

# **Review of the realisation of the Autumn Forecast of Economic Trends 2014**

**Ljubljana, December 2014**

**Review of the realisation of the Autumn Forecast of Economic Trends 2014 (Pregled uresničevanja Jesenske napovedi gospodarskih gibanj)**

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## Summary and explanation

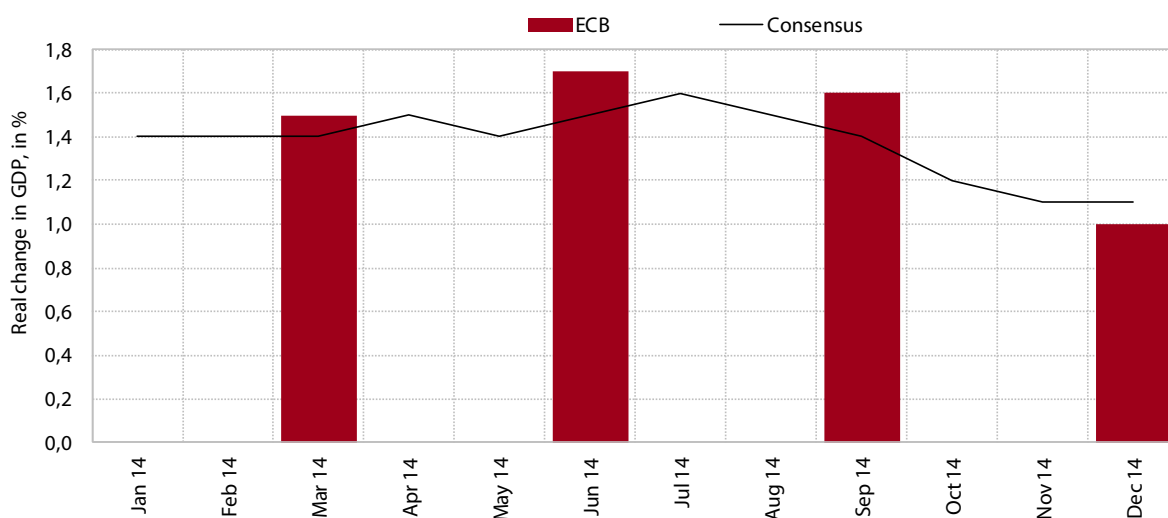
*GDP growth since the preparation of the Autumn Forecast (September 2014) has been higher than expected, which has together with some favourable changes in the international environment and in Slovenia improved expectations regarding GDP growth in 2014 and in 2015: Oil prices plummeted, thus contributing to a significant improvement in business conditions, and the set of fiscal policy measures is more clearly defined than when the previous forecast was made, which reduces uncertainty related to domestic factors.* After the continuation of growth in the third quarter, GDP was up 2.7% year-on-year in the first three quarters of 2014. The main factor in the recovery of economic activity remains exports, which is rising amid the otherwise subdued recovery in Slovenia's main trading partners and improved cost competitiveness in the tradable sector, which is reflected in market share growth. Export growth will be higher this year and in 2015 than expected in autumn, owing to more favourable terms of trade amid a pronounced decline in prices of oil. The beginning of the production of new car models will also have a greater positive effect than expected in autumn. Growth in public investment related to the stronger absorption of EU funds is another factor that makes a significant contribution to economic recovery this year, but it is expected to slow in 2015. Investment consumption growth will nevertheless be somewhat higher in both years than expected in autumn, due to higher investment in machinery and equipment related to stronger growth in exports and value added in manufacturing and higher gross profits in the tradable sector owing to better terms of trade. Expectations regarding private and government consumption have not changed much with regard to the Autumn Forecast. Household consumption will increase gradually with the recovery on the labour market and improved confidence, while government consumption will continue to fall due to fiscal consolidation. GDP is therefore projected to increase by 2.5% this year and 2.0% in 2015. Lower oil prices and, to a lesser degree, other commodity prices, have significantly impacted expectations regarding inflation, which will be much lower than projected in autumn particularly in 2015.

*The risks surrounding the forecast, which are much more balanced than was the case in some previous forecasts, are primarily associated with the situation in the international environment and somewhat less than when the Autumn Forecast was made with the domestic developments.* The risks of lower GDP growth than assumed under the baseline scenario are related particularly to the possibility of slower-than-assumed economic recovery in Slovenia's main trading partners, which would relatively quickly translate into lower activity growth in Slovenia. Another risk factor is geopolitical tensions. However, there is also a possibility of higher-than-expected growth in Slovenia's main trading partners due to a positive impact of lower oil prices and a lower value of the euro. In the domestic environment, the fiscal policy stance is somewhat more clearly defined than when the Autumn Forecast was made, the main goal remaining the reduction of the general government deficit below 3% of GDP in 2015. However, if the structure of measures planned to achieve this goal changes, or the measures prove insufficient, the baseline scenario of GDP growth may change. The risks regarding inflation are mainly related to oil price movements. Were these prices to drop more than assumed, inflation would even be lower than under the baseline scenario. However, given the rapid decline in oil prices recent months, there is also a probability of an equally rapid increase, which would however result in higher inflation than assumed under the baseline scenario.

## International environment

The weak recovery of economic activity in the international environment will continue next year, but the forecasts of international institutions for 2015 GDP growth in Slovenia's main trading partners have been revised downwards in recent months. GDP in the euro area rose by 0.2% in quarterly terms in the third quarter (seasonally adjusted). In the first nine months of this year, it was up 0.8% year-on-year. This year's fragile recovery is based on growth in household consumption and exports amid relatively less favourable movements in investment consumption. Uncertain prospects regarding the recovery of investment activity are, alongside lower forecasts for global economic growth than in autumn, also the main reason for the downward revisions of GDP growth forecasts for next year. GDP growth in 2015 is still expected to be higher than this year, relying on a further recovery of private consumption (also owing to a positive impact of lower commodity prices on household disposable income) and exports.

Figure 1: Revision of the forecast for 2015 GDP growth in the euro area



Source: Consensus forecasts, ECB.

A significant change regarding developments in the international environment since the time when the Autumn Forecast was prepared has been a substantial decline in oil prices. The price of Brent crude oil in USD fell almost by 40% between August and the beginning of December; the decline in euro prices was somewhat less pronounced due to the depreciation of the euro, but still at around 30%. Based on the current prices, the assumption of the average price of Brent crude in 2015 used in this forecast is USD 30 lower than in the Autumn Forecast. Non-energy prices also declined in this period, albeit less notably, the assumption of their movements thus also being lower than in autumn.

Table 1: Assumptions for oil price, non-energy commodities and USD/EUR exchange rate

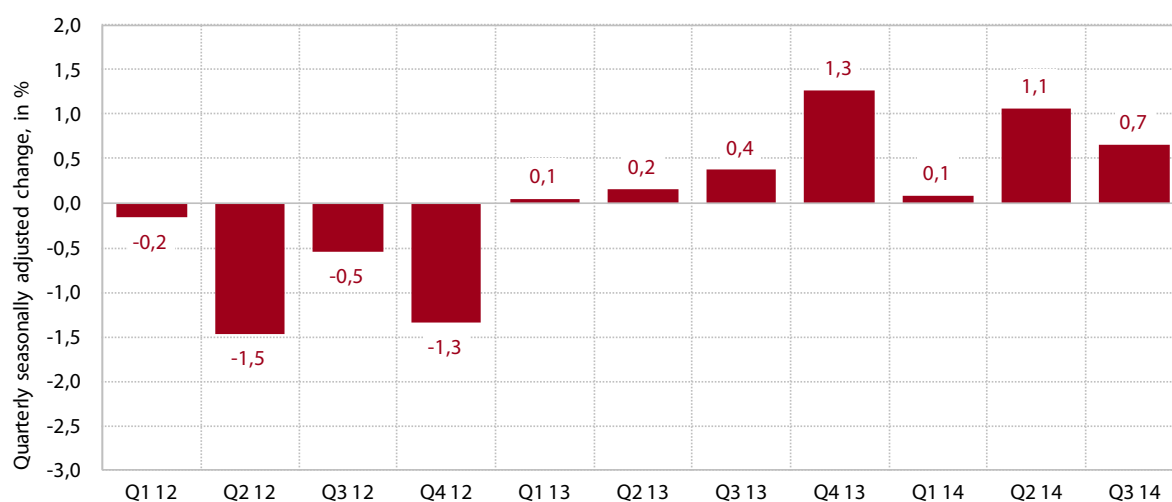
	2013	2014		2015		2016	
		Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)
Brent crude prices, in USD	108,6	107,0	99,5	102,0	73,4	102,0	78,4
Brent crude prices, in USD, growth	-2,7	-1,5	-8,4	-4,7	-26,2	0,0	6,8
Non-energy commodity prices, in USD, growth	-1,2	-1,6	-3,9	0,0	-1,3	0,0	1,0
USD/EUR exchange rate	1,328	1,353	1,329	1,332	1,240	1,332	1,240

Source: EIA, IMF, ECB.

## Economic activity in Slovenia

The economic recovery continued in the third quarter mainly due to faster growth in exports; GDP was up 2.7% year-on-year in the nine months to September. GDP rose by 0.7% relative to the previous quarter (seasonally adjusted) mainly on the back of a further strengthening of growth in merchandise exports. Total exports were thus up 5.6% year-on-year in the first three quarters of the year, which is, amid the relatively weak recovery in external demand, related to an improvement in the cost competitiveness of the tradable sector and better terms of trade due to the decline in global commodity prices. Another factor that contributed to higher export growth than expected in the Autumn Forecast of Economic Trends released at the end of September is the extent of the positive effect of the production of a new car model. Domestic consumption also continued to rise year-on-year in the third quarter. The quarterly increase in gross fixed capital formation was similar to that in the second quarter but its structure was slightly different. Growth in construction investment, in particular public investment related to the strong absorption of EU funds, moderated, while investment in machinery and equipment rose. Furthermore, the strengthening of year-on-year growth in the number of employees and average gross earnings was reflected in a further year-on-year increase in household consumption, particularly in the durable goods segment. According to our estimate, this was also attributable to an improvement in consumer confidence indicators, also as a result of lower uncertainty after the banking system restructuring. The latter also contributed to an improvement in access to finance for the government, together with the moderation of the situation on international financial markets. After declining year-on-year for a long period, government consumption remained unchanged in year-on-year terms, the main reason being higher expenditure on intermediate consumption, which had still recorded a considerable year-on-year decline in the first half of the year.

Figure 2: Quarterly GDP change in Slovenia (seasonally adjusted)



Source: SURS.

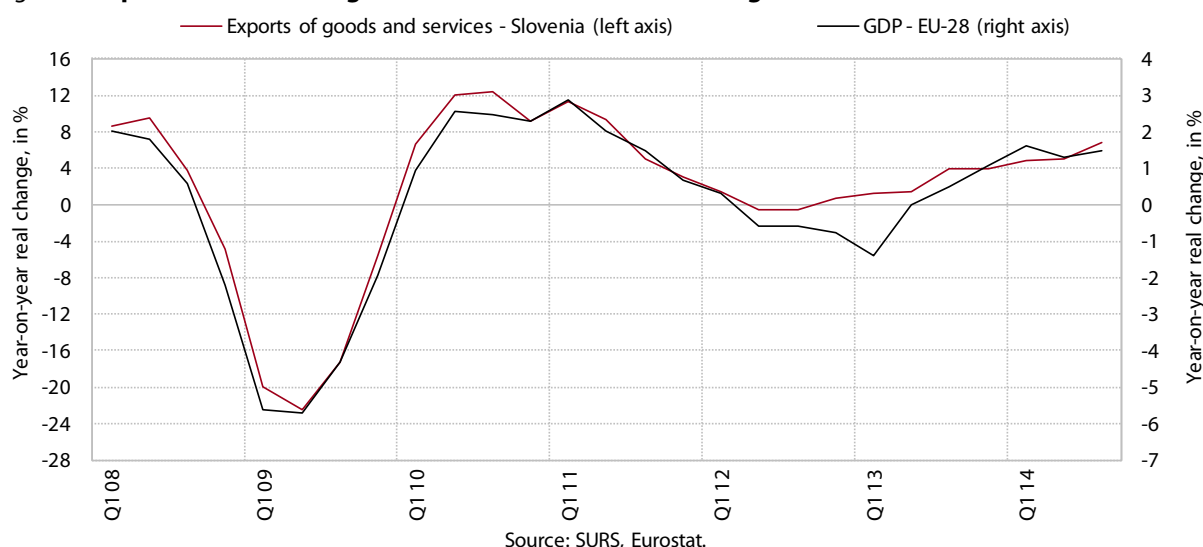
**Economic growth** in 2014 and 2015 is expected to be higher than projected in the Autumn Forecast of Economic Trends, particularly due to higher expectations regarding export growth and a slightly higher forecast for investment consumption. While the structure of the expected GDP increases in 2014 and 2015 remains the same as in the Autumn Forecast, the changes in individual aggregates are set to be more favourable than anticipated in September (see Table 1), particularly as regards exports and investment.

Table 2: **Economic growth forecast**

Real growth rates, in %	2013	2014		2015		2016	
		Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)
Gross domestic product	-1.0	2.0	2.5	1.6	2.0	1.6	1.7
Exports	2.6	3.7	5.2	4.3	4.7	4.9	5.3
Imports	1.4	3.1	3.9	4.2	4.1	4.5	4.5
External balance of goods and services (contribution to growth in percentage points)	1.0	0.6	1.2	0.4	0.7	0.7	0.9
Private consumption expenditure	-3.9	0.5	0.7	1.3	1.1	1.8	1.6
Government consumption expenditure	-1.1	-0.4	-1.0	-1.0	-0.6	-1.1	-0.6
Gross fixed capital formation	1.9	4.5	5.8	2.5	3.5	0.5	0.5
Change in inventories and valuables (contribution to growth in percentage points)	0.1	0.3	0.1	0.2	0.2	0.1	0.0

Source: SURS; forecast by IMAD.

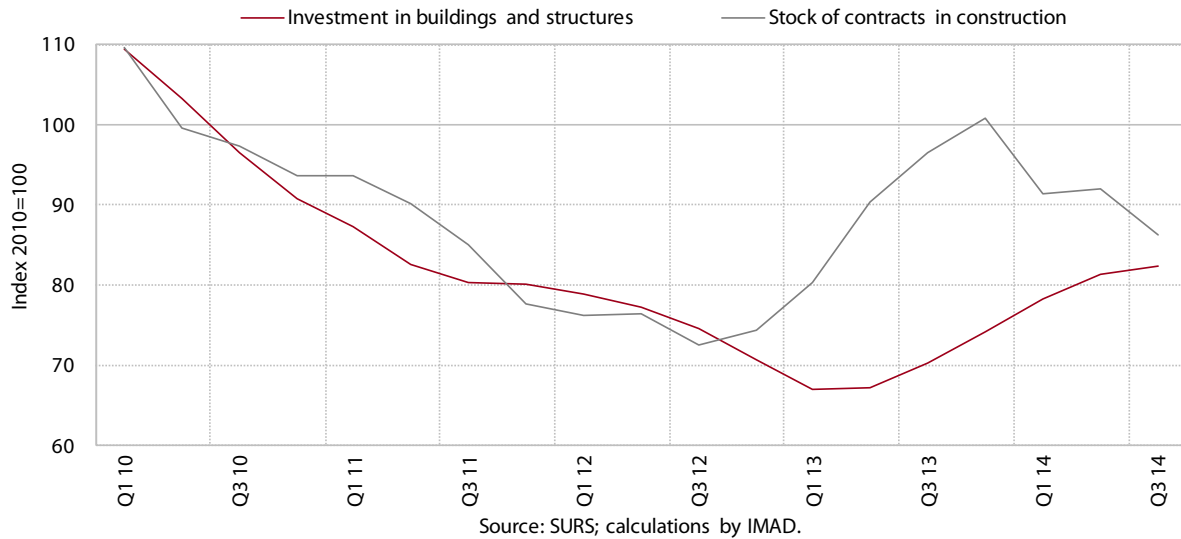
Amid further growth in external demand, improvement in cost competitiveness of the tradable sector and more favourable terms of trade, **exports** will remain the main engine of economic growth in Slovenia. Considering the assumptions for the international environment, growth in external demand is expected to strengthen slightly again in 2015. With the improvement in the cost competitiveness of the tradable sector, the market share continues to increase this year and is also expected to see similar movements next year, according to our estimate. A major factor contributing to higher expectations for export growth than in the Autumn Forecast is better terms of trade (the ratio of import to export prices) amid a considerably lower assumption for next year's average prices of oil and other commodities due to their pronounced declines in recent months. As a result of more positive-than-expected movements in the third quarter of this year, the forecast for road vehicle exports is also slightly higher than in autumn, which is attributable to the production of two new car models.

Figure 3: **Exports of Slovenia's goods and services and economic growth in the EU**

After strengthening significantly in 2014, growth in **gross fixed capital formation** will slow in 2015, the decisive factor being the dynamics of gross investment, while a slightly higher forecast for total investment consumption than in the Autumn Forecast reflects improved expectations for investment in machinery and equipment. The main driver of this year's growth in fixed capital formation is public investment in other buildings and structures related to the stronger absorption of EU funds before the expiry of the financial perspective next

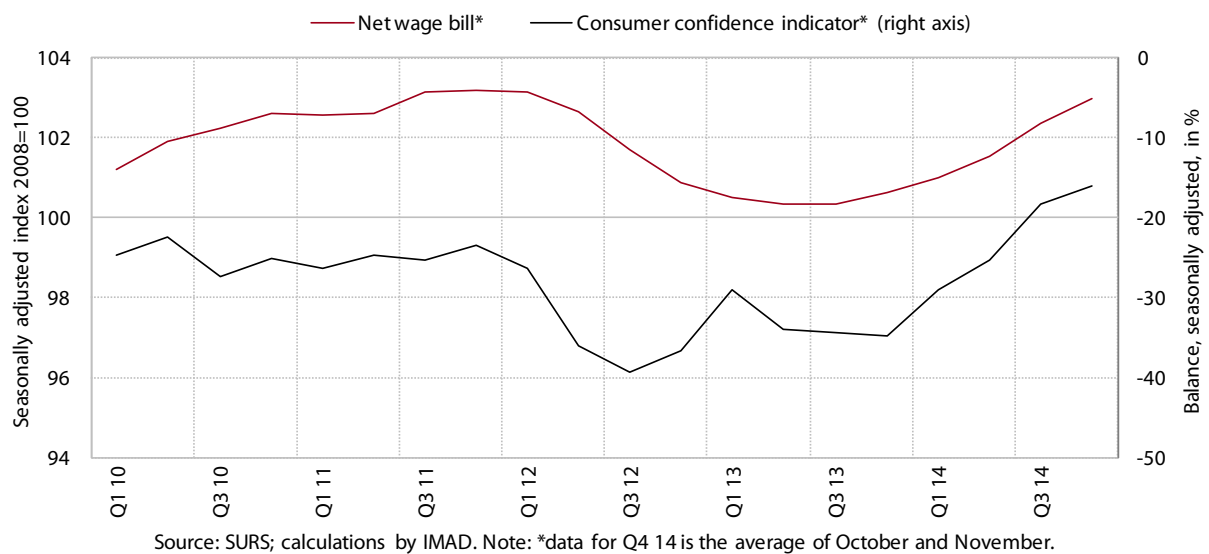
year. The 2015 growth of this investment is projected to be much lower than this year, so that total investment growth is also expected to ease. The somewhat higher forecast than in autumn is a result of higher forecasts for private investment in machinery and equipment associated with stronger growth in exports and value added in the manufacturing sector and, in our estimation, higher gross profits in the tradable sector as a result of better terms of trade.

Figure 4: Selected indicators of construction activity



With the recovery on the labour market and improved confidence, **household consumption** started to pick up this year after declining strongly for two years; it is also expected to increase slightly next year in line with the anticipated increase in disposable income. Both average earnings and employment are rising this year, which is reflected in higher household disposable income. Consumer confidence has also improved notably since the beginning of the year and thus their propensity to buy. The latter has also been observed in the segment of durable goods, for the first time in a long period, which is reflected in the quarterly increases in durable goods consumption in the second and third quarters of this year. With the expected further improvement in the labour market situation, private consumption growth will strengthen slightly more next year and continue to follow growth in disposable income.

Figure 5: Selected indicators of household consumption



With ongoing fiscal consolidation, **general government consumption** will drop further in 2014 and 2015. This year's decline will be similar to last year's and the result of the government streamlining expenditure on goods and services, a decline in social transfers in kind and, in the area of labour costs, further cuts in the number of

employees. Next year, government consumption will be falling somewhat more slowly; the decline in expenditure on goods and services is assumed to be smaller, while social transfers in kind will increase after three years of decline (expenditure on medicines and medical devices, increase in payments to institutions providing public health services). The extension of measures in the area of wage policy and the assumed reduction in the number of employees in the general government will result in a further nominal decline in compensation of employees in 2015.

## Labour market developments

**Employment** started to rise this year under the impact of economic recovery, and a continuation of these movements is also projected for 2015; in line with the higher forecast for economic growth in 2014 and 2015 than projected in the Autumn Forecast, growth in employment will also be slightly higher than anticipated. The number of employees as measured by the national accounts statistic has been rising since the last quarter of 2013 (seasonally adjusted). Employment trends will improve in most private sector activities this year: while some activities will record growth, most of them will see a smaller decline than in 2013. We estimate that companies have remained cautious about hiring in the initial phase of the recovery. In the first nine months of this year, the number of employed persons therefore increased most in employment activities leasing labour. Next year, total employment is expected to rise in a similar way, but the increase will be recorded in more activities.

Table 3: **Forecasts for employment and unemployment**

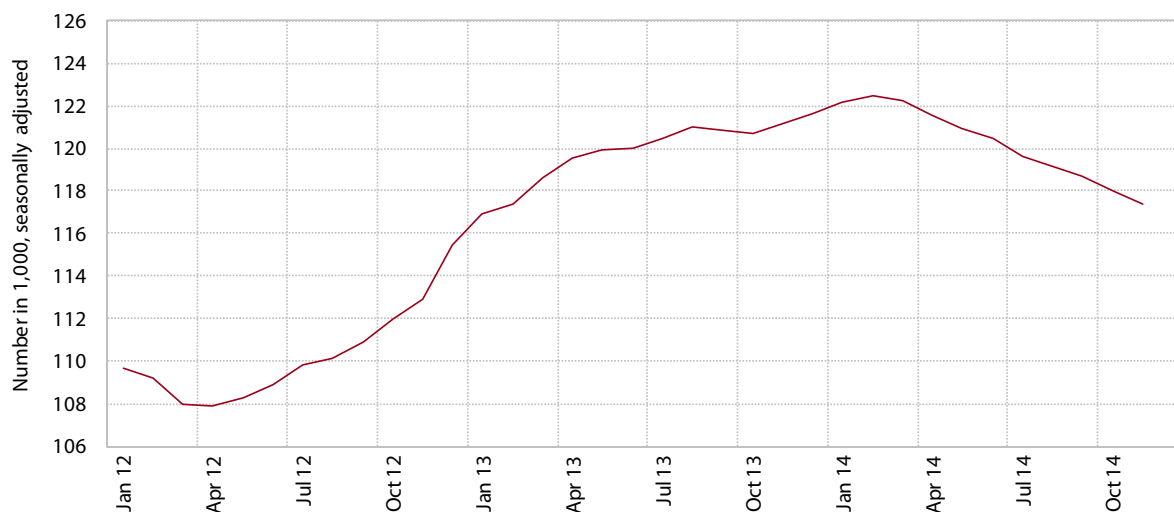
In %	2013	2014		2015		2016	
		Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)
Employment according to the SNA, growth	-1.5	0.6	0.7	0.4	0.6	0.5	0.6
Number of registered unemployed, annual average	119.8	120.6	120.1	119.4	115.7	116.7	112.0
Registered unemployment rate	13.1	13.1	13.1	13.0	12.6	12.7	12.2
ILO unemployment rate	10.1	10.0	9.7	9.9	9.3	9.4	8.9

Source: SURS, ESS; IMAD forecast.

The decline in **registered unemployment** has intensified in the months after the preparation of the Autumn Forecast; in 2014 as a whole, the number of registered unemployed persons will be slightly lower than expected in September and will continue to drop in 2015. The number of registered unemployed persons started to fall in March 2014 (seasonally adjusted). In the last three months the decline intensified, registered unemployment being down 3.3% year-on-year at the end of November. The average number of the unemployed in 2014 will nevertheless be somewhat higher than last year due to a substantial increase early in the year. Next year, the number is expected to decline only slightly more slowly than this year, partly as a result of a smaller amount of funds allocated for the implementation of active employment policy measures than this year. The annual average in 2015 will be lower than expected in autumn due to a lower number of the unemployed at the end of this year.



Figure 6: Number of registered unemployed



Source: ESS; calculations by IMAD.

Average **gross earnings per employee** will rise this year after two years of nominal stagnation, and they are also expected to increase next year. This year's increase will be similar to what was expected in the Autumn Forecast, relying on stronger growth in the private sector and, for the first time in two years, growth in the public sector. Private sector growth, which started at the beginning of 2013 (seasonally adjusted), is related to the economic recovery and increased productivity. Outstanding growth was recorded in industry, including manufacturing and some market services. After two years of significant decline, average earnings will also rise in the general government, which will be solely the result of the beginning of the payment of suspended promotions. Growth in public corporations continues this year. Next year's nominal growth in total gross earnings will be lower than projected in autumn mainly due to wage movements in the general government. Namely, when preparing the Autumn Forecast, we assumed a prolongation of all measures, while the latest agreement anticipates certain additional measures as a result of which average gross earnings will remain unchanged in nominal terms, according to our estimate. With a similar forecast for nominal growth of average gross earnings in the private sector as in autumn, real growth in 2015 will be higher than forecast in autumn due to the much lower-than-expected inflation.

Table 4: Forecasts for average gross earnings per employee

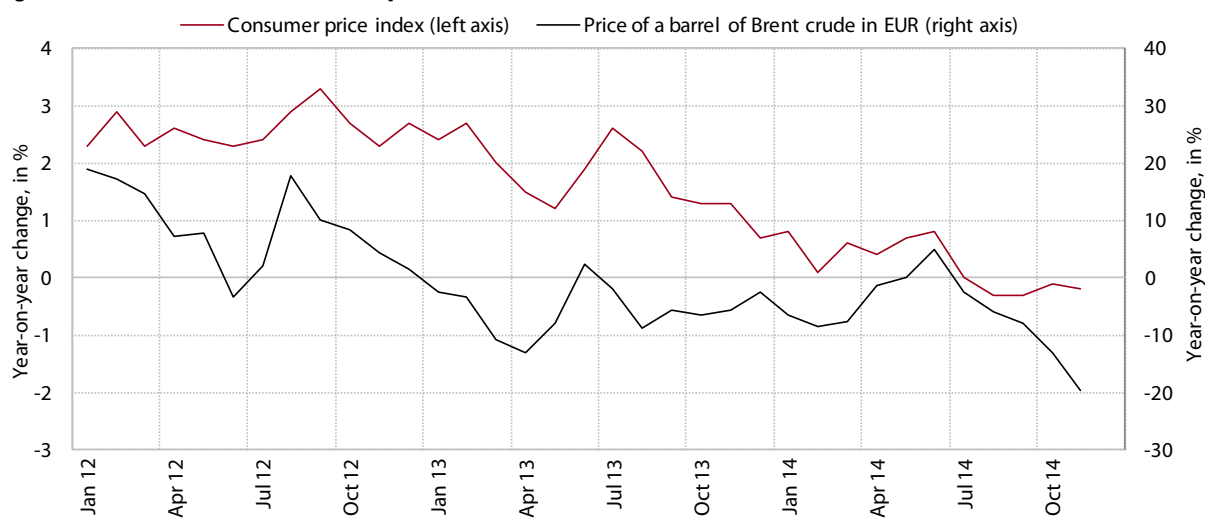
Growth, in %	2013	2014		2015		2016	
		Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)
Gross earnings per employee – nominal	-0.2	1.3	1.2	1.3	1.0	1.8	1.9
- Private sector activities	0.6	1.6	1.6	1.6	1.5	2.2	1.9
- Public sector activities	-1.3	1.1	1.0	1.0	0.5	1.4	1.8
Gross wage per employee – real	-2.0	1.0	1.0	0.7	1.0	0.6	1.3
- Private sector activities	-1.2	1.3	1.4	1.0	1.5	1.0	1.3
- Public sector activities	-3.0	0.8	0.8	0.4	0.5	0.2	1.2

Source: SURS; forecast by IMAD.

## Prices

The significant decline in oil and other commodity prices since the preparation of the Autumn Forecast is reflected in a lower forecast for inflation in 2014 and particularly 2015. November recorded year-on-year deflation (-0.2%) for the fourth month in a row, while the expected year-on-year growth in December will be primarily the result of the base effect, as in 2013, supplementary health insurance premiums declined in December (this year, in November). In 2015, inflation will be lower than this year, and much lower than expected in autumn, taking into account much lower assumptions for prices of oil and some other commodities than in the Autumn Forecast. Furthermore, prices of other non-industrial goods and services will increase less than expected in autumn amid the still modest recovery of private consumption and due to a gradual transfer of lower commodity prices into other prices.

Figure 7: Inflation in Slovenia and price of a barrel of Brent crude



Source: SURS, EIA; calculations by IMAD.

Table 5: Inflation forecast

In %	2013	2014		2015		2016	
		Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)	Forecast (Sep 14)	Forecast (Dec 14)
Inflation – Dec/Dec	0.7	0.6	0.5	1.1	0.1	1.3	1.0
Inflation – annual average	1.8	0.3	0.2	0.6	0.0	1.2	0.6

Source: SURS; forecast by IMAD.

## Risks

*The risks surrounding the GDP forecast are mainly related to the international environment and slightly less than when the Autumn Forecast was made to the domestic situation, which is largely attributable to the slightly more clearly defined fiscal policy stance. The risks of lower GDP growth than assumed under the baseline scenario arise from the international environment and are related particularly to the possibility of slower-than-assumed economic recovery in Slovenia's main trading partners. This would be relatively quickly reflected in lower GDP growth in Slovenia. Another risk factor is geopolitical tensions (the Russia-Ukraine conflict), which would, if intensified, also contribute to lower activity growth. However, there is also a possibility of higher-than-expected growth in Slovenia's main trading partners due to a positive impact of lower oil prices and a lower value of the euro. Faster export growth than assumed under the baseline scenario could also be influenced by a faster increase in the market share due to improved cost competitiveness in the tradable sector. In the domestic environment, the fiscal policy stance is somewhat more clearly defined than at the time of the Autumn Forecast, the main goal remaining the reduction of the general government deficit below 3% of GDP in 2015. However, if the structure of measures planned to achieve this goal changes, or the measures prove insufficient, the baseline scenario of GDP growth may change.*

*Amid current oil price dynamics, significant risks to the forecast are also associated with the forecast for inflation. Were oil prices to drop more than assumed, inflation would be even lower than under the baseline scenario. However, given the rapid decline in oil prices in recent months, there is also a probability of an equally rapid increase, which would however result in higher inflation than assumed under the baseline scenario. If this were the case, the positive effects of the improved terms of trade on business conditions (of export-oriented companies in particular) would be smaller.*