BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

SUMMARY OF MACROECONOMIC DEVELOPMENTS

OCTOBER 2018

Summary of macroeconomic developments, October 2018

Although the risks in the international environment are increasing, international institutions have not yet lowered their global GDP growth forecasts for the medium term in a more substantial manner. It is a similar case for the euro area, where growth is expected to be stable, at around 2%. Unlike the US, the increase in economic activity in the euro area will continue to be supported by expansionary monetary policy, as the process envisaged for its normalisation is very gradual. The most recent estimate of weighted economic growth forecasts for Slovenia's main trading partners indicate solid growth in foreign demand for the products of Slovenia's export sector over the medium term. The euro has been down against the US dollar in year-on-year terms since August, which is favourable for euro area exporters. Inflationary pressures from the international environment increased, as oil prices rose sharply as a result of the US embargo against Iran. The price per barrel stood at EUR 68.9 on 18 October, up 38.6% in year-on-year terms.

In the structure of domestic GDP growth, the anticipated reversal in the direction of stronger private consumption has not taken place, and the export orientation of the economy is continuing to increase. In the second quarter, year-on-year GDP growth stood at 3.8%, down 0.7 percentage points on the previous quarter. Growth in private consumption was unexpectedly weak, and indicates the continuation of the pattern seen over the first three quarters of last year, when a rapid improvement in the situation on the labour market was not tracked by increased growth in private consumption. Growth in investment in machinery and equipment also slowed sharply in the second quarter of this year. Should these trends continue, it might already be indicative of the impact of the reduced confidence caused by the tense international situation on investment decisions by the export sector. Judging by the export dynamics, growth in foreign demand remained relatively high at least until August, and, in the wake of weaker growth in imports, net trade was again a significant factor in domestic economic growth. It is rather difficult to estimate GDP growth in the third quarter, as the confidence indicators suggest a continuation of the moderate slowdown, while the available activity indicators suggest that the dynamic from the previous quarter was at least maintained.

Firms are increasingly compensating for the shortage of domestic labour by importing foreign labour, which is most likely one of the reasons that growth in the average gross wage has been curbed. Although in surveys firms are reporting major difficulties in recruiting, and unemployment is falling rapidly towards its pre-crisis lows, growth in employment remains high. The reason is the increasing employment of foreign workers, who again accounted for more than half of the year-on-year increase of 3% in the workforce in employment excluding farmers recorded in August. This is associated with a negative structural impact on growth in the average nominal gross wage, as foreign workers are mostly employed in sectors with below-average wages, while growth in employment in these sectors continues to be above-average. Growth in average real wages has also been reduced this year by higher inflation. Nevertheles, situation remains favourable for growth in private consumption: growth in employment is still high, for which reason real growth in the wage bill also remains high. It stood at 4.8% in August, down only slightly on the pre-crisis period of 2006 to 2008.

The high export orientation of the economy, the rather low growth in private consumption, and debt repayments in the rest of the world have all been reflected in an increasing current account surplus. In August, the 12-month surplus approached 8% of estimated GDP. After declining in the first quarter, nominal growth in exports of merchandise and services strengthened again, although the situation in the international environment deteriorated. At the same time, nominal growth in merchandise imports declined despite an increase in growth in import prices. The net external debt has been declining since 2015, and fell by almost EUR 2 billion over the last year alone, for which reason the deficit in primary *income is also diminishing. Rising household savings, so far moderate fiscal spending, and growth in private investment predominantly on the basis of firms' internal resources suggest a continuation of economic growth that is to a large extend based on exploiting foreign demand. This structure of growth is reducing the economy's dependence on financing on the international financial markets, but at the same time is increasing the risks associated with the current highly uncertain situation in international trade.*

Headline inflation remains above 2%, while core inflation remains low, despite strong domestic economic dynamics. In September, headline inflation was comparable to that in the euro area overall. It stood at 2.2%, and has mostly been above the 2%-mark as of May. The main factors remain unchanged. The notable external factor is higher oil prices, while growth in services prices is highlighted among domestic factors. At the same time, core inflation remains low, and comparable to the average in the euro area overall, despite Slovenia's significantly stronger economic growth. The narrowest core inflation indicator stood at 1.1% in September, up just 0.2 percentage points on the beginning of the year. Domestic unit labour costs have begun to rise, albeit without any notable impact yet on inflation developments.

The fiscal position is continuing to improve, as a result of the favourable cyclical situation, a reduction in the interest burden, and moderate growth in expenditure. Over the 12 months to June, the general government sector recorded a surplus in the amount of 0.6% of GDP. At the end of June, general government debt stood at 72.8% of GDP, and is expected to decline to 70.3% of GDP by the end of the year. In the second quarter, the decline in the general government debt was attributable to payments of maturing bonds. Borrowing terms remain favourable, and treasury bills have continued to be issued at negative interest rates. According to the government's plans, a small surplus is expected to be recorded again in the public finances in the coming years. Given the current favourable economic situation, converging on the medium-term fiscal objective will require generation of larger surpluses. From the perspective of the sustainability of public finances, the key is to avoid measures that would cause a deterioration in the structural fiscal position, as general government debt remains high.

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Growth in labour productivity is low, and is indicative of the deterioration in the quality of economic growth after the crisis. Economic growth in the current cycle is comparable to the 4% average annual growth recorded between 1993 and 2005, i.e. before the beginning of the excessive loan financing of growth. Labour productivity increases of around 4% accounted for virtually all of the economic growth in the pre-crisis period, while in the current cycle GDP growth is largely being driven by employment. Growth in labour productivity has averaged just 1.9% over the last two years, and averaged merely 1% in the first half of this year. The large supply of labour from the pool of unemployment created during the crisis has been a factor in the disproportionate growth in employment in recent years. This factor has now largely been exhausted, although GDP growth remains labour-extensive, as the economy is addressing its difficulties with a shortage of domestic labour by importing foreign workers. The continuation of labour-extensive growth is an indication of weak technological progress, and the limited reach of the generation of GDP per employee in today's economic structure. Economic policy therefore needs to be focused away from merely supporting the existing economy, to supporting the restructuring of the economy.

Main macroeconomic indicators

	2015	2016	2017	17Q4	18Q1	18Q2	2015	2016	2017	17Q4	18Q1	18Q2
	Slovenia						*euro area*					
Economic developments	*y-o-y growth rates in %*											
GDP	2.3	3.1	4.9	6.3	4.5	3.8	2.1	1.9	2.4	2.5	2.1	2.3
- industry	1.0	4.6	7.7	9.8	5.9	5.1	3.6	3.4	3.1	3.5	2.0	2.9
- construction	-1.5	-3.7	8.5	13.0	11.8	10.6	0.8	1.5	3.2	3.5	3.3	3.8
- mainly public sector services	0.9	2.3	1.6	2.0	2.1	2.2	0.8	1.3	1.1	1.1	1.5	1.5
- mainly private sector services	2.6	3.3	6.0	7.7	4.8	4.4	2.2	2.0	2.6	2.8	2.3	2.6
Domestic expenditure	1.9	2.9	3.9	5.0	5.5	2.3	2.4	2.4	1.7	1.1	1.6	1.7
- general government	2.4	2.7	0.5	1.3	1.2	5.3	1.3	1.8	1.2	1.4	1.1	1.3
- households and NPISH	2.3	3.9	1.9	3.1	3.4	1.1	1.8	2.0	1.6	1.3	1.8	1.3
- gross capital formation	0.1	0.0	13.2	15.3	14.6	2.9	5.1	4.2	2.4	0.2	1.9	3.3
- gross fixed capital formation	-1.6	-3.7	10.7	12.0	10.1	8.2	4.9	4.0	2.6	1.8	3.0	3.3
- inventories and valuables, contr. to GDP growth in pp	0.3	0.7	0.6	0.5	1.1	-0.9	0.0	0.1	0.0	-0.4	-0.2	0.0
Labour market												
Employment	1.3	1.8	2.9	3.0	3.3	3.0	1.0	1.4	1.6	1.6	1.5	1.5
- mainly private sector services	1.4	1.7	3.0	3.2	3.6	3.2	1.0	1.4	1.7	1.7	1.6	1.6
- mainly public sector services	0.8	2.2	2.6	2.3	2.2	2.1	1.1	1.4	1.3	1.3	1.2	1.2
Labour costs per employee	1.3	3.0	3.2	4.4	3.6	4.4	1.4	1.2	1.6	1.7	2.0	2.4
- mainly private sector services	1.5	2.4	3.2	4.5	3.8	4.6	1.5	1.2	1.6	1.8	2.0	2.5
- mainly public sector services	0.7	5.2	3.1	3.1	3.5	3.7	1.1	1.3	1.5	1.5	2.0	2.1
Unit labour costs, nominal*	0.3	1.8	1.2	1.2	2.4	3.6	0.3	0.6	0.8	0.9	1.4	1.6
Unit labour costs, real**	-0.7	1.0	-0.3	-0.4	0.1	0.9	-1.0	-0.2	-0.3	-0.4	0.0	0.2
	in %											
LFS unemployment rate	9.0	8.0	6.6	5.8	5.9	5.2	10.9	10.0	9.1	8.7	8.9	8.2
Foreign trade	*y-o-y growth rates in %*											
Current account balance as % of GDP	4.5	5.5	7.2	7.5	6.1	7.4	2.9	3.2	3.2	4.2	3.5	2.8
External trade balance as contr. to GDP growth in pp	0.6	0.5	1.3	1.5	-0.4	1.7	-0.2	-0.4	0.8	1.4	0.5	0.7
Real export of goods and services	5.0	6.4	10.7	12.7	8.7	9.3	6.5	3.0	5.2	6.0	3.1	4.2
Real import of goods and services	4.7	6.6	10.3	11.8	10.5	8.3	7.6	4.2	3.9	3.2	2.2	3.1
Financing	*in % of GDP*											
Banking system's balance sheet	106.9	99.3	93.9	93.9	91.8	91.1	281.3	275.7	260.7	260.7	260.6	260.9
Loans to NFCs	26.3	22.6	21.8	21.8	21.5	21.0	38.7	37.8	36.9	36.9	36.9	36.7
Loans to households	21.1	21.1	21.5	21.5	21.5	21.6	49.7	49.4	49.4	49.4	49.1	49.0
Inflation	*in %*											
HICP	-0.8	-0.2	1.6	1.5	1.5	2.1	0.0	0.2	1.5	1.4	1.3	1.7
HICP excl. energy, food, alcohol and tobacco	0.3	0.7	0.7	0.6	0.8	1.0	0.8	0.9	1.0	0.9	1.0	0.9
Public finance	*in % of GDP*											
Debt of the general government	82.6	78.7	74.1	74.1	75.5	72.8	89.9	88.7	86.5	86.5	86.5	...
One year net lending/net borrowing of the general government	-2.8	-1.9	0.1	0.1	0.5	0.6	-2.0	-1.5	-0.9	-0.9	-0.7	...
- interest payment	3.2	3.0	2.5	2.5	2.4	2.3	2.3	2.1	2.0	2.0	1.9	...
- primary balance	0.4	1.1	2.6	2.6	2.9	2.9	0.3	0.6	1.1	1.1	1.2	...

Note: Data is not seasonally and working days adjusted.
** Nominal unit labour costs are the ratio of nominal compensation per employee to real labour productivity.*
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Source: SORS, Eurostat, Bank of Slovenia, ECB, Ministry of Finance, Bank of Slovenia calculations.