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Policy brief 2023/02

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Slovakia will avoid recession this year

Macroeconomic forecasts for years 2022 – 2026

IFP Analysts

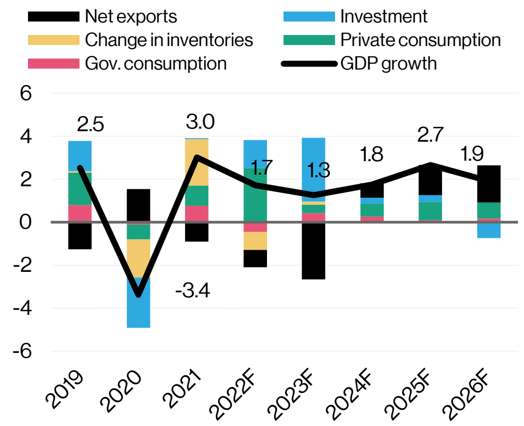
As the euro area economy will avoid recession, Slovak GDP will rise by 1.3 per cent in 2023. The economy will be driven by domestic demand supported by the energy prices cap and the drawing of EU resources. The labor market will be resilient even though the dynamics of job creation will be moderate. Average inflation will ease to below 10 per cent leading to real wage stagnation. In 2024 and 2025, the Slovak economy is set for a recovery supported by stronger external demand. However, the duration of the energy prices cap will play a key role, as the government subsidies will expire and prices will have to match actual market values. Escalation of Russian aggression and the low Recovery and Resilience Plan funds drawings, which would cut off half of the economic growth this year, remain a risk to the development.

Government aid cushioned the sharp fall of European economies

The Slovak economy grew by 1.7 per cent in 2022 despite double-digit inflation. GDP growth was mainly driven by household consumption, but at the expense of savings. The savings rate has thus reached an all-time low. Consumers kept their spending above the previous year's level thanks to assurances of energy aid and the promised energy price caps for next year. Investments that had been postponed during the pandemic also contributed positively to economic development. Exports remained subdued[1] during the year due to supply chains issues and weak external demand amid rising prices.

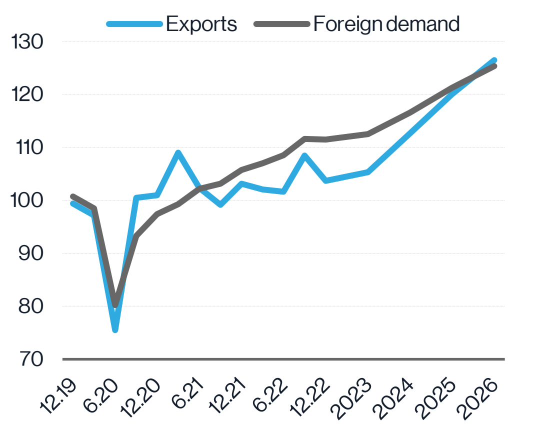
Government measures to support companies and households and a warmer winter will prevent a stronger recession in Europe. Due to that Slovak GDP will grow by 1.3 per cent in 2023. The European Central Bank continues to fight inflation by raising interest rates. However, inflation expectations eased gradually and economic sentiment rebounded at the end of the year, improving the outlook for economic growth in Europe (see Box 2). Nevertheless, growth prospects remain only moderate for the time being, which will also be reflected in subdued exports from Slovakia.

Figure 1: Contributions of individual components to GDP growth (constant prices, p.p.)



Source: SO SR, IFP

Figure 2: Export convergence will be slow in 2023 (constant prices, 2019 = 100)



Source: IFP

[1] Strong exports in the third quarter were just a one-off increase caused by the release of inventories.

Slovakia can build on 2015 successes and draw billions of euros from EU funds

The dynamics of the Slovak economy will be driven by domestic demand in 2023 supported by easing inflation and stabilising real incomes of households. The ongoing implementation of the Recovery and Resilience Plan will contribute to as high as half of the GDP growth. Government transfers will inflate household disposable incomes, mainly through the tax bonus, and prevent a slowdown in consumption. Consumer inflation will be dampened by capped energy prices, but food and service prices may still rise. Nevertheless, households will build up their savings again thanks to higher incomes. Due to them, real wages are expected to increase slightly in 2023. The growth of public sector wages will be faster thanks to the announced across-the-board indexation and strong wage increases for healthcare workers. However, the strong growth of nominal wages will not be high enough to exceed the effects of previous inflation. For private-sector wages it will also take several years to offset the inflation shock.

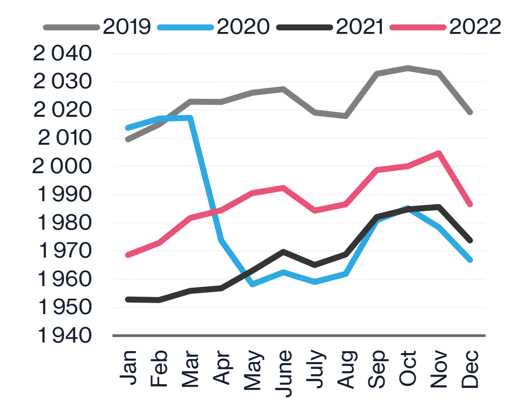
Completion of EU funds drawing from the previous programming period and the initiation of funds drawing from the Recovery and Resilience Plan will boost employment. The labour market will remain resilient owing to energy price caps for firms and municipalities, but employment dynamics will remain low. Rising costs and weaker sales are hindering faster job creation. Meanwhile, Slovak car companies will adapt production facilities to new models but exports will not yet converge with lost market shares. Imports will be boosted not only by the higher private consumption and investment but also by the contractual delivery of fighter jets.

Growth for 2024 to 2026 is built on several pillars

In 2024 and 2025, we expect Slovak GDP growth to accelerate. Foreign trade will increase and European exports will be driven by the post-pandemic China recovery. With new models, Slovak carmakers will gradually penetrate foreign markets and the reacquisition of lost market shares is expected. Net exports will support the economy as the negative energy price shock will cease. The growth rate will peak in 2025 at 2.7 per cent before the Recovery and Resilience Plan expires.

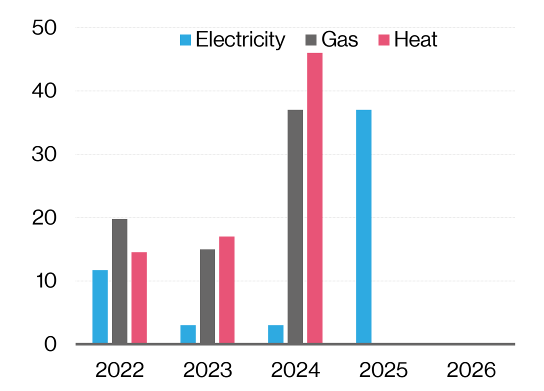
The downside risks to the forecast prevail, as further aggression by Russia may bring renewed price pressures for the agricultural products and energy commodities with additional spillovers for the prices of goods and services. The positive risk is a stronger integration of Ukrainian refugees in the domestic labour market. In Box 1, we assess the assumptions for a successful drawdown of EU funds in 2023, and in Box 3 we estimate the risk of non-drawdown of part of the Recovery and Resilience Plan funds.

Figure 3: Employment has yet to reach pre-crisis levels (employment relations in thousands)



Source: Source Security Agency

Figure 4: Energy prices have yet to have the last word and we expect them to rise further in the coming years (annual growth, per cent)

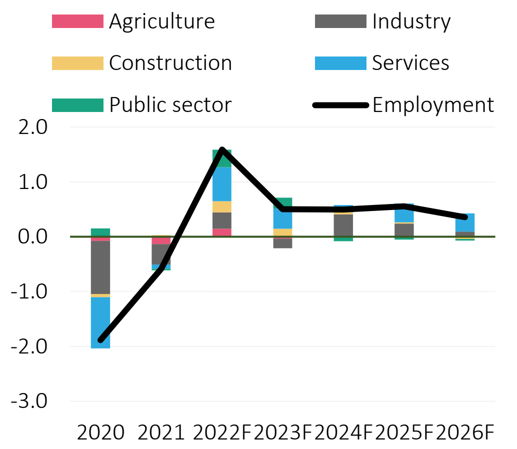


Source: SO SR, IFP

Inflation has peaked

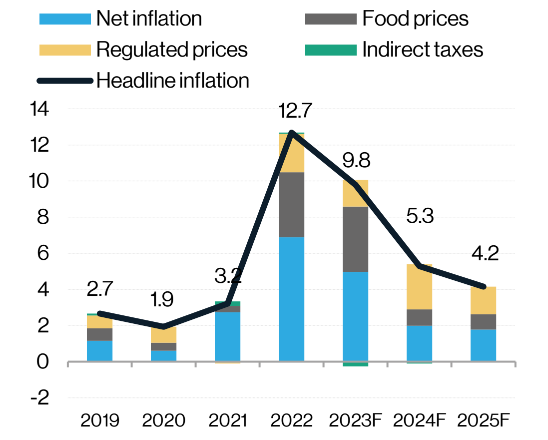
The average inflation will reach 9.8 per cent in 2023. Year-on-year price growth will be largely influenced by the base effect of the strong price increases at the end of last year. Due to government measures energy prices for households rose only slightly in January compared to developments on commodity markets. Food prices will rise moderately affected by persistently high global agri-commodity prices, and we expect prices to stabilise only in the second half of the year. On the other hand, fuel prices will continue to decline this year. While the goods inflation pace will ease to lower growth levels towards the end of the year, services inflation will slow only slightly due to robust labour market developments.

Figure 5: Sectoral contributions to ESA employment growth (p.p.)



Source: SO SR, IFP

Figure 6: Inflation trend and forecast, including contributions of individual components (p.p.)



Source: SO SR, IFP

We expect the adoption of additional measures to curb the energy prices

Inflation will slow to 5.3 per cent next year and return close to 2 per cent in the medium term. Food and goods inflation will normalise, while it will take longer for services inflation to decelerate. On the other hand, an increase in energy prices should be expected. For the electricity prices, we assume that the development in 2024 will be similar to this year's due to Memorandum with the Slovak Power Plants. However, for gas and heat prices the development is uncertain as the price caps are set to expire at the end of the year.

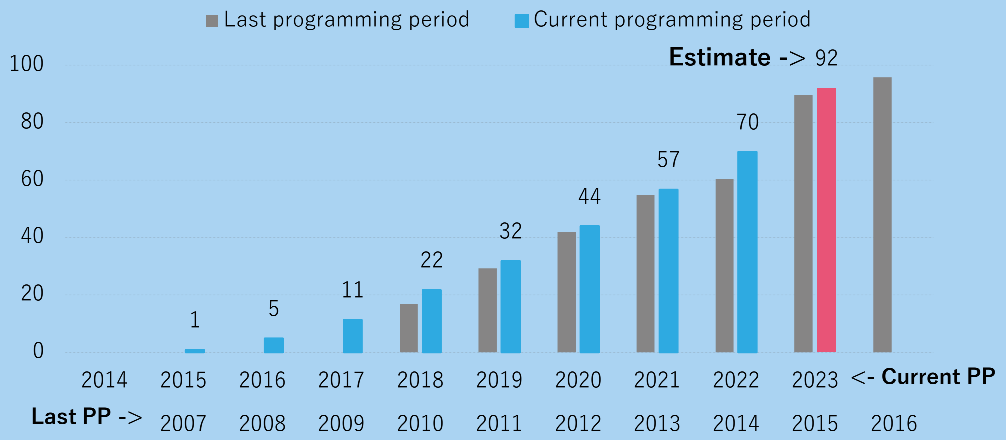
If there were an immediate switch to market prices next year, gas prices would more than double, despite an apparent fall in world market prices. At the same time, heat prices would rise as well. However, we expect some measures to prevent price rises to occur in the years to come. The assumption is that the gas price would be set to reflect the anticipated market price in the medium term (2026). This would imply an increase in the price of gas of almost 40 per cent next year and unchanged prices in 2025 and 2026. We apply a similar approach for electricity prices. They are expected to increase in 2025 (also by almost 40 per cent) after the expiry of the Memorandum, and then settle on near-market values in 2026. Electricity and gas prices should thus stabilise at around 50 per cent and 60 per cent above 2022 levels in the medium term.

BOX 1: Will we successfully draw down all the EU funds?

The current forecast assumes that the economy will be boosted in 2023 by the drawdown of EU funds from the outgoing programming period. Is this assumption valid given the low absorption rate so far? We present several arguments in support of this assumption. In the following box, we estimate the impact of the lower drawdown of Recovery and Resilience Plan funds.

Despite the relatively low current rate of EU funds absorption, the drawdown is still higher than it was at the same time in the last programming period. By December 2022, Slovakia utilised 70 per cent of the funds, compared to only 60 per cent for the same period in the past. By the end of 2023, we expect to absorb 92 per cent of the package. Thus, in 2023 alone the drawdown of 22 per cent of the allocation is expected, whereas in 2015 it was up to 35 per cent. To simplify: in the past, the drawdown had accelerated in the last year of the programming period more than we assume for 2023.

Figure A: The cumulative absorption of EU funds is higher today than in the last programming period (PP) (cumulative per cent of total allocation)

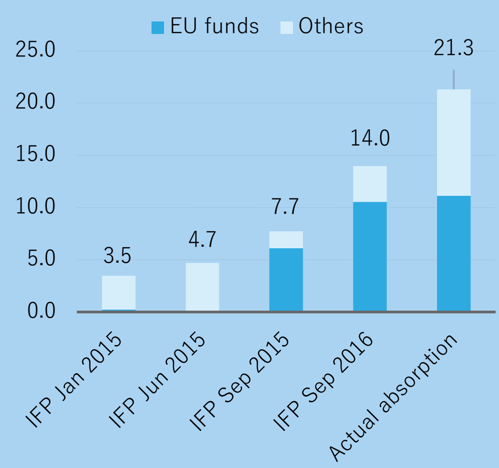


Source: RIS, IFP

In the past, signals about the EU funds absorption came late. Even in June 2015, forecasts did not foresee an acceleration of investment activity in 2015. While the MFSR forecast from June 2015 expected a zero contribution of EU funds to the overall investment growth, the September forecast already expected a contribution of 6 p.p.. In reality the contribution was almost twice as high (about 11 p.p.).

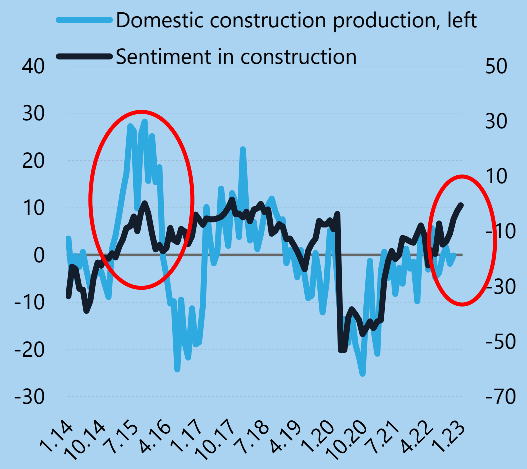
Leading indicators and sentiment in the construction industry are at relatively high levels. While activity in the industrial sector slowed during the year because of the Russian invasion and the energy crisis, the construction sector fared much better. Sentiment in the construction industry suggests that domestic construction output will grow over the winter and spring. This signals an acceleration in the absorption of EU funds in this sector, similar to 2015.

Figure B: Past forecasts did not foresee EU funds drawdown and an increase in investment (contributions to 2015 GFCF growth, current prices)



Source: IFP, SO SR

Figure C: Sentiment in the construction industry signals positive development of construction output (left-hand side: per cent, YoY; right-hand side: points)



Source: IFP, SO SR

Momentum from the EU Recovery Plan will support the labour market

The labour market is resilient, but job creation momentum is low. Employment stagnated at the end of 2022 and the labour market recovery has slowed again. High energy prices and problems in supply chains contributed to declines in industrial employment. In 2022, employment was dragged down mainly by the service sector, which had already reached pre-pandemic levels. Ukrainian refugees of whom around 15,000 found a job by the end of the year also contributed to higher employment. After an initial strong influx, their employment has stabilised at steady gains of around 1,000 per month, and it is expected to total 20,000 in 2023.

In 2023, the labour market will create an additional 12,000 jobs amid the investments of the Recovery and Resilience Plan in the second half of the year. We still expect employment to stagnate in the first half of 2023. Lay-offs due to the energy crisis will be more moderate, as firms will start to receive compensation for high energy prices from February. Investment from the Recovery and Resilience Plan will contribute significantly to the labour market recovery in the coming years. These will mitigate the decline in the labour force due to an ageing population until 2026. At the end of the forecast period, positive effects of Volvo's arrival on the Slovak labour market are assumed.

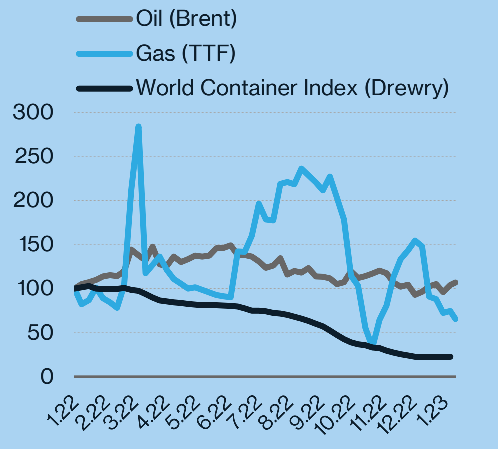
Despite the crisis, the disposable unemployment rate continued to fall slightly. Reaching 6 per cent at the end of 2022, the long-term unemployment rate also fell. This year, we expect a slight rise in unemployment (0.1 pp), which will affect mainly workers in energy-intensive sectors. In the second quarter, however, unemployment should start to fall again, reaching 5.8 per cent on average in 2023. In the following years, as the economy accelerates, the unemployment rate will approach 5 per cent and the labour shortage problem will worsen.

The growth of nominal wages will outpace the rate of inflation in 2023. In 2022, nominal wages grew by 8.1 per cent. However, this was not enough to keep up with inflation, thus real wages fell by 4.2 percent. In 2023, nominal wages will grow by 10.5 per cent. The high growth numbers will be driven by the public sector, which will see historic pay rises. In addition to the salary indexations in January (public administration: 7 per cent, education: 10 per cent) and September (public administration: 10 per cent, education: 12 per cent), health care workers also negotiated significant increases at the end of the year, which will contribute roughly the same amount (EUR 0.5 billion) to the wage base. From 2024 onwards, wage negotiations will reflect the lower rate of growth in consumer prices. In the public sector, from 2024 onwards, the forecast assumes lower wage growth due to spending cuts.

BOX 2: External environment assumptions

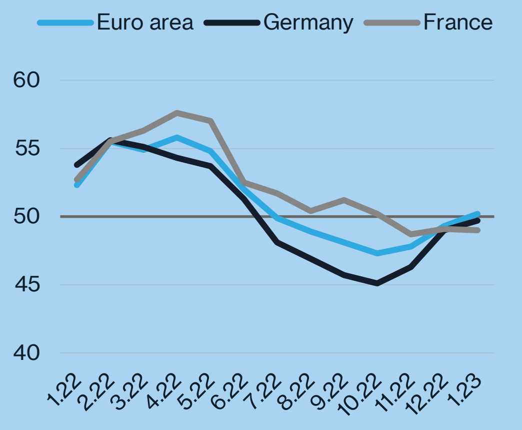
Global inflation and the bottlenecks in supply chains are easing. Falling energy commodity prices, and the associated month-on-month decline in euro area inflation, suggest that inflation may have passed its peak. By the end of the year, oil had erased most of its gains from the first half of the year and moved closer to its long-term price average. This was despite the uncertainty caused by the imposition of a price cap on Russian oil and the curbs on production by the OPEC. As a result, sentiment in the euro area across sectors improved towards the end of the year. Better outlook for firms was supported in particular by shortening delivery times and falling input prices. The abandonment of the zero Covid policy in China also had a positive impact. On the other hand, firms are starting to feel the negative effects of tight monetary conditions on the decline in orders. The low unemployment rate and non-declining core inflation are likely to force the ECB to hold key interest rates higher for a longer period of time.

Figure A: Prices of energy commodities are on decline (price index , January 2022=100)



Source: Bloomberg, IFP

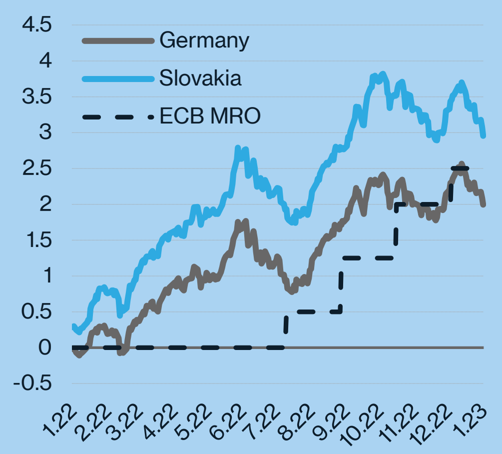
Figure B: Sentiment in the euro area has been improving (Purchasing Managers' Index, readings above 50 = expansion)



Source: Macrobond, IFP

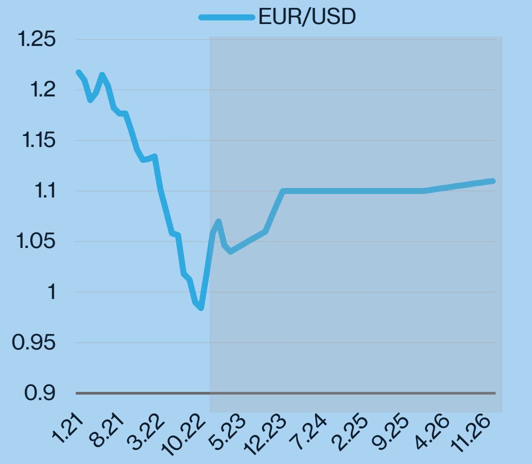
Financial markets were also affected by the year-end positive development. European stock indices gained around 20 per cent since October. The common European currency also appreciaited significantly in recent weeks, rebounding from parity with USD to 1.08 USD per euro. Despite the ECB's strong tightening of monetary policy, bond yields gradually declined and the risk premium to German bonds decreased.

Figure C: Bond yields have fallen despite rising ECB rate (p.p.)



Source: Bloomberg, IFP

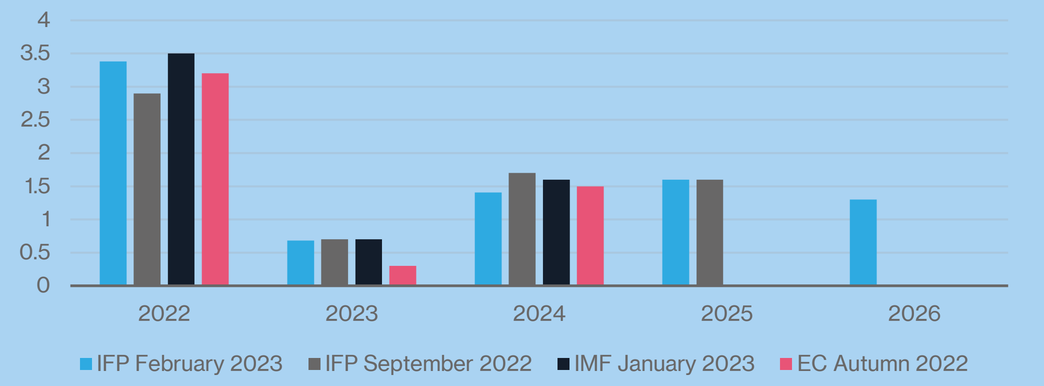
Figure D: The euro has been gaining a ground against the dollar. Forecast suggests further exchange rate appreciation



Source: Bloomberg, IFP

The better prospects of the main trade partners' economies are reflected in the forecast. Stronger results of our foreign partners in the third quarter and improving sentiment in the fourth quarter indicated that the GDP of our trading partners will be higher at the end of 2022 than was forecast in September. The positive trend is expected to continue into early 2023. However, later in the year, the delayed effects of tight monetary policy will start to weigh on consumption and output. Although any major revisions of the forecast for 2023 have not been done, our expectations are more optimistic compared to the latest forecasts of international institutions (International Monetary Fund, European Commission). Over the longer term, the economies of our foreign partners are expected to absorb shocks and gradually return to growth at the pace of potential GDP.

Figure E: GDP growth forecast for the external environment is more positive (annual growth, per cent)

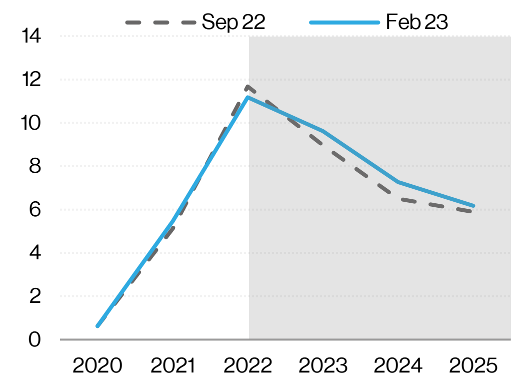


Source: IFP, EC, IMF

The overall impact of the macroeconomic forecast update on tax bases is positive over the entire horizon from 2023 onwards. This is mainly due to more resilient household consumption and tight labour market. However, faster energy price growth than assumed in the September 2021 forecast boosts tax bases for 2024. The precise impact on the tax and social contribution estimates will be scrutinized by the Tax Forecasting Committee on 9 February 2023.

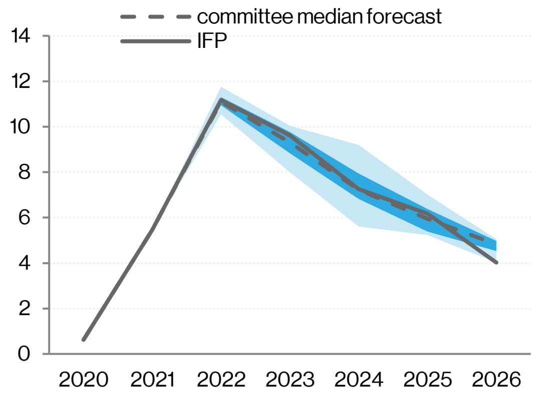
The update of the Ministry of Finance's macroeconomic forecast was the subject of a meeting of the Committee for Macroeconomic Forecasts on 1 February 2023. **The forecast was assessed as realistic by the majority of the Committee's members** (RRZ, SLSP, Tatrabanka, Infostat, Unicredit and ČSOB)**, while two members** (NBS, VÚB) **assessed it as optimistic.** The forecast update, as well as the minutes of the Macroeconomic Forecast Committee and the background materials, are available on the IFP website.

Figure 7: Evolution of macroeconomic bases compared to the previous forecast (growth, per cent)



Source: IFP

Figure 8: Comparison of tax base forecasts[2] by members of the MFC (growth, per cent)



Source: IFP

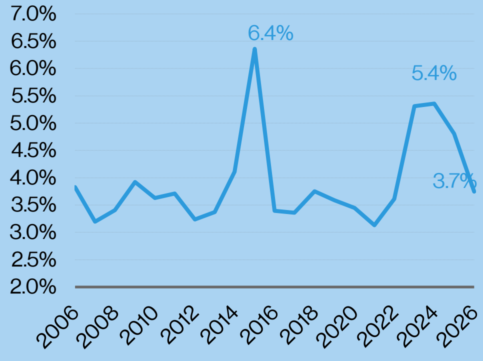
BOX 3: Alternative scenario - pessimistic development of the Recovery and Resilience Plan funds absorption

We reflect the negative risks associated with the insufficient absorption of the Recovery and Resilience Plan (RRP) funds in a risk scenario which assumes lower absorption by 33 per cent in comparison with the base scenario. Dragged down by lower spending, GDP will decline by 0.6 pp to 0.7 per cent in 2023 and the economy will move closer to stagnation. This scenario is based primarily on a shortfall in import-intensive investment, which accounts for almost 90 per cent of the funds. For this reason, the economy's overall potential will also deteriorate, by a cumulative €1 billion by 2026.

Investment activity in public administration was low in recent years, which also poses risks for the future. Since 2018, it declined as a share of GDP from 3.8 per cent in 2018 to 3.1 per cent in 2021. In addition to EU funds, the drawdown of the Recovery and Resilience Plan, which raised funds to support reforms and investment in response to the pandemic, may also help to boost the investment. Incremental spending in 2022, together with one-off investments (military equipment), accelerated public investment to 3.6 per cent of GDP. In subsequent years the investment activity is expected to be exceptionally high, similar to 2015, due to the effects of RRP.

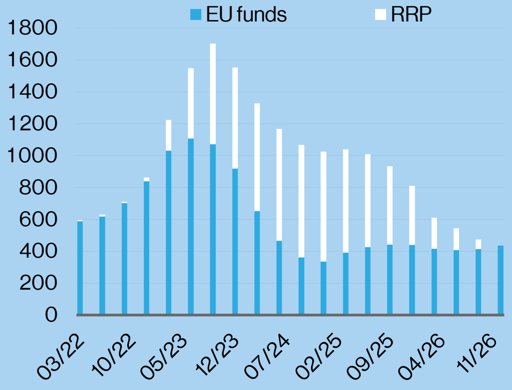
[2] Macroeconomic bases for budget revenues (weight of indicators depends on a proportional share of particular taxes on total tax revenues): Wage base (employment + nominal wage) – 55.9 per cent; Nominal private consumption – 24.4 per cent; Real private consumption – 4.2 per cent; Nominal GDP growth – 10.6 per cent; Real GDP growth – 4.9 per cent.

Figure A: Share of public investment on GDP (per cent)



Source: IFP

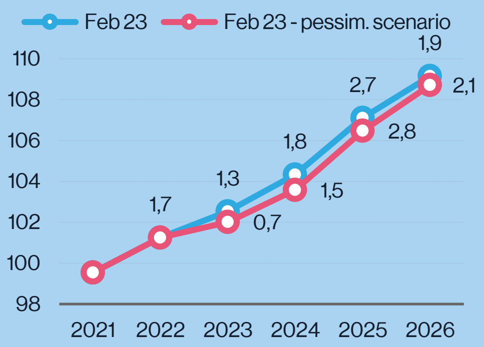
Figure B: Absorption of funds from EU – IFP forecast assumptions (cummul. EUR million)



Source: IFP

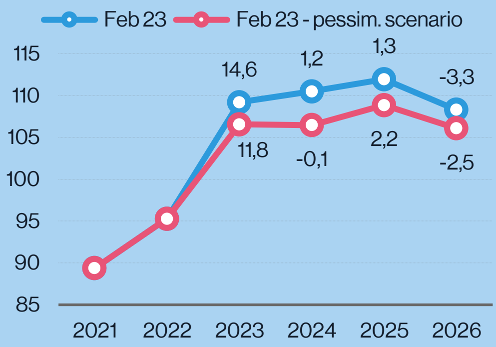
If the downside risks of the Recovery and Resilience Plan funds drawing materialize, GDP will grow by only 0.7 per cent in 2023. Adverse signals were indicated in 2022 in the form of slow absorption of funds after the end of the call, or delays in the opening of the calls themselves. Slovakia could thus lose EUR 2 billion dedicated for investment, which would slow down GDP growth in the first year by 0.6 p.p. to 0.7 per cent. The permanent loss of GDP is 0.5 per cent, a level of potential GDP in 2026 below the original trajectory with full absorption.

Figure C: Real GDP base vs. alternative scenario (index, 2019 = 100, per cent, YoY)



Source: IFP

Figure D: Impact of the pessimistic scenario on investment growth in the forecast (index, 2019 = 100, per cent, YoY)



Source: IFP

MF SR FORECAST - MAIN ECONOMIC INDICATORS (February 2023)

indicator (growth in per cent unless otherwise noted)	2021	forecast 2022	2023	2024	2025	2026	diff. from Sept. 2022 2022	2023	2024	2025
Gross Domestic Product										
GDP, real	3,0	1,7	1,3	1,8	2,7	1,9	-0,2	0,6	0,1	0,4
GDP, nominal (bn. €)	5,5	9,4	9,1	7,3	6,9	4,5	-0,8	-3,6	0,9	0,2
Private consumption, real	1,7	4,5	0,7	1,1	1,5	1,3	-0,1	4,3	-0,9	0,0
Private consumption, nominal	5,0	18,3	10,2	6,4	5,9	3,6	-0,7	0,7	0,7	0,1
Government spending	4,2	-2,5	2,3	1,4	0,5	1,0	-0,9	3,0	1,4	1,3
Fixed investment	0,2	6,6	14,6	1,2	1,3	-3,3	1,2	-1,7	7,6	-0,4
Export of goods and services	10,6	0,3	1,3	6,9	6,6	5,4	1,9	-0,3	-0,6	0,7
Import of goods and services	12,1	1,1	4,2	6,2	5,2	3,8	2,0	1,7	0,7	0,4
Labour market										
Registered employment	-0,7	1,7	0,4	0,5	0,6	0,3	-0,5	0,2	-0,2	-0,2
Wages, nominal	6,9	8,1	10,5	8,1	6,3	4,2	-0,2	0,0	0,6	0,2
Wages, real	3,6	-4,2	0,6	2,6	2,0	1,9	-0,5	3,3	-1,3	-0,1
Unemployment rate	6,9	6,2	5,8	5,4	5,2	5,2	0,1	-0,3	-0,2	0,4
Inflation										
CPI	3,2	12,8	9,8	5,3	4,2	2,2	0,3	-3,7	1,9	0,3

Source: SO SR, IFP

Preliminary plan of allocating RRP resources (mil. EUR, excl. VAT, ESA2010)

	2022	2023	2024	2025	2026
RRP total	**49**	**1 647**	**2 394**	**1 817**	**334**
Public investment	11	904	1 633	1 209	128
Compensations	16	122	106	97	31
Intermediate consumption	4	86	89	56	20
Soc. transfers in kind	2	7	7	3	0
Social transfers	0	24	24	24	0
GFCG firms	1	325	422	316	75
GFCG households	16	179	112	112	80

Source: IFP