BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

SUMMARY OF MACROECONOMIC DEVELOPMENTS WITH PROJECTIONS

APRIL 2015

Summary of macroeconomic developments with projections, April 2015

GDP increased by 2.6% in 2014, as the economic recovery continued in the final quarter, albeit at a more modest pace than in the middle of the year. Economic growth significantly outpaced that in the euro area average last year, albeit largely as a result of one-off factors. Foreign demand remained the main engine of economic growth, while a large contribution also came from government investment, partly financed by EU funds. GDP growth is forecast to reach 2.2% this year, before slowing to 1.8% next year. In both years it will largely be determined by the temporary nature of public investment. The current account surplus will remain at around 6% of GDP over the projection period, as a result of solid growth in exports, despite the gradual recovery in domestic demand and thus in imports. There has been a sharp fall in inflation, as a result of falling commodity prices on global markets and the persistence of relatively weak domestic demand. After temporarily dipping below zero, inflation will gradually rise to just over 1%.

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The solid economic growth that began in the first half of 2013 continued in 2014. After a rapid growth in the middle of the year, the quarterly rate slowed to 0.3% by the end of the year, the same as in the euro area overall. Average annual growth was nevertheless significantly higher than in the euro area, where it stood at just 0.9%. Alongside favourable exports, the main factor in the faster growth in Slovenia was growth in investment in public infrastructure.

Last year exports were supported by solid foreign demand and improved cost competitiveness. Year-on-year growth in exports increased further at the end of the year. This was primarily attributable to the stabilisation of economic activity in the majority of the main trading partners, and to firms' effectiveness in seeking new sales markets. The more stable signals from the international environment are reflected in the confidence indicators, which improved again in the early part of this year.

Last year also saw heavy investment in infrastructure, particularly at local level, which was partly financed by EU funds. The high growth in investment was thus the product of factors that were mostly temporary in nature, which was reflected in the second half of last year, when government investment declined sharply. At the same time investment in machinery and equipment declined last year, which is not encouraging from the point of view of increasing the potential of the economy. After several years of decline, final government consumption increased slightly in the final quarter of last year.

Although the situation on the labour market was favourable, with rising employment and wages, there was no notable increase in private consumption. The main factor was new hires, where flexible forms of employment were prevalent. This is giving firms flexibility, but is also limiting growth in household consumption. The structure of unemployment is becoming increasingly skewed towards long-term unemployment. Outflows from registered unemployment increased sharply on account of new hires, while the increased inflows into unemployment owing to the expiry of temporary employment contracts at end of the year were an indication of the waning effect of the labour market reforms. Unemployment remained almost unchanged on average last year, but had fallen by around 7,000 in year-on-year terms to 123,000 by this February, as a result of favourable intra-year dynamics.

Falling commodity prices on global markets and the persistence of weak domestic demand brought a sharp fall in inflation. It averaged 0.4% last year, the same as in the euro area overall. Prices were down in year-on-year terms in the first quarter, although the fall is probably only temporary, as it is entirely attributable to developments in energy prices.

The current account surplus in 2014 amounted to 5.8% of GDP, slightly more than in 2013. The large surplus was the result of solid growth in merchandise exports. The deficit in primary income widened, primarily as a result of the increasing burden of interest payments on the public debt.

In a situation of favourable growth in the export sector, the current account surplus is being reflected in high net saving by the private sector, which is facilitating the deleveraging of the economy. Corporates have been net savers for three years now, amid weak nominal growth in investment and further reductions in indebtedness. The stock of corporate liabilities in the form of bank loans declined again last year. The decline in loans to the private sector despite strengthened economic growth was primarily the result of high corporate indebtedness, which remains concentrated in just a few sectors, and a lack of willingness on the part of the banks to take up risks when approving loans. Corporates are thus seeking alternative forms of financing within the available options, such as loans from the rest of the world and retained earnings. Households last year maintained their financial surplus close to its level of the end of 2013, and remained cautious in their consumer decisions despite higher income.

Confidence was gradually restored in the domestic banking system in 2014. This was reflected in an increase in deposits by the non-banking sector, to which almost all the sectors contributed. The increased confidence is the result of the successful process of the recovery, resolution and stabilisation of the banking sector. The contraction in the banking system's balance sheet total on the funding side was the result of a reduction in the banks' debt to the Eurosystem and to the rest of the world. Last year the contraction on the asset side was primarily the result of the further decline in loans to the private sector.

The government was again the sole sector to run a financial deficit last year. According to SORS estimates, it amounted to 4.9% of GDP in 2014. Excluding the assistance to financial institutions and other one-off effects, it was smaller than in the previous year at 3.5% of GDP. The general government debt had increased to 80.9% of GDP by the end of last year. The primary deficit excluding one-off effects narrowed significantly last year, while the primary deficit excluding interest amounted to just 0.3% of GDP.

The projections suggest only a gradual economic recovery. GDP growth is forecast to reach 2.2% this year, before slowing to 1.8% next year primarily as a result of a decline in government investment. The economic recovery will be based on a positive contribution from net trade, although the domestic demand components will also gradually strengthen.

In addition to the positive impact of the carry-over of growth from the previous year and the maintenance of solid growth in exports, the main factors in the economic growth forecast for 2015 are the expectations of heavy public investment partly financed by EU funds, as the disbursement of funds from the old 2007-2013 financial perspective finishes this year. Investment of this type will also have a decisive role over the remainder of the projection period in determining the dynamics of aggregate activity. An upward revision in GDP growth compared with the previous projection has therefore been made for this year alone. The GDP growth forecast for 2016 is the same as in the previous projection, despite the expected fall in public investment.

Net trade will make a positive contribution to GDP growth over the entire projection period. Increased impetus in private-sector investment will be limited in particular by persistently high corporate indebtedness. Household consumption will only increase gradually, given the still uncertain situation on the labour market, while government consumption will be constrained by the need for fiscal consolidation. The maintenance of solid growth in exports will hold the current account surplus around 6% of GDP, despite a slight increase in domestic consumption. In light of the weakness of domestic demand, and the absence of price pressures from the international environment, inflation is forecast to gradually rise to around 1% over the projection period.

The risks to the economic growth projections are slightly tilted to the downside. The largest risk to economic growth is growth in investment and the export sector. Growth in government investment is uncertain, as the current financing period from the European cohesion funds ends this year, while there are significant unknowns surrounding the disbursement of funds in the new period. The scheme for financing government investment within the framework of the Juncker investment plan is also unclear. The risks related to growth in foreign demand are balanced. The main risk to export growth is the fall in the number of manufacturing sectors that were contributing to growth in industrial production at the end of last year, which is diminishing export potential, at least temporarily. Growth in private-sector investment is also uncertain, although in this case the risks are tilted to the upside in light of high capacity utilisation, access to financing for successful firms, and the significant amount of retained earnings. Given that growth in private consumption lagged behind the recovery in purchasing power of households in 2014, the likelihood of stronger growth in household consumption is also relatively high.

The risks to inflation over the projection period are on the upside. Faster-than-expected rises in oil prices, higher wage growth and an impact of expansionary monetary policy that is larger than forecast under the baseline scenario could all result in price growth that is faster than expected in the baseline.

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In July 2014 the Bank of Slovenia outlined its view of the future strategic challenges for the functioning of economic policy in Slovenia.[1] In the opinion of the Bank of Slovenia, economic policy measures should focus primarily on the strengthening of banking sector balance sheets, the establishment of the foundations for financial stability, corporate deleveraging and restructuring, and the strengthening of the long-term sustainability of public finances. The measures taken should have as low as possible short-term adverse impact, particularly on exports, but also on domestic demand. The measures should also focus as far as possible on encouraging long-term economic potential and on ensuring sustainable long-term growth. Only thus will the conditions for the gradual elimination of high unemployment be put in place.

[1] http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=5833

	2008	2009	2010	2011	2012	2013	2014	Projections					
								2015		2016		2017	
								Apr.	Δ	Apr.	Δ	Apr.	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	3.3	-7.8	1.2	0.6	-2.6	-1.0	2.6	**2.2**	0.9	**1.8**	0.0	**2.0**	…
Employment	2.6	-1.8	-2.2	-1.6	-0.8	-1.5	0.7	**0.6**	0.4	**0.4**	-0.2	**0.4**	…
Compensation per employee	7.2	1.8	4.0	1.6	-1.2	1.9	-0.2	**1.1**	-0.3	**1.3**	-0.3	**1.4**	…
Productivity	0.7	-6.1	3.5	2.3	-1.8	0.5	2.0	**1.6**	0.4	**1.3**	-0.2	**1.6**	…
ULC (nominal)	6.4	8.5	0.5	-0.7	0.6	1.4	-2.1	**-0.5**	-0.7	**0.0**	-0.1	**-0.2**	…
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	4.0	-5.7	-2.8	-1.3	-3.7	-2.1	1.0	**0.7**	0.2	**0.7**	-0.5	**1.2**	…
Net exports	0.2	1.9	2.1	1.4	2.9	1.0	1.9	**1.1**	0.4	**1.0**	0.5	**0.7**	…
Changes in inventories	-0.9	-4.0	1.9	0.6	-1.8	0.1	-0.2	**0.4**	0.4	**0.0**	0.0	**0.0**	…
Domestic demand	*real growth rates, %*												
Domestic consumption	3.1	-9.5	-0.9	-0.8	-5.6	-2.1	0.8	**0.8**	0.3	**0.8**	-0.4	**1.3**	…
Private consumption	2.4	0.9	1.0	-0.1	-3.0	-3.9	0.3	**0.5**	0.0	**1.2**	0.2	**1.3**	…
Government spending	4.9	2.4	0.1	-1.3	-1.5	-1.1	-0.5	**0.4**	0.8	**0.5**	0.9	**0.5**	…
Gross fixed capital formation	7.0	-22.0	-13.7	-4.6	-8.9	1.9	4.8	**1.9**	0.1	**-0.1**	-4.0	**2.3**	…
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	4.2	-16.6	10.1	7.0	0.3	2.6	6.3	**4.7**	1.0	**4.9**	-0.1	**5.1**	…
Imports of merchandise and services	3.8	-18.8	6.6	5.0	-3.9	1.4	4.1	**3.6**	0.5	**4.1**	-0.9	**4.7**	…
Current account: EUR billion	-2.1	-0.2	0.0	0.1	1.0	2.0	2.2	**2.2**	0.5	**2.3**	0.6	**2.5**	…
as % GDP	-5.4	-0.6	-0.1	0.2	2.7	5.6	5.8	**5.8**	1.0	**5.9**	1.3	**6.2**	…
Terms of trade*	-1.3	3.5	-4.0	-1.4	-1.0	1.0	0.8	**0.4**	0.8	**-0.7**	-0.8	**-0.7**	…
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	5.5	0.9	2.1	2.1	2.8	1.9	0.4	**-0.1**	-0.8	**1.1**	-0.1	**1.4**	…
HICP excluding energy	4.9	1.7	0.3	1.0	1.8	1.9	0.7	**0.9**	0.1	**1.2**	-0.2	**1.5**	…
HICP energy	9.4	-4.5	13.9	8.8	9.0	1.8	-1.4	**-6.0**	-6.0	**1.0**	1.0	**0.8**	…
International environment	*growth rates, % (if not specified otherwise)*							Assumptions					
Foreign demand**	2.7	-13.7	10.1	6.9	0.5	1.5	1.9	**2.4**	0.0	**3.2**	0.1	**3.4**	…
Oil (USD per barrel)	98	62	80	111	112	109	99	**62**	-45	**68**	-39	**72**	…
Non-oil commodities	10.5	-23.3	36.5	21.9	-12.5	-5.0	-6.4	**-11.0**	-11.1	**2.6**	-1.8	**4.8**	…
EMU inflation	3.3	0.3	1.6	2.7	2.5	1.4	0.4	**0.3**	-0.8	**1.1**	-0.3	**1.7**	…
PPI Germany	5.4	-4.0	1.5	5.1	1.7	0.0	-0.9	**-0.5**	-1.1	**1.5**	-0.1	**1.8**	…

* Based on national accounts deflators.

** Volume of imports from the basket of foreign partners.

D : Difference between current projections and projections in Macroeconomic Developments and Projections, September 2014.

Source: Bank of Slovenia, Consensus Economics, Eurostat, JP Morgan, OECD Outlook, SORS, ECB.