BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

SUMMARY OF MACROECONOMIC DEVELOPMENTS WITH PROJECTIONS

OCTOBER 2015

Summary of macroeconomic developments with projections, October 2015

As a result of revisions to the national accounts and stronger realisation in the first half of this year, the Bank of Slovenia's projections of economic developments have been revised upwards. GDP is forecast to increase by more than 2.5% this year, with growth averaging in excess of 2% over the next two years. The slowdown in growth compared with this year will primarily be a result of the dynamics in government investment. With the recovery in private consumption, the structure of economic growth is becoming better balanced. This is creating the conditions for solid growth in activity despite a decline in government investment, while at the same time stimulating growth in general government revenues, which is easing the fiscal consolidation process. This will continue to hold down growth in total final consumption. With the anticipated solid growth in exports, supported by improved cost competitiveness in the export sector, and with stronger performance on the domestic market, investment in machinery and equipment will gradually increase, which will contribute to the renewal of the technological capacity of the economy. The financing for this investment will primarily come from corporate financial surpluses, while domestic bank financing will not yet be a decisive factor. Inflation will rise only gradually over the projection period, and will not exceed 1.5%.

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Of the components of domestic demand, a notable feature in these projections is the rise in estimated growth in private consumption. This was attributable to the revision to the national accounts for 2014, and faster-than-expected growth in employment and consumption in the first half of this year. The developments are now more in line with an increase in survey-based consumer confidence. Growth in private consumption will reach approximately 2% towards the end of the projection period, but will remain constrained by the breakdown of new hires, where uncertain, poorer-paid forms of work are prevalent. Stronger private consumption will promote employment in service activities. Because growth in labour productivity in private-sector services is rather low in general, a considerable decline in aggregate growth in productivity is also expected. Real consumer purchasing power will strengthen slightly faster, albeit largely as a result of growth in employment. Wage growth will depend primarily on the negotiations in the public sector and adjustments for inflation.

A major factor in developments in investment this year and in 2016 will be the end of disbursement of EU funds from the "old" financial perspective, and the beginning of disbursement from the "new" perspective. The significant decline in government infrastructure investment in 2016 and 2017 will gradually be compensated for by the private sector investment into machinery and equipment, which will improve the structure of investment. Taking the government plans partly into account, aggregate gross fixed capital formation will increase by just under 3% this year, and is expected to decline in 2016, as growth in private investment will not yet be high enough. Private investment will gradually increase throughout the projection period, as further improvements are expected in corporate results, and with utilisation of production capacity already high. The technological capacity of the economy will thus be gradually renewed, thereby increasing growth potential.

Although domestic demand will strengthen slightly faster, the export sector will remain the key factor in economic growth. Export growth in the first half of the year was higher than expected, as a result of which the estimate for annual growth is also higher, and is indicative of a further increase in the market shares of Slovenian exporters, *having outpaced growth in foreign demand. Growth in industrial production will remain at a level of around 5%, in line with export growth, while stronger demand on the domestic market means that exposure to fluctuations in foreign demand will be slightly smaller than in previous years. At the same time growth in the export sector is having a positive impact on numerous domestic suppliers of goods and services, which is additionally encouraging economic growth. As a result of the faster recovery in domestic demand, a gradual decline is expected in the contribution made to GDP growth by net exports, although the projected pace of import growth will not close the current account surplus.*

Economic growth will take place in an environment of low inflation. The inflation projection for 2015 is down 0.5 percentage points on the previous projection, as a result of a fall in core inflation and a fall in energy prices. Inflation is expected to gradually increase over the next two years, as commodity prices rise gradually and private consumption strengthens, but will remain below the monetary policy target level until the end of the projection period.

The risks to the realisation of these projections are relatively balanced. The largest uncertainty in the domestic environment is the amount of government investment, but the international environment entails the greater risk. This relates to the situations in Russia, China, Brazil and Turkey. The Volkswagen scandal could also have an adverse impact on export growth, as could any closure of borders because of the refugee crisis. By contrast, the ECB's quantitative easing programme could have stronger positive effects. The latter could also have a larger impact on inflation, where the uncertainties are related to oil price developments and, in the domestic environment, to wage growth.

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Slovenia continued to outperform the euro area as a whole in terms of growth in the first half of this year. GDP growth stood at 2.7%, to which the export sector made the principal contribution. This year the export sector is again demonstrating its flexibility in the context of volatile foreign demand, having compensated for the decline in exports to Russia by exporting to non-traditional markets. On these markets, exporters' price competitiveness has been boosted by the ECB monetary policy. Tourism is also a major factor in export growth, the number of foreign visitors having increased sharply. The current account surplus remained around 7% of GDP. Household final consumption is gradually strengthening as employment rises and consumer confidence increases, which is encouraging growth in numerous private-sector services. The sole exception among the major sectors is construction, where activity has declined sharply this year in line with the decline in investment in buildings and infrastructure. However, an improvement in the structure of aggregate investment is already taking place, corporate investment in machinery and equipment having strengthened slightly in the first half of the year. At the same time the provisional figures suggest that economic growth has remained solid in the third quarter of this year.

Growth in employment in the first half of the year was stronger than expected, although structural weaknesses remain on the labour market. Employment was up 1.6%, the largest rise since 2008. Uncertain forms of employment remain prevalent, and the proportion of jobs that they account for is increasing. At the same time the number of self-employed is rising; their share of total employment is significantly higher than in the most developed European countries. Unemployment is continuing to fall, but there was a deterioration in this fall in terms of structure. The number of deregistrations for reason of employment is falling, which is also attributable to a decline in employment subsidies. At the same time the proportion of those registering as unemployed because their temporary employment has ended is increasing. Wage growth has slowed sharply this year as a result of its adjustment to deflation, *but also as a result of the change in the breakdown of employment. This year's recovery in purchasing power is thus primarily occurring via an increase in employment.*

Evidence that firms are not yet sufficiently confident that current economic growth will be sustained comes from Slovenia's 12-month financial surplus against the rest of the world. In the first quarter, surplus in national saving over investment stood at 6.5% of GDP. It is striking that corporate saving is already at the pre-crisis level, but investment is only just over half of the pre-crisis level, which is indicative of the autonomous investment potential of the corporate sector. With the exception of the general government sector, the domestic institutional sectors have recorded financial surpluses over the last two years. The corporate sector primarily directed its surplus into paying down debt, while households directed their surplus into bank deposits, despite the sharp fall in interest rates. The restoration of confidence in the banks has improved their funding structure, thereby reducing systemic risks. Interest rates on corporate loans have fallen, but the banks remain cautious about investment, and their credit terms remain a strong limiting factor on the supply side.

The improved economic situation is easing the fiscal consolidation process, although there remain considerable risks to the attainment of the fiscal plans. This year the key target in the fiscal realm is permanently eliminating the excessive general government deficit, i.e. reducing it to below 3% of GDP. In the wake of the positive developments on the labour market and growth in private consumption, general government revenues are strengthening. At the same time growth in general government expenditure remains low, but is still highly influenced by a large burden of interest payments on the public debt. These are estimated at 3.1% of GDP this year, although the burden will fall in the coming years as a result of the more favourable terms of government financing on international markets. The risks in the fiscal realm include those in relation to macroeconomic developments being less favourable than those expected when the fiscal plans were drawn up, to the upward pressure on expenditure from various interest groups and to the potential impact of expenditures of a one-off nature.

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The Bank of Slovenia estimates that, in the absence of major shocks from the international environment, growth in the Slovenian economy will remain solid, and will be more sustainable than before the crisis because of the smaller role played by debt financing. Despite significant progress, numerous obstacles are still preventing growth from becoming more robust.

The corporate restructuring process is not yet complete. The Bank of Slovenia has been proactively involved in this process since the very start, and has been recently advocating a stronger focus on SMEs, which play a predominant role in the Slovenian economy. The successful completion of the restructuring of over-leveraged firms would release additional potential for investment and employment, which would improve the conditions for faster economic growth.

For firms to genuinely embark on more significant investment, confidence in sustained economic growth must first be established across society. This is largely dependent on the situation in the external environment, although the domestic business environment also has an important impact. Here the role of the government is key, as with zero tolerance to payment indiscipline and corruption, a flexible, professional and responsive public administration, and an efficient legal system it can ensure that the domestic business environment is stable and predictable. The vital fiscal adjustment must also remain gradual, without sudden measures that might interrupt the projected growth in private consumption.

								Projections					
								2015		2016		2017	
	2008	2009	2010	2011	2012	2013	2014	Oct.	Δ	Oct.	Δ	Oct.	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	3.3	-7.8	1.2	0.6	-2.7	-1.1	3.0	**2.6**	0.4	**1.9**	0.1	**2.2**	0.2
Employment	2.6	-1.8	-2.1	-1.7	-0.9	-1.4	0.6	**1.4**	0.8	**1.1**	0.7	**1.3**	0.9
Compensation per employee	7.2	1.8	4.0	1.5	-1.0	0.6	1.1	**0.7**	-0.4	**1.9**	0.6	**2.2**	0.8
Productivity	0.7	-6.1	3.4	2.4	-1.8	0.3	2.5	**1.1**	-0.5	**0.8**	-0.5	**0.9**	-0.7
ULC (nominal)	6.4	8.5	0.6	-0.8	0.8	0.2	-1.3	**-0.4**	0.1	**1.1**	1.1	**1.3**	1.5
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	4.0	-5.7	-2.7	-1.2	-3.7	-2.3	1.0	**1.2**	0.5	**0.7**	0.0	**1.7**	0.5
Net exports	0.2	1.9	2.0	1.3	3.0	1.1	1.6	**1.1**	0.0	**1.0**	0.0	**0.6**	-0.1
Changes in inventories	-0.9	-4.0	1.9	0.6	-2.0	0.2	0.5	**0.2**	-0.2	**0.1**	0.1	**0.0**	0.0
Domestic demand	*real growth rates, %*												
Domestic consumption	3.1	-9.5	-0.8	-0.7	-5.8	-2.2	1.6	**1.6**	0.4	**0.9**	0.1	**1.8**	0.4
Private consumption	2.4	0.9	1.3	0.0	-2.5	-4.1	0.7	**1.1**	0.6	**1.8**	0.6	**2.0**	0.7
Government spending	4.9	2.4	-0.5	-0.7	-2.3	-1.5	-0.1	**0.3**	-0.1	**0.4**	-0.1	**0.5**	0.0
Gross fixed capital formation	7.0	-22.0	-13.3	-4.9	-8.8	1.7	3.2	**2.9**	1.0	**-1.7**	-1.6	**3.2**	0.9
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	4.2	-16.6	10.2	6.9	0.6	3.1	5.8	**5.0**	0.3	**4.7**	-0.2	**5.0**	-0.1
Imports of merchandise and services	3.8	-18.8	6.8	5.0	-3.7	1.7	4.0	**4.0**	0.4	**3.9**	-0.2	**4.8**	0.1
Current account: EUR billion	-2.0	-0.2	0.0	0.1	0.9	2.0	2.6	**2.6**	0.4	**2.8**	0.5	**2.7**	0.2
as % GDP	-5.3	-0.6	-0.1	0.2	2.6	5.6	7.0	**6.7**	0.9	**7.0**	1.1	**6.6**	0.4
Terms of trade*	-1.3	3.5	-4.0	-1.4	-1.1	0.8	1.0	**1.3**	0.9	**-0.1**	0.6	**-0.8**	-0.1
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	5.5	0.9	2.1	2.1	2.8	1.9	0.4	**-0.6**	-0.5	**1.0**	-0.1	**1.5**	0.1
HICP excluding energy	4.9	1.7	0.3	1.0	1.8	1.9	0.7	**0.5**	-0.4	**1.2**	0.0	**1.6**	0.1
HICP energy	9.4	-4.5	13.9	8.8	9.0	1.8	-1.4	**-7.3**	-1.3	**-0.2**	-1.2	**0.9**	0.1
International environment	*growth rates, % (if not specified otherwise)*							Assumptions					
Foreign demand**	3.0	-13.7	10.0	6.8	0.7	1.8	2.2	**2.1**	-0.3	**2.7**	-0.5	**3.4**	0.0
Oil (USD per barrel)	98	62	80	111	112	109	99	**53**	-9	**54**	-14	**60**	-12
Non-oil commodities	10.3	-23.2	36.9	22.2	-14.3	-6.1	-8.6	**-19.7**	-8.7	**-4.6**	-7.2	**4.4**	-0.4
EMU inflation	3.3	0.3	1.6	2.7	2.5	1.4	0.4	**0.1**	-0.2	**1.1**	0.0	**1.7**	0.0
PPI Germany	5.3	-3.9	1.5	5.1	1.7	0.0	-1.0	**-0.8**	-0.3	**1.3**	-0.2	**1.5**	-0.3

* Based on national accounts deflators.

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

Δ : Difference between current projections and projections in Macroeconomic Developments and Projections, April 2015.

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