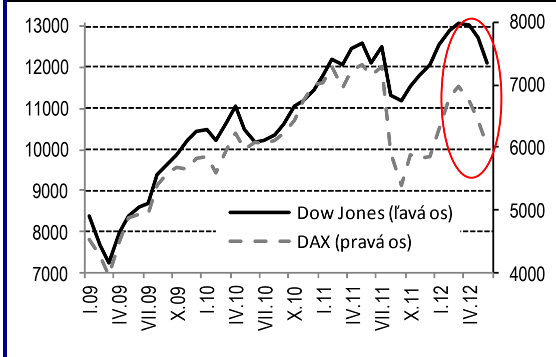
Global economic situation has improved since February

The economic situation of our trading partners has been improving since the last official forecast from February 2012. Although the euro area has fallen into recession, it has been caused by the development in the peripheral countries, which are less crucial with regards to our foreign trade. On the contrary, our most important trading partners, especially Germany, have experienced stronger economic growth than expected. Several international institutions have therefore improved their forecasts. The IMF increased its estimate of the German economic growth in April by 0.3 pts to 0.6%, the European Commission in May to 0.7%. The latest OECD forecast from the end of May assumed the growth of the German economy at 1.2% (0.7 pts higher compared to February assumptions).

Although latest weeks bring negative signals

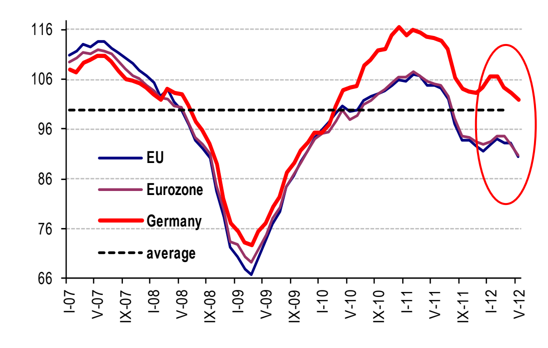
The situation on the financial markets, after calming down in the first quarter of 2012 due to ECB providing liquidity, has again worsened and represents a significant negative risk for the forecast. The problems of the peripheral countries, especially Greece and Spain, have been again brought to the forefront. In the case of Greece their domestic political situation has caused the possibility of exit from the monetary union to enter the discourse, which would make further development difficult to predict and would have serious negative impact on the economy of the whole euro area **(Ministry of Finance still considers this scenario as highly improbable)**. Spain is the center of attention mostly due to the size of its economy, which makes its impact on the other EU countries significantly higher compared to that of Greece[1].

Graph 1: Stock markets DAX (Germany) and DJIA (USA)



Source: Reuters

Graph 2: Economic sentiment indicator in the EU and euro area



Source: EC, MF SR

Nervousness on the financial markets

The rise of the nervousness on the market has been felt on the development of almost all financial assets. In contrast to the crisis of 2009, the current crisis is localized mostly in the euro area (see Graph 1). Bond yields of the risk EA countries remain high, Spanish 10Y bonds have been above 6% for some time now, similarly the Italian bonds are above 5.5%. On the other end the yields of German bonds, currently considered as one of the safest investments, continue to rewrite historical lows, with 10Y bond yield dropping below 1.2%. The flight to safe havens can be seen on the currency markets as well. The dollar has appreciated vis-à-vis the

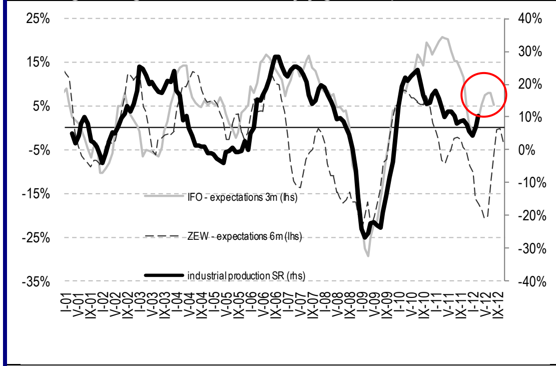
[1] The share of Spain on the euro area economy is more than 11%, whereas the share of Greece is below 3%.

euro to the strongest level in the past two years, the currencies considered as risky, including Czech, Hungarian and Polish currencies, are currently depreciating. The worries concerning the spillover of the uncertainty from the financial markets to the real economy can be seen on the drops of the stock and commodities markets. German DAX as well as the European EuroStoxx lost over 15% compared to the local maximum from spring 2012, the fall of American indices was less pronounced. The oil price has also fallen rapidly, by over 20%, in the last two months.

Worsened expectations in the euro area

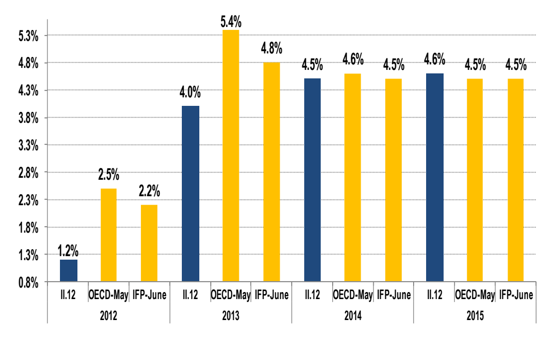
The expectations for the future have begun to worsen in the last week due to the negative development around the debt crisis in the EA. The confidence indicators in the EU continued to fall after a short stabilization and their levels are below long-term average. The economic sentiment in Germany is still above average, but has been falling in the last three months. The business expectations index in Germany (IFO) has fallen considerably in May and reached January levels (see Graph 3).

Graph 3: Expectations in Germany vs. reality in Slovakia (3M moving average, SA, normalized y/y growths)



Source: ZEW, CESifo, ŠÚ SR

Graph 4: Weighted imports of main trade partners of Slovakia according to OECD and IFP (%)



Source: OECD, IFP

External environment assumptions

We have adjusted the most recent OECD forecast for our main trading partners downwards with the aim of capturing the heightened uncertainty and unfavorable expectations. We have revised the assumed German growth downwards to 0.9% and deepened the EA recession to -0.3% (using the Goldman Sachs forecast from June). Even with the adjustment **the external assumptions remain more favorable compared to the February forecast** (Graph 4).

Table 1: External environment in 2011-2015

	GDP (% growth)				Difference from February 2012				Import (% growth)				Difference from February 2012			
	2012	2013	2014	2015	2012	2013	2014	2015	2012	2013	2014	2015	2012	2013	2014	2015
Main trading partners of SR	**0.2**	**1.4**	**1.7**	**1.8**	**0.0**	**0.0**	**-0.2**	**-0.2**	**2.2**	**4.8**	**4.5**	**4.5**	**1.0**	**0.8**	**0.0**	**-0.1**
incl. ***euro area***	**-0.3**	0.6	**-**	**-**	0.2	-0.4	-	-	0.0	1.9	-	-	0.0	-1.8	-	-
Germany	**0.9**	1.5	**-**	**-**	0.4	-0.2	-	-	4.1	6.0	-	-	0.3	0.4	-	-
Czech Rep.	-0.5	1.7	**-**	**-**	-1.8	-0.6	-	-	1.3	6.8	-	-	-1.4	1.2	-	-
Poland	2.9	2.9	**-**	**-**	0.4	0.4	-	-	4.8	5.7	-	-	0.7	2.2	-	-
Hungary	-1.5	1.1	**-**	**-**	-0.9	0.0	-	-	3.2	6.3	-	-	-0.7	0.8	-	-

Source: IFP

The current forecast of the **real GDP growth for 2012 (2.5%)** is higher by 1.4 pts compared to February forecast. It thus confirms our "flash" estimate from March, which revised the forecast for the current year to 2.3%. The main factors behind the improvement of the expected economic activity in Slovakia are the **continuing GDP growth at the start of the year** and a small improvement of the outlook of the foreign demand, which is mostly related to the current **forecast for Germany**. In the current quarter the Slovak economy does not slow down and the growth is driven mainly by the net export. Contrary to the expectations, there has also been no correction of the GDP growth downwards after a strong last quarter of the previous year, which has been partially caused by one-off factors. Furthermore, the second quarter of 2012 will see another positive impulse from new production capacities in the automotive industry coming on-line. We expect a moderation of the economic activity, as well as the foreign demand, in the second half of 2012. The households' consumption and the labor market will stagnate throughout the entire year 2012. The growth of investments should slow down overall, which can be traced to a lack of a large volume of one-off investments in the automotive industry from the last year. **Real GDP growth** will continue **in 2013**, when we expect a negligible acceleration to **2.6%. In the following years** the growth should accelerate to yearly rates **barely below 4%,** when the export performance should be joined by the domestic demand.

MF SR FORECAST - MAIN ECONOMIC INDICATORS (June 2012)									
Indicator (%)	Actual	Forecast				Difference from Feb 2012			
	2011	2012	2013	2014	2015	2012	2013	2014	2015
GDP, real growth	**3.3**	**2.5**	**2.6**	**3.9**	**3.7**	**1.4**	**-0.1**	**0.3**	**0.0**
Inflation, annual average; CPI	3.9	3.5	2.5	2.1	2.3	0.7	0.2	-0.2	-0.2
Inflation, annual average; HICP	4.1	3.7	2.5	2.1	2.3	0.9	0.2	-0.2	-0.2
Nominal wages, growth	2.2	3.2	4.0	4.5	5.2	-0.2	-0.3	-0.2	-0.4
Nominal wages, change in EUR	17.0	25.1	32.3	38.0	46.0	-1.6	-2.4	-1.6	-3.6
Real wages, growth	-1.7	-0.3	1.4	2.3	2.8	-0.9	-0.5	0.0	-0.2
Employment (ESA), growth	1.8	0.3	0.3	0.6	0.8	0.5	0.0	0.1	0.0
Employment (thous. persons)	38.5	5.6	7.3	12.9	17.1	11.0	1.0	2.8	0.0
Unemployment rate (LFS)	13.5	13.9	13.7	13.6	13.2	0.1	0.0	0.1	0.0
Real wage base	0.1	-0.1	1.8	2.9	3.6	-0.5	-0.4	0.2	-0.2
Government consumption, real growth	-0.4	0.1	1.4	3.3	4.0	0.1	0.7	0.4	0.1
Investments, real growth	5.7	3.0	0.6	3.0	2.7	1.4	-1.5	1.1	-0.2
Export of goods and services, real gro	10.8	5.2	5.6	5.3	5.3	3.0	-2.6	-0.6	0.0
Current account, % of GDP	0.1	1.1	1.2	1.7	2.2	1.3	1.5	1.4	1.5

Source: ŠÚ SR, MF SR

Consolidation will lower growth by 0.4 pts

The GDP growth in 2013 will be dampened by new **consolidation measures**. The IFP forecast takes into account a preliminary structure of the consolidation measures[2]. The consolidation efforts should in two thirds take place on the revenue side of the budget. The expected increase of the corporate income tax rate should lower the profitability of the businesses, which could lead to lower investment expenditures in 2013. The changes in personal income tax, social and healthcare contributions and social benefits should have an impact on the disposable income and consumption expenditures of higher-income households. We assume that the fiscal measures will lower the GDP growth in 2013 by 0.4 pts., with the highest impact on fixed investments and smaller on households' consumption. The expected fiscal multiplier of the consolidation package is 0.19 in 2013, while the reduction of the privately-funded pillar of the social security has a multiplier of zero (in 2011 the fiscal multiplier was estimated[3] at 0.27). In 2014 the contribution of consolidation to GDP growth should be fairly neutral and in 2015 again slightly negative (-0.2 pts.), mainly through lower disposable income and households' consumption expenditures.

Necessary fiscal measures compared to unchanged policies scenario (ESA95, % of GDP)			
	2013	2014	2015
TOTAL	**3,1**	**3,1**	**4,1**
Expenditure measures			
TOTAL	**0,9**	**1,0**	**1,8**
Measures included in the GG Budgetary Framework 2013–2015	0,7	0,9	1,5
Other	0,2	0,1	0,3
Revenue measures			
TOTAL	**2,1**	**2,1**	**2,2**
Direct taxes	1,0	1,0	1,1
Wealth taxes	0,1	0,1	0,1
Income taxes	0,9	1,0	1,0
Indirect taxes (excise taxes)	0,0	0,0	0,0
Social security	0,7	0,8	0,9
Bank sector levy	0,1	0,1	0,1
Temporary levy on enterprises in regulated sectors	0,1	0,0	0,0
Other	0,2	0,2	0,2
Necessary consolidation measures *	**2,3**	**2,7**	**3,3**
Residual (-) indicates potential sources for priorities of the Government **	0,8	0,4	0,8

* *Impact on the macroeconomic forecast assumes only the necessary consolidation measures*
** *Difference between possible measures (3.1% of GDP in 2013) and necessary consolidation measures (2.3% of GDP in 2013) represents sources for government priorities or lesser range of realized measures*

Source: IFP

[2] Definitive form of the consolidation package will be published in September 2012, its rough outline is already known.
[3] More in the Stability Programme of the Slovak Republic for 2011 – 2014: http://www.finance.gov.sk/Components/CategoryDocuments/s_LoadDocument.aspx?categoryId=120&documentId=7274

Gradual recovery on the labor market

Despite the improved economic outlook, **the labor market recovery will continue to be slow**. The economic growth by 2.5% will not be sufficient to generate significantly higher number of jobs. The number of workers should grow by over 5.6 thousand persons in 2012 (ESA95 methodology), driven mostly by new job openings in the industry and services. In the following years the employment growth will be dampened by the fiscal consolidation. **The number of workers in Slovakia should reach the pre-crisis levels at the end of the forecast period by 2015**. Despite the growth of employment in 2012 the unemployment rate will rise to 13.9%[4]. The main reason is the growth of economically active population[5]. The employment growth would need to be higher to counteract the population growth and cause a drop in the unemployment. The rate of unemployment should fall starting in 2013 to 13.2% in 2015.

The wages should grow more slowly than expected in the February forecast. The wages growth should nevertheless be higher than in 2011. The main reasons are the increases of wages in the healthcare sector and the inflation in 2011, which pushed wages upward during the negotiations for their indexation. In the following years the public sector wages should be influenced by the slow increase in the central government wages until 2015. On the other hand, the higher wages growth in the private sector should gradually reflect a rise in the labor productivity. However, the growth of nominal wages will be influenced by the fiscal package. The average nominal wage in 2012 should reach 811 EUR, which is 25.1 EUR more than in 2011. Since 2013 the nominal wages should increase at a faster rate. Despite the planned consolidation, the real wages will accelerate by 2.2% on average in the following years.

Higher prices in 2012 due to higher food prices

Compared to the February forecast, we expect a significantly higher rise of prices (increase of 0.7 pts). This difference is caused by relatively more positive macroeconomic development compared to February expectations. More positive foreign development is also reflected in a high increase of food prices, which has not stabilized at lower levels despite the good harvest from the previous year. A significant contribution to the total price growth in this year has been a January increase of regulated prices, even though it has been partially compensated by a March decrease of gas price due to a new contract between SPP and Gazprom. However, its effect will be fully realized in 2013. In the horizon of 2013-2015 we do not expect further dramatic increase of regulated prices, which is one of the reasons why we expect the inflation to slow down to 2.5%.

The medium-term macroeconomic **forecast** prepared by the MF SR **has been characterized as realistic by the majority of the members of the Committee** (SLSP, ČSOB, Tatra banka, UniCredit, ING, NBS, VÚB). Infostat and Volksbank evaluated the forecast as optimistic. The detailed macroeconomic forecast as well as minutes from the session of the Committee of the macroeconomic forecasts and supplementary materials is available on the IFP website.

[4] Demographic data are calculated for population as of 1.1.2012 according to the latest census

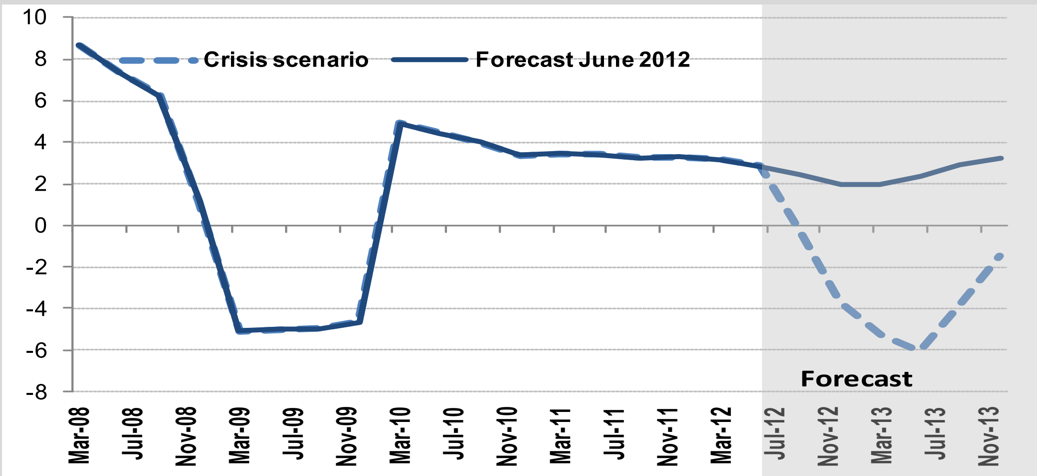
Box 1: Crisis scenario of the external environment

Due to high uncertainty of the external environment **related to** the ongoing **debt crisis**, we decided to prepare a crisis macroeconomic scenario. **We present it as a contribution to the public discussion. The Ministry of Finance still considers this development of external environment as very improbable**. Should the debt crisis in the peripheral countries escalate and cause some countries to eventually leave the monetary union, it could worsen the economic outlook of our most important trade partners. Foreign institutions who have dealt with similar crisis scenarios estimate that EA GDP would fall by 1 – 11% cumulatively in 2012 and 2013, depending on the number of countries leaving the union (studies by ING, Bank of America, Merill Lynch and Capital Economics).

In our calculations we have used the assumptions of the **median crisis scenario of Capital Economics** from May 21st. It assumes a cumulative drop of the EA GDP by 3.5% by 2013, with the drop in oil price to 95 USD/bl, and with the depreciation of the euro exchange rate to 1.1 USD/EUR. Furthermore, we assumed the drop of foreign prices related to the recession in the similar amount as in 2009 crisis, the increase of the risk premium on the long term interest rates in Slovakia and the appreciation of the euro exchange rate towards the V3 economies. We would like to reiterate that **we consider this scenario as illustrative and improbable**.

The impact of the change of external environment **on the Slovak economy** was estimated using the simulations of the above mentioned shocks in the medium-term macroeconomic model of IFP. The shocks were simulated on the period from July 2012 until the end of 2013. The comparison of the crisis scenario with the current forecast can be found in the chart and the table below. The recession in the euro area would lead to the drop in the Slovak export through the channels of foreign demand and loss of price competitiveness. The worsened situation on the labor market and lower availability of loans would limit domestic demand. The inflation would be lower due to the recession.

Real GDP in Slovakia – crisis scenario vs. forecast



Impact of the crisis scenario on the Slovak economy (pts)

	forecast (June)		*crisis scenario*		*diff. in pts*	
	2012	**2013**	**2012**	**2013**	**2012**	**2013**
GDP, real growth	**2.5**	**2.6**	**0.4**	**-3.9**	**-2.1**	**-6.5**
Export, real growth	5.2	5.6	2.3	-3.1	-2.9	-8.7
Final households' consumption, real growth	0.1	1.4	-1.3	-5.1	-1.4	-6.5
Gross fixed investments, real growth	3.0	0.6	0.9	-7.2	-2.1	-7.8
Unemployment rate (%)	13.9	13.7	14.1	15.1	0.2	1.4
Average nominal wage, growth	3.2	4.0	1.5	-3.1	-1.7	-7.1
CPI (%)	3.5	2.5	3.7	1.1	0.2	-1.4

Source: IFP

[4]„The consequences of a euro-zone break-up“, European Economics Focus, Capital Economics, May 21st, 2012. http://www.capitaleconomics.com/european-economics/european-economics-focus/the-consequences-of-a-euro-zone-break-up.html