June 21st, 2021

One wave after the other

Macroeconomic forecast for 2021 - 2024

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The economy has weathered the second wave of the pandemic with relatively minor losses. GDP will grow by 4.6 per cent in 2021 and the economy will recover to its pre-crisis levels over the course of this year. The pandemic has shifted consumers´ preferences from services to goods which benefits world trade, including Slovak exports. The second wave of the pandemic led to a fall in household consumption at the beginning of the year, but with a more favorable epidemic development, the recovery seems swift at the moment. As a result, Slovak GDP could reach its pre-crisis level sooner, before the end of this year. In 2022, output growth will reach 5 per cent, aided by the Recovery and Resilience Plan, as well as a post-crisis revival of private investment. At the same time, the uncertainty about the future remains high. A potential third wave poses a negative risk to the forecast, as it would slow down economic recovery. Thanks to progressing vaccination however, its impact on the economy could be somewhat milder compared to the second wave of the pandemic. On the plus side though, private consumption could increase faster than in our baseline projetions if households opt to spend more of their savings accummulated at the beginning of the year.

Consumers prefer goods over services which benefits world trade

The economic recovery from the second wave is now under way and GDP will increase by 4.6 per cent this year. The pandemic has shifted global consumer preferences from services to goods, which benefits world trade, industrial production and hence Slovak exports. Thanks to these changes, the second wave brought about smaller economic losses, allowing the economy to return to its pre-crisis level in the current year. A higher demand for goods has resulted in component shortages and factory shutdowns which, combined with more prevalent issues concerning logistics, cause inflationary pressures.

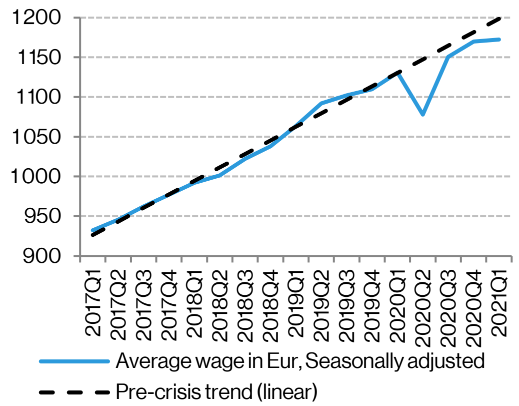
The second wave led to an increase in savings, the relaxation of restrictions will have the opposite effect

Renewed domestic demand will boost economic activity in the coming months. Following a fall in household consumption at the beginning of the year, domestic demand started to recover in the second quarter. Government measures have helped stabilise disposable income during the pandemic and wages remained more resilient than during the first wave (Figure 1). Savings and deposits hence increased (Figure 2). The relaxation of restrictions has motivated consumers to start spending again and turnover in retail stores and services is rising (Figure 3). After significant increases during the second wave, the savings activity of the population will start to decline over the course of this year before gradually returning to pre-crisis levels. At the same time, progressing vaccination could help dampen the impact of a potential third wave of the pandemic.

2022 will be the year of investment, partly thanks to the RRP

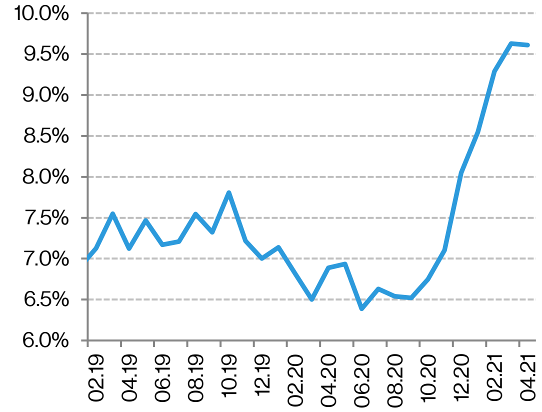
Investment will be the dominant contributor to growth in 2022, when output will increase by another 5 per cent. The uncertainty around the pandemic has decreased the motivation of firms to create new production capacities. Once the pandemic retreats in 2022, firms´ investment activity will fully renew. In addition, resources from the EU´s Recovery and Resilience Facility will also boost capital formation. In fact, investment will be the biggest contributor to economic growth, adding four percentage points. The stimulus from government spending and transfers will gradually fade away. Exports too will be less dominant in line with less dynamic foreign demand, given that foreign trade will have fully recovered by the end of the preceding year.

Figure 1: Relative to the first wave, average wage remained more stable



Source: ŠÚ SR, IFP. Note: The pre-crisis trend equals the linear trend observed between 2017Q1 and 2020Q1.

Figure 2: Household deposits are rising (year-on-ear growth rates in %)

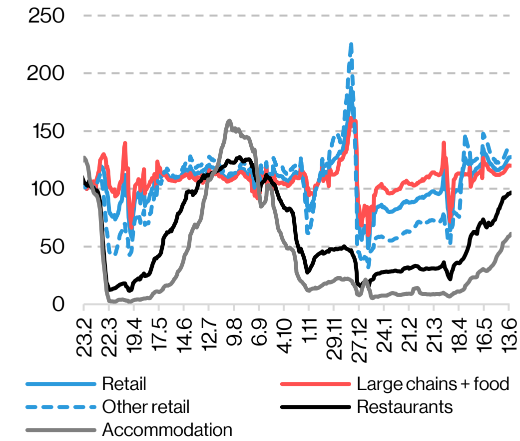


Source. NBS, IFP

In 2023, the last-minute drawing of EU funds will boost GDP growth

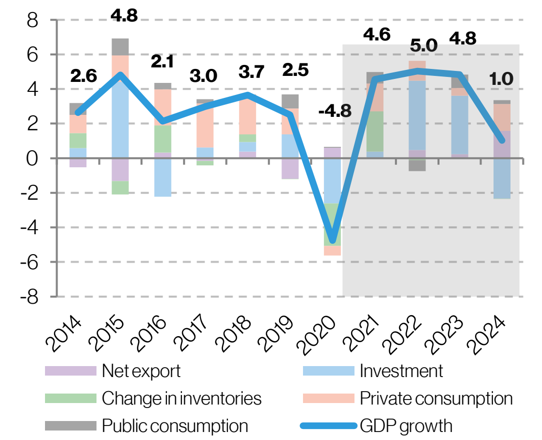
At the end of the forecasting horizon, the economy will be affected by the drawing dynamics of EU funds. Following the experience from 2015, we expect all allocated resources from the expiring programme period to be spent in 2023. This will increase output growth to 4.8 per cent in 2023. Since we expect the drawing of resources from the new programme period to be only gradual, output growth will slow down to 1 per cent in 2024. RRP investments together with regular EU funds will significantly increase the amount of capital in the economy, raising potential output as well. At the same time, potential output was severely affected by the pandemic, hence three years of solid growth will likely lead to some overheating in the economy.

Figure 3: eKasa turnover points to a recovery in household consumption (100 = 11.2.2020)



Note: 7DMA index relative to the beginning of Feb 20.
Source: eKasa, FSSR, IFP

Figure 4: Contributions to GDP growth (constant prices, p.p.)



Source: ŠÚSR, IFP

Risks of the forecast are both positive and negative

The risks of the forecast are both positive and negative. During the second wave of the pandemic, households accumulated substantial amounts of savings in the form of bank deposits. These are liquid, which, provided the epidemic situation remains favourable, can motivate consumers to increase their spending in the quarters ahead. That would translate into higher private consumption and GDP growth over 5 per cent in the current year. On the other hand, a rising number of new infections could lead to a third wave which would require the re-introduction of some restriction towards the end of the year.

Due to progressing vaccination, however, we expect the impact of a potential third wave of the pandemic to be roughly half of the impact of the second wave. As a result, output growth in would be slower by 0.5 percentage points in 2021.

Preliminary assumptions about the drawing of resources from the RRP (mil. EUR)

	2021	2022	2023	2024	2025	2026
RRP Total	177	1156	1374	1490	1186	765
Investment	114	978	1161	1280	1035	688
Compensations	34	112	125	125	95	58
Intermediate consumption	29	66	88	85	56	19

The fiscal impulse from the RRP will contribute to the recovery of the labour market

Due to the second wave, the recovery of the labour market will be postponed, employment however, should stabilise this year. Even though the second wave had a milder impact on the economy, the labour market was affected to a greater extent. Employment decreased mostly in services, but also in manufacturing. With a rapid recovery in household consumption though, we expect job creation in the private sector to increase in the second half of the year. Progressing vaccination will also help the labour market, allowing for a gradual relaxation of epidemic restrictions.

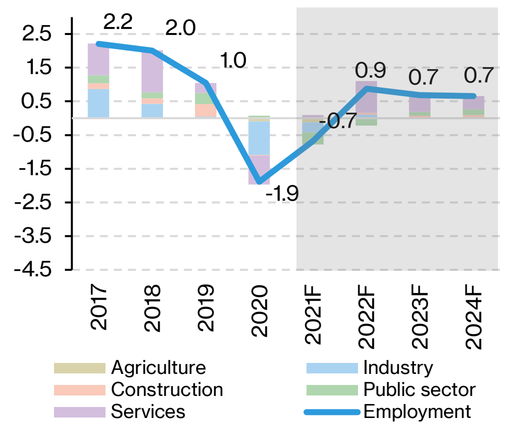
The unemployment rate will reach 7 per cent in 2021, but will gradually decrease in the following years. New job creation will continue, aided partly by RRP funds. The decrease in unemployment at the forecasting horizon will be somewhat dampened by public sector consolidation, where the number of jobs is expected to decline.

Average nominal wage will increase by 6.2 per cent. Wages this year will be affected by the base effect from 2020, but the economy´s resilience during the second wave will also add to wage growth. Wage dynamics will renew in the years ahead, with renewed output growth and job creation. On the other hand, public sector wages will lag behind compared to the rest of the economy, due to budget cuts in the public sector.

Inflationary pressures are becoming more significant, though they should only be temporary

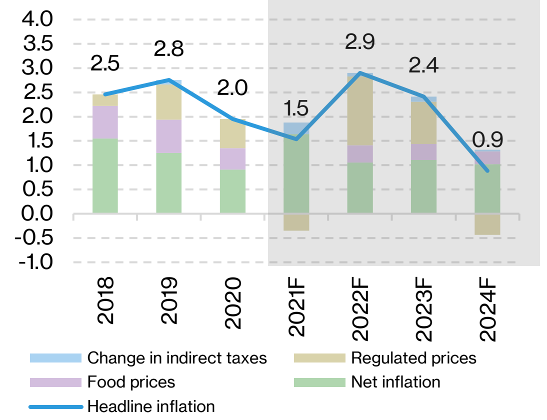
Inflationary pressures will strengthen in the second half of the year and prices will increase in 2021. According to the forecast, prices will grow by 1.5 per cent this year, but price developments in May, which were published after the forecast deadline, suggest that inflation could climb up to 2 per cent. With the economy recovering and restrictions being relaxed, the price growth of goods will increase relative to last year and the price of services will return to their pre-crisis dynamic. Rising oil prices push fuel prices upward and higher global demand for goods leads to higher prices of other materials too. This trend should only be temporary, however. The decrease in regulated energy prices in effect from this January has dampened inflation.

Figure 5: Contributions of various sectors to the increase in ESA employment (in p.p.)



Source: ŠÚ SR, IFP

Figure6: Actual and forecasted inflation, with contributions to price growth (in p.p.)



Source: ŠÚ SR, IFP

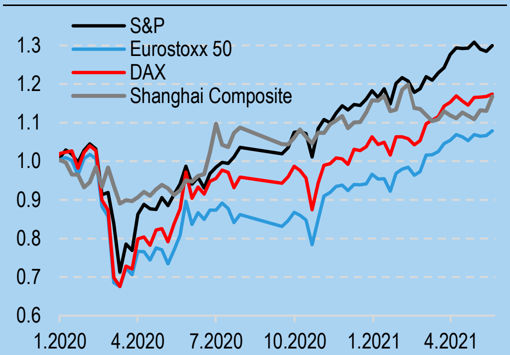
With economic recovery comes renewed price growth

Inflation will end up just under 3 percent next year. With global demand recovering and emission allowances becoming more expensive, energy futures contract prices have gone up, which will lead to an increase in regulated prices between 2022 and 2023. We expect the price growth of materials to slow down in 2023 and input prices to stabilise. Demand inflation too will be stable, limited by lower employment and wage growth in the public sector. In 2023, prices will rise further following another round of consumption tax increases concerning tobacco products.

BOX 1: External environment assumptions

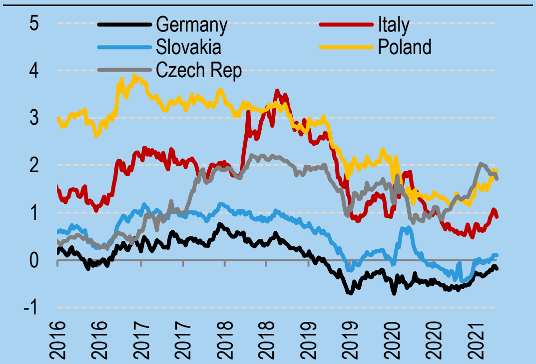
Stock markets continued to grow at a solid pace and reached new historic highs (*Figure A*). The reasons behind the increased interest of investors include vaccination related optimism around the world, as well as generous monetary and fiscal stimuli. High global demand combined with rising energy prices and long delivery times of certain components, increases inflation expectations and creates concerns about sudden prices hikes. Inflationary pressures have translated into rising government bond yields (*Figure B*), which could potentially increase the costs of servicing government debt. The improving epidemic situation in Europe and renewed confidence have manifested themselves in the the value of the euro, which appreciated against the dollar last month. **The price of Brent oil went up hand in hand with rising energy prices and reached 70 USD/bl.** At the forecasting horizon, we expect oil prices to stabilise around 60 USD/bl.

Figure A: Stock indices have flourished in the past six months(10 Jan = 100)



Source: Bloomberg, IFP

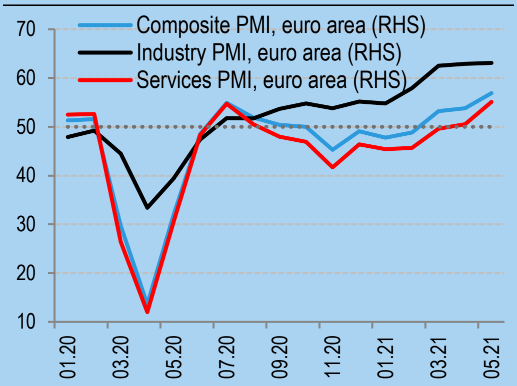
Figure B: 10-year government bond yields increased in March



Source Bloomberg, IFP

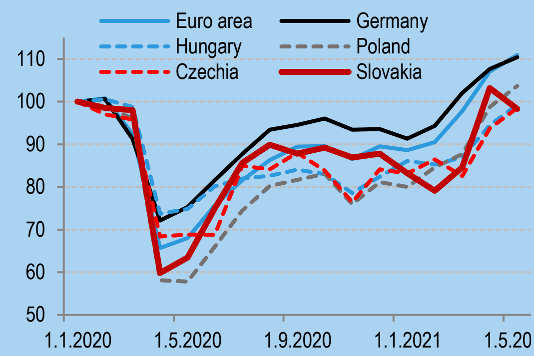
The improving epidemic situation in Europe over the spring months led to a revival in service activity which rose after several months of decline (*Figure C*). Delivery delays and temporary shortages of certain components in the automobile industry will likely slow down manufacturing in the months ahead. The gap between industry and services is narrowing and we expect services to be the main pulling force behind economic growth. We expect a swifter recovery not only in Euro area countries, but also in our closest partners within the V4 (*Figure D*).

Figure C: Services are rising again in the Eurozone (PMI index)



Source: IHS Markit, IFP

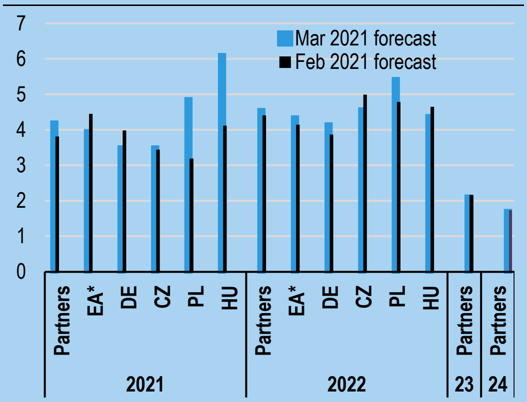
Graf D: Recovery is under way in all of our partner countries (ESI, 100 = Jan 2020)



Source: Eurostat,, IFP

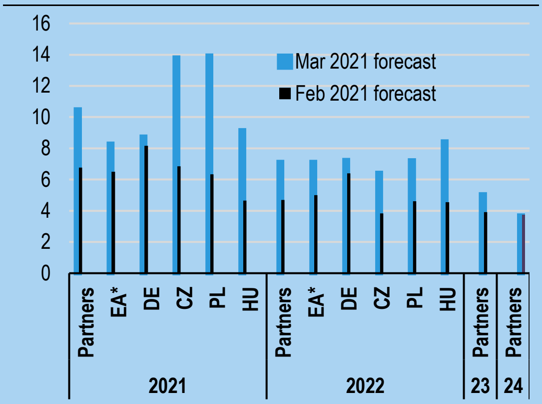
Retail sales and industrial production point to a brisk economic recovery. The upcoming holiday season will be crucial from the short-term perspective, and is expected to bring about a strong increase in activity similar to last year. Trading partnes from V4 performed significantly better than expected in the first quarter of the year and economic sentiment remains strong. Output growth will also benefit from extra resources from the RRP which could start flowing into the economy in the second half of the year. We therefore revise our GDP and import projections in 2021 for our main trading partners upward, which will also increase growth in the following year (*Figures E and F*). The cut-off date for the assumptions about the external environment, including interest rates, commodity prices, and exchange rates, was June 2nd, 2021.

Figure E: GDP growth forecast of external environment



**weighted Eurozone based on exports* *Source: IFP*

Figure F: Import growth forecast of the external environment

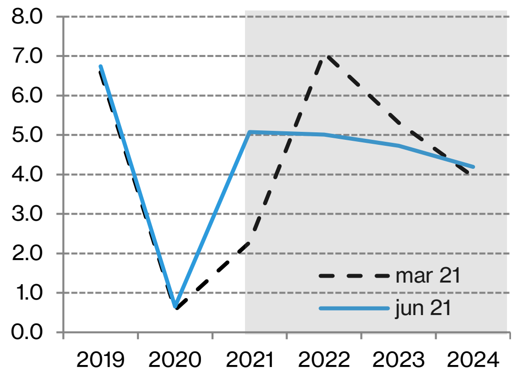


Source: IFP

The overall impact of the updated macroeconomic forecast on tax bases is positive. Higher GDP growth, as well as its structure will positively affect revenue from all major taxes. The overall impact of the macroeconomic forecast on tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee´s (TFC) meeting held on June 24th, 2021.

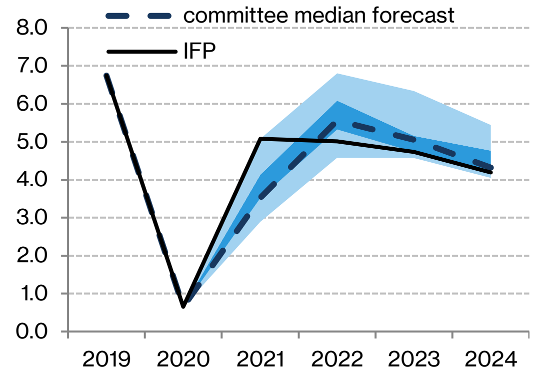
The medium-term forecast prepared by the Ministry of Finance was discussed at the Macroeconomic Forecast Committee´s (MFC) meeting held on June 16th, 2021. **The forecast was evaluated as realistic by all members of the Committee** (NBS, RRZ, SLSP, Tatrabanka, Infostat, SAV, Unicredit, and ČSOB). The detailed macroeconomic forecast as well as the minutes from the meeting and all supporting documents are available at the IFP´s website.

Figure 7: Growth of macroeconomic bases compared to the previous forecast



Source: IFP

Figure 8: Comparison of tax base forecasts[1] by members of the MFC



Source: IFP

BOX 2: The risk of a third wave

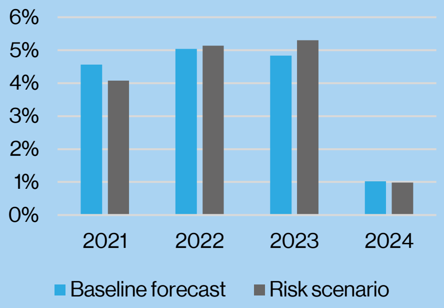
In this risk scenario, we assume that the number of new infections will start rising again in Autumn 2021, leading to the re-introduction of restrictions in the fourth quarter, as well as the first quarter of the next year. The intensity of the outbreak will be half of what was observed during the second wave, allowing for milder government measures to curb the spread of the virus. **For the most part, Slovakia will be in the second to third degree of emergency**, meaning that shopping malls will be able to operate on a limited basis. The fall in consumption will therefore be milder than in the winter of 2020/21. While restaurants will be able to operate outside, turnover in the sector will be low given the cold winter weather. Restrictions will negatively affect tourism as well. Primary schools will remain open during the third wave, meaning that the need for nursing benefits will be lower than during the second wave. Average wages will hence remain stable. This scenario is calibrated based on the projections of a potential third wave in England by Imperial College London. We adjust the model to account for lower vaccination rates in Slovakia.

Under these circumstances, GDP would grow by 3.9 per cent in 2021, which is 0.7 percentage points lower than in the baseline forecast. Slower growth in the first quarter of

[1] 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) – 51.1 %; Nominal private consumption – 25.7 %; Real private consumption – 6.6 %; Nominal GDP growth – 9.9 %; Real GDP growth – 6.7 %.

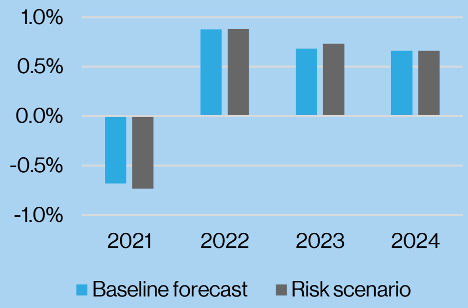
2022 would be followed by economic recovery in the second quarter and the economy would return to its trend from before the third wave. Given the less stringent measures implemented, the third wave would not lead to a permanent decrease in GDP. Hence, output growth would reach 5.1 per cent in 2022. Overall costs associated with the third wave would equal 820 mil. EUR. Employment would decrease by five thousand workers, mostly from the services sector.

Figure G: GDP growth in the baseline forecast and risk scenarios



Source: IFP

Figure H: Employment growth in the baseline forecast and risk scenarios



Source: IFP

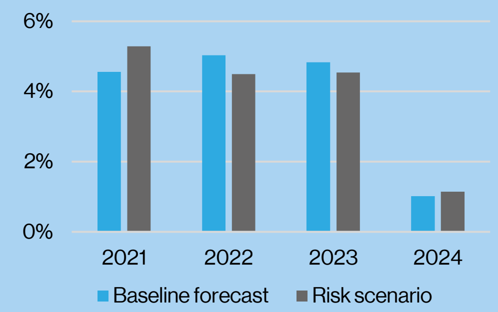
BOX 3: Scenario with a faster dispersion of savings

The positive scenario of the forecast considers higher spending and a reduction in the saving rate which would lead to an increase in private consumption over the course of this year. As a result, the Slovak economy would grow by 5.3 per cent in 2021 which is 0.7 percentage points more than in our baseline forecast.

The restrictions which were introduced during the second wave of the pandemic had narrowed down the consumption possibilities of households. This led to a fall in private consumption and the increase of savings in the first quarter. Consumers hold a significant share of their income in the form of bank deposits which rose dramatically in recent months, at rates close to 10 per cent. These resources are liquid and can quickly translate into consumption. **In this scenario, we assume that due to the relaxation of restrictions and the positive outlook for the future, households will spend 1 bn. EUR of their accumulated savings during the second half of the year.** The saving rate would hence decrease to 10.7 per cent (from 11.9 per cent in the baseline scenario).

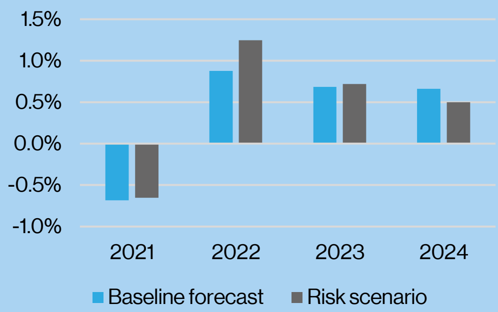
Real GDP would increase by 5.3 per cent this year, which is 0.7 percentage points more than in our baseline projection. Faster growth is caused mainly by higher household consumption, which would increase by 4.5 per cent year-on-year. This scenario has no long-term impact on real GDP. The labour market will react to higher consumption with a delay and the effect of the scenario would only manifest itself in 2022 when employment would be higher by 10 thousand jobs relative to the baseline projections.

Figure G: GDP growth according to the baseline forecast and the positive risk scenario (in %)



Source: IFP

Figure H: Employment in the baseline forecast and the positive risk scenario (in %)



Source: IFP

MF SR FORECAST – MACROECONOMIC INDICATORS (June 2021)

indicator (growth in %, unless otherwise noted)		forecast				difference from Mar 2021			
	2020	2021	2022	2023	2024	2021	2022	2023	2024
Gross domestic product									
GDP, real	-4.8	4.6	5.0	4.8	1.0	1.3	-1.3	2.0	0.7
GDP, nominal (bn. €)	91.6	97.0	103.8	111.0	113.7	1.6	0.3	1.7	1.3
Private consumption, real	-1.0	2.8	2.0	0.8	2.9	6.1	-4.8	-1.9	0.5
Private consumption, nom.	1.1	4.1	5.1	3.2	3.8	6.1	-4.0	-2.1	-1.0
Public consumption	0.3	3.5	-3.4	4.5	1.3	-0.1	-4.3	0.8	2.0
Fixed investment	-12.0	1.9	20.5	15.1	-9.5	1.1	8.6	6.7	1.4
Export, goods and services	-7.5	14.9	6.5	5.9	3.6	4.3	1.7	1.7	0.0
Import, goods and services	-8.3	15.4	6.2	5.9	2.2	6.6	0.9	1.8	0.2
Labour market									
Registered employment	-1.8	-0.4	0.9	0.7	0.7	-0.1	0.0	-0.5	0.4
Wages, nominal	3.8	6.2	4.1	4.9	4.6	1.3	-0.9	0.2	0.5
Wages, real	1.8	4.6	1.2	2.4	3.7	0.9	-1.5	0.2	1.9
Unemployment rate	6.7	7.0	6.3	5.7	5.1	-0.1	-0.2	0.3	0.4
Inflation									
CPI	1.9	1.5	2.9	2.4	0.9	0.4	0.7	-0.1	-1.4

Source: ŠÚ SR, IFP