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Headwinds continue

Macroeconomic Forecast 2019 – 2023

Branislav Žúdel

On the back of foreign factors, the Slovak economy continues to grow at a slower pace. The growth is set to reach 2.2 per cent this year, compared to 2.3 per cent in 2019. The cool off is limited to the export-oriented industry, while the labour market continues to resist. Unemployment rate will land close to its historical lows; wages will follow the productivity growth. The recovery in the coming years will gain momentum with the completion of the third EU fund programming period in 2023. Trade disputes, the longer-lasting weak performance of the euro area, hard Brexit and spillovers from manufacturing to labour market pose a risk to the economic development.

Domestic demand will be negatively affected by foreign demand

After reaching its peak in 2018, the Slovak economy slowed down to an estimated 2.3 per cent last year. The slack in foreign demand affected mainly the Slovak export-oriented industry. Nevertheless, the labour market has resisted as the unemployment rate hits the record low and wage-growth was fastest since 2008. Households, however, remained cautious in spending, and the saving rate sky rocketed. The fast growth in government consumption was driven by public sector salary increases.

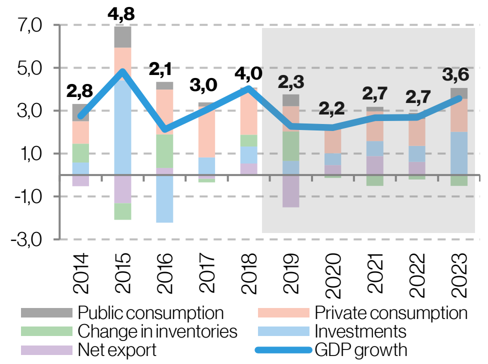
Export and investment will pull the economy down

We expect the moderate performance to persist in 2020, when GDP is projected to grow by 2.2 per cent. Although Jaguar Land Rover will support the economy with its new production, the export dynamics will be dampened by weaker foreign demand. After an overheating in 2018, the economy will cool down. The growth in the employment will be modest and the increase in wages will be slower, corresponding to labour productivity growth. Household consumption will be in line with earnings dynamics. Government consumption will be lower and there will be a shortage in public investment.

Completion of EU fund programming period will jog investments in 2023

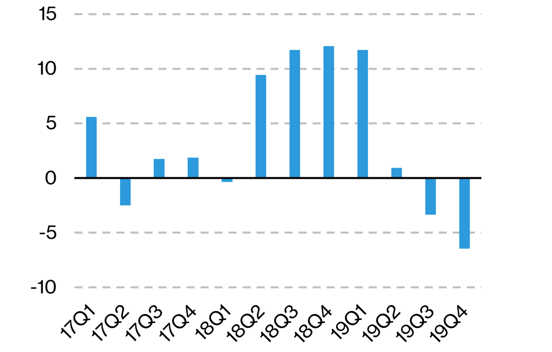
The economy will recover in the coming years. Higher foreign demand and the car production will boost the export. The economic recovery is expected to reduce the elevated savings rate, thus increasing the private consumption. **Completion of EU fund programming period will jog investments in 2023.** Owing to EU funds effect, government investments and consumption are set to increase. However, the drawing of EU funds will also have a positive impact on the private construction, private investment and the labour market. Higher wages will fuel household consumption and the economy is expected to start to overheat slightly.

Figure 1: Contributions to GDP growth (constant prices, in p.p.)



Source: IFP

Figure 2: A marked slowdown in the Slovak manufacturing (constant prices, yoy per cent)



Source: ŠÚ SR

MF SR FORECAST - MAIN ECONOMIC INDICATORS (February 2019)

Indicator (growth in % unless otherwise noted)	Actual 2018	Forecast 2019	2020	2021	2022	2023	Diff. from Sept 2019: 2019	2020	2021	2022
Gross domestic product										
GDP. real	4,0	2,3	2,2	2,7	2,7	3,6	-0,1	-0,1	-0,1	0,0
GDP. nominal (bn €)	89,7	93,9	97,9	102,7	107,9	114,6	-0,7	-0,7	-0,8	-0,9
Private consumption. real	3,9	2,1	2,1	2,5	2,3	2,8	0,4	0,0	0,0	0,2
Private consumption. nominal	6,3	4,7	4,3	4,6	4,5	5,0	0,7	0,1	-0,1	0,0
Public consumption	0,2	3,2	0,8	1,2	1,6	3,0	0,1	-0,3	-0,1	-0,1
Fixed investments	3,7	3,1	2,6	3,3	3,4	9,3	1,2	-1,0	0,0	-0,4
Export of goods and services	5,4	1,5	3,4	4,5	4,0	3,8	-1,3	-1,9	-0,1	-0,2
Import of goods and services	5,0	3,1	3,0	3,6	3,5	4,0	-0,1	-1,1	-0,2	-0,3
Labour market										
Employment (registered)	1,9	1,1	0,2	0,3	0,2	0,4	0,0	0,0	0,0	0,0
Wages. nominal	6,2	7,4	4,5	5,2	5,0	5,2	0,0	-0,2	0,1	0,2
Wages. real	3,6	4,6	2,2	3,1	2,8	2,9	-0,2	-0,3	0,2	0,4
Unemployment rate	6,5	5,8	5,8	5,8	5,7	5,5	0,0	0,0	0,0	0,0
Inflation										
CPI	2,5	2,7	2,3	2,1	2,2	2,2	0,2	0,2	-0,1	-0,1

Source: ŠÚ SR, IFP

Employment will stall, service sector likely to offset the decline in manufacturing

Employment in 2020 will stall and about 5 thousand new jobs will be created. The decline in manufacturing is expected to be compensated in the service sector. In 2021 the moderate economic recovery will increase the job creation. Yet, the labour shortages will limit the employment growth. At the end of the forecast horizon, job creation in the construction sector is expected to increase owing to the EU funds drawings. **The unemployment rate will remain flat in 2020 and close to its historical low of 5.8 per cent.** In the upcoming years, we expect the space for the unemployment rate for further decline to be very limited.

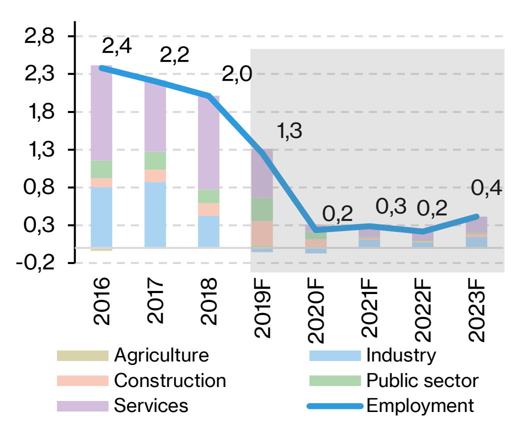
Wages will grow at a slower pace in 2020

The average nominal wage is set to rise by 4.5 per cent in 2020, which is a marked slowdown compared to 7.4 per cent in 2019. Employees in the public sector, in particular, will benefit from substantial valorisation. On the other hand, wage dynamics will slow down in the manufacturing and construction. In 2021, another minimum wage hike will boost the earning for the low income decile. The real wage will thus rise on average by 3 per cent over the forecast horizon, which corresponds to labour productivity growth.

A lower VAT rate is to push food prices down

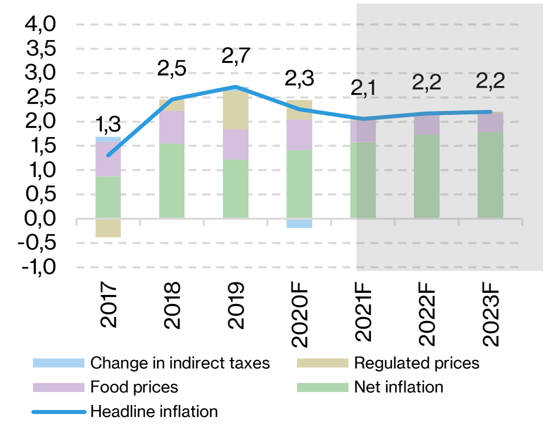
The inflation rate **will decrease to 2.3 per cent in 2020**. In particular, the rise in food prices will significantly decrease, which will also be supported by a reduction in VAT on selected foods from the beginning of the year. Regulated prices will be driven by the increase in energy prices, especially electricity, from January. In response to a stable labour market, service prices will maintain higher growth. The prices of tradable goods will reflect subdued price developments abroad.

Figure 3: Contribution to the employment growth (p. p.)



Source: ŠÚ SR, IFP

Figure 4: Headline inflation and contributions of individual components (p. p.)



Source: ŠÚ SR, IFP

Stable inflation over the medium term

Headline inflation will not change significantly in the coming years. Goods prices will stabilize based on inflation expectations abroad, while services prices will accelerate in line with the assumptions of economic convergence and a still robust labour market. The fall in fuel prices in response to the expected oil price developments and a slowdown in food price inflation will act in the opposite direction. The development of future energy commodity contracts has not yet indicated any significant shift in regulated energy prices in any direction. In the medium term, inflation is expected at 2.2 per cent.

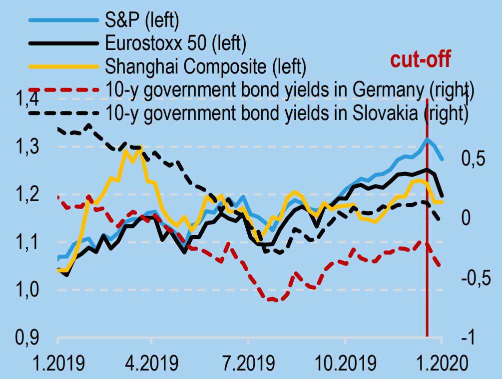
BOX 1: External Environment Assumptions

Global financial markets appreciated the more positive outlook in world trade and the avoidance of „hard" Brexit. The Phase 1 of the China-US Trade Agreement stimulated investor expectations. The decline in risk aversion was also reflected in bond markets and yields have bottomed out of historical lows (see Figure 5). However, at the end of January (after the cut-off date), the Chinese economy suffered a negative shock caused by the spread of coronavirus. Preventive measures and adverse expectations are thus likely to worsen the performance of Asian economies in particular in the first quarter of 2020.

The loose monetary policy supported the markets in order to achieve the inflation target. In 2019, the US Fed lowered its key interest rate three times in total to 1.5 - 1.75 per cent . The markets expect a further 2 to 3 rate cuts during 2020. At the same time, the US central bank provided a significant amount of liquidity into the system through daily repo transactions. The ECB's interest rate on the main refinancing operations remains at 0 per cent , with the first expected increase again postponed until 2021. At its September meeting, the ECB announced a reduction in deposit rates from -0.4 to -0.5 per cent , while launching a quantitative easing in amount of EUR 20 billion per month to provide an additional stimulus to the economy and inflation.

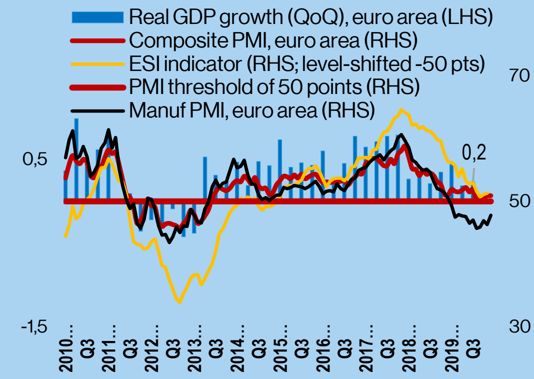
At the turn of 2019 and 2020, calming the world trade situation was also a positive impulse for oil, whose price climbed back to USD 65 per barrel. Oil price growth was due to expectations of higher demand for commodity, which was created as a result of more optimistic sentiment at the global level. At the end of January 2020, however, prices started to fall sharply again due to concerns about coronavirus. The exchange rate of the euro against the US dollar remained unchanged at 1.1 EUR/USD.

Figure 5: Coronavirus interrupted growth in bond yields and stock indices



Source: Bloomberg

Figure 6: Leading indicators in the euro area

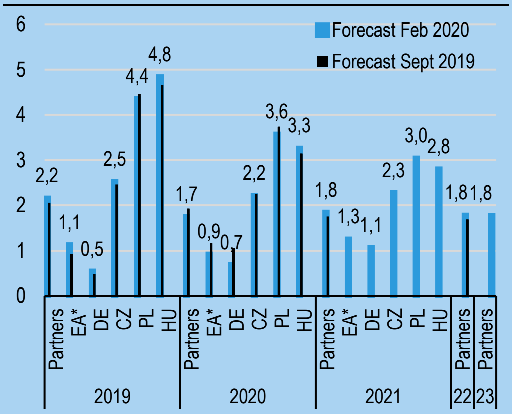


Source: IFP, Markit, EK, Eurostat

Global trade and the world economy were also flat at the end of 2019. The euro area economy grew modestly but steadily in the second half of the year. Performance was dampened mainly by Germany, which in the third quarter just avoided the technical recession. The longer-lasting blackout of the automotive industry in the euro area's largest economy continues to create concerns for the whole region. **So far, domestic demand in V3 region resists the pressure from Germany, but industrial production is slowing down.** Only Poland benefited from a positive contribution from abroad. Any decline in domestic demand in V3 countries could also pose a risk for Slovak exporters.

Conjunctural survey readings for the euro area industry indicate achieving a bottom line (Figure 6). The euro area economy continues to operate in a two-speed regime, with services resisting the slowdown in industrial production. The recovery is expected in the second half of 2020. In 2020, we revise GDP and imports down for most major trade partners of Slovakia, with the exception of Hungary (Figures 7 and 8). The cut-off date for external environment assumptions, including interest rates, commodity prices, and exchange rates was January 20, 2020.

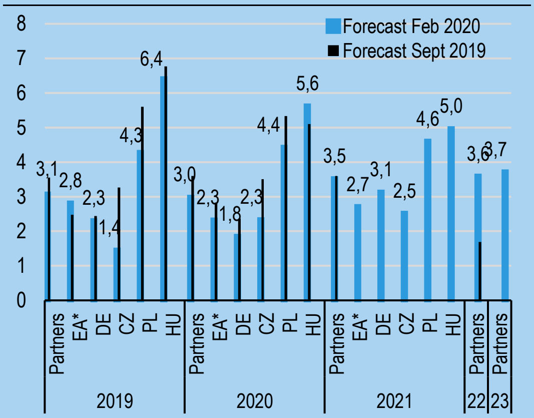
Figure 7: External environment GDP growth forecast



Source: IFP, EK

* *exports-weighted euro area*

Figure 8: External environment imports growth forecast



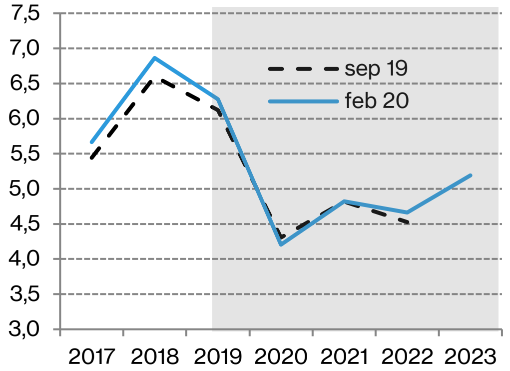
Source: IFP, EK

The balance of risks is tilted downward

The balance of risks to the forecast is tilted downwards. In the external environment, the risk is mainly the continuing anemic performance of the euro area economy, closing the output gap in the V3 countries, the persistence of trade disputes and, since 2021, the hard Brexit again. In the first quarter of 2020, global developments will also be exacerbated by the impact of preventive measures against the spread of coronavirus. In the domestic environment, the stronger response of the labour market to the economic slowdown is a negative risk, which may affect private consumption in particular.

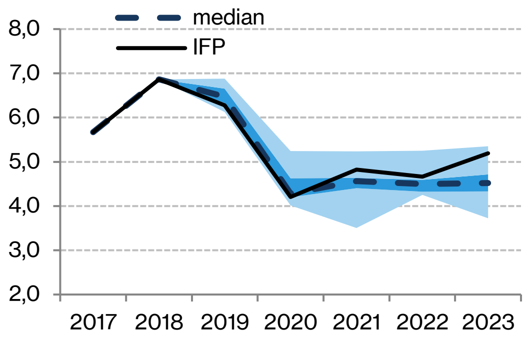
The overall impact of the macroeconomic forecast update on tax bases is slightly negative. The development will be influenced mainly by lower wage growth and the wage base respectively. The exact impact of the present macroeconomic forecast on tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee meeting held on February 12, 2020.

Figure 9: Macroeconomic tax bases growth compared to previous forecast



Source: IFP

Figure 10: Comparison of forecasts of macroeconomic bases[1] with the members of the Macroeconomic Forecasts Committee



Source: IFP

The medium-term forecast prepared by the Institute for Financial Policy (IFP) of the MF SR has been discussed at the Macroeconomic Forecast Committee on February 5, 2020. The medium-term forecast was evaluated as realistic by all members of the Committee (ČSOB, Infostat, NBS, SLSP, VÚB, Tatrabanka, Unicredit, SAV). The detailed macroeconomic forecast, as well as the minutes from the meeting and all supporting documentation are available at the IFP website.

[1] Macroeconomic base for the budget revenues (weight of indicators depends on the proportional share of the particular tax on the total tax revenues); Wage base (employment x nominal wage) – 51.1 per cent; Nominal private consumption – 25,7 per cent; Real private consumption – 6.6 per cent; Nominal GDP growth – 9.9 per cent; Real GDP growth – 6.7 per cent.