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Euro area slow-down hits Slovakia

Macroeconomic Forecast 2019 – 2022

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The growth of the Slovak economy in 2019 will soften to 3.5 per cent as a result of theslow-down in the euro area. The pressure from weak external environment will also translate into lower household consumption. Such a negative trend will be offset by the export of Slovak carmakers. In 2020, the economy will further ease and the depleted labour market will reduce job creation. The downside risks to the development emanate from the Brexit without agreement, hard landing in the euro area and protectionism in world trade.

Slowing dynamics during uncertain times

The growth of the Slovak economy is expected to slow to 3.5 per cent in 2019 on the back of weaker economic performance in the euro area. The unfavorable development of foreign demand will affect Slovakia's key partner. Economic performance is dampening especially in Germany, where local carmakers are particularly affected. Car production in Slovakia, however, accelerates and negative effects are offset by the ongoing onset of new JLR and VW production capacities. The actual development thus recalls the period of 2012 and 2013, when the new production in VW backed exports despite the deceleration in the EU. This year's growth will also be lower due to the stumbling of household consumption in the first quarter, which is likely associated with the worsening economic sentiment. Capital formation will be lower than last year, which was affected by JLR's one-off investment.

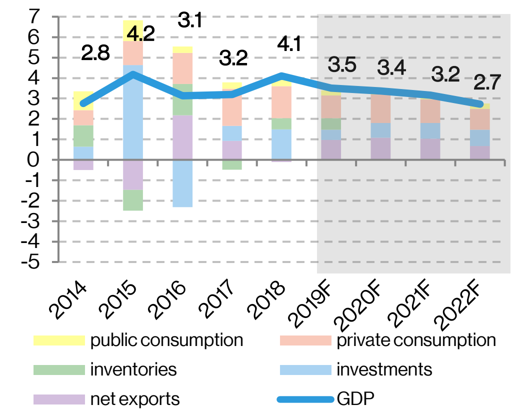
After stumbling, the household consumption recovers

In 2020, economic growth will slow slightly to 3.4 per cent. From a structural perspective, performance will mainly be driven by private consumption and export. Household consumption is set to accelerate due to fast-growing wages accompanied by a slight decline in high savings ratio. Export will still benefit from new production in JLR, where production of the second model is about to start at the end of the year. The investments are expected to recover partially after a previous slump. Government consumption will add to GDP only slightly, as valorization of the public sector salaries will only push upwards prices within the government sector.

The upcoming EU fund fever

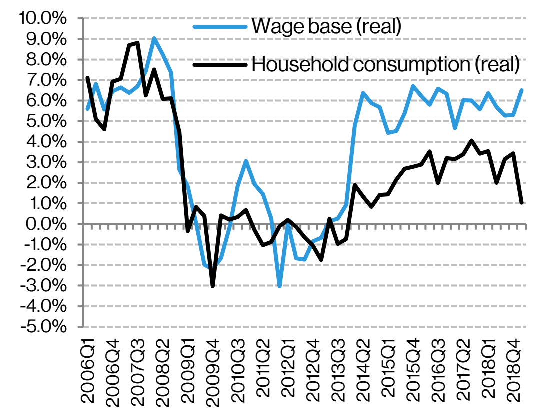
In the following years, economic performance will converge to its potential. Weaker wage dynamics will translate into a moderate slowdown in household consumption, but will remain the main driver of growth. Export will soften, but in 2021 will still be influenced by the positive contribution of JLR since the production of both models will be already well underway. However, with the approaching end of the third programming period, investments will accelerate.

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



Source: IFP

Figure 2: The spread between the real wage base and the final household consumption



Source: IFP

MF SR FORECAST - MAIN ECONOMIC INDICATORS (June 2019)

indicator	actual	forecast				diff. from Jan 2019			
(growth in % unless otherwise noted)	2018	2019	2020	2021	2022	2018	2019	2020	2021
Gross domestic product									
GDP, real	4.1	3.5	3.4	3.2	2.7	-0.5	-0.3	0.0	0.2
GDP, nominal (bn €)	90.2	95.8	101.5	107.2	112.8	-0.9	-1.2	-1.3	-1.0
Private consumption, real	3.0	2.2	2.7	2.3	2.0	-1.1	-0.2	0.1	0.3
Private consumption, nominal	5.4	4.8	5.3	4.7	4.5	-1.2	0.0	0.0	0.4
Public consumption	1.9	1.4	1.3	1.5	1.6	-0.4	-0.4	0.5	0.4
Fixed investments	6.8	2.2	3.3	3.4	3.6	0.3	0.4	0.3	0.0
Export of goods and services	4.8	6.1	5.9	5.2	4.1	-0.8	-0.2	0.0	0.0
Import of goods and services	5.3	5.5	5.3	4.6	3.8	-0.4	0.0	0.1	0.0
Labour market									
Employment (registered)	1.9	1.2	0.7	0.6	0.5	0.1	-0.1	0.0	0.0
Wages, nominal	6.2	6.7	6.2	5.3	4.8	0.0	-0.1	0.0	0.3
Wages, real	3.6	4.1	3.6	2.8	2.4	0.1	-0.2	-0.1	0.4
Unemployment rate	6.6	5.7	5.6	5.5	5.3	-0.3	0.0	0.0	0.0
Inflation									
CPI	2.5	2.5	2.5	2.4	2.4	-0.1	0.1	0.0	0.0

Source: ŠÚ SR, IFP

Another good year in the labour market

Slovak economy will add more than 30 thousand jobs, increasing employment in 2019 by 1.2 per cent. Half of the jobs will be generated in the market services sector. The recovery in construction will continue, which should lead to the fastest growth in this sector in terms of structure. On the contrary, the new jobs creation in industry will significantly slow down partly in response to the cooling of the foreign demand. Easing of the economic activity together with the economically active population stagnation in the coming years eases the employment dynamics towards 0.5 per cent at the end of the forecasting horizon. Negative trend of the active population will be partially mitigated by the continued increasing participation of foreign labour force along with the returning Slovaks from abroad.

Unemployment rate below 6 per cent already this year

Unemployment rate should decline to 5.7 per cent. The rate of decline in the number of jobless persons at the beginning of the year slowed to roughly half, compared to the average over the past two years. A similar trend is also seen in the unemployment rate according to the Central Office of Labour. The labour market is thus likely to hit its limits. The number of unemployed is expected to fall just modestly in the rest of the year. Overall unemployment rate should decline to 5.3 per cent at the end of the forecasting period.

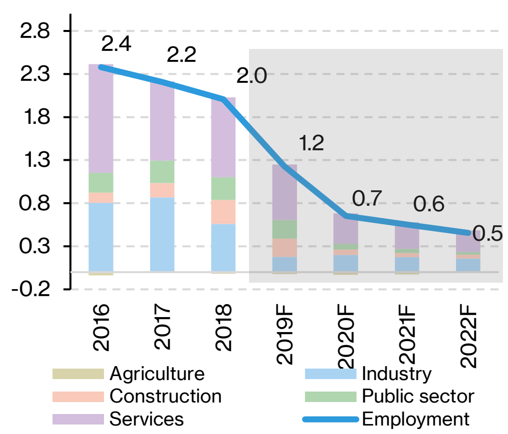
Wage growth will rise up to 7 per cent

The average nominal wage is projected to accelerate to 6.7 per cent. Wages will prop up mostly in the public sector, where the growth is expected to rise over 9 per cent due to the valorization of the public sector salaries. Private sector wage should keep up its dynamic at 6 per cent. The gap between the productivity and wage growths should gradually close in the upcoming years. **Real wage will increase by 4.1 per cent in 2019.** The dynamics should decelerate in the following years towards 2.4 per cent at the end of the forecasting horizon.

Stable inflation

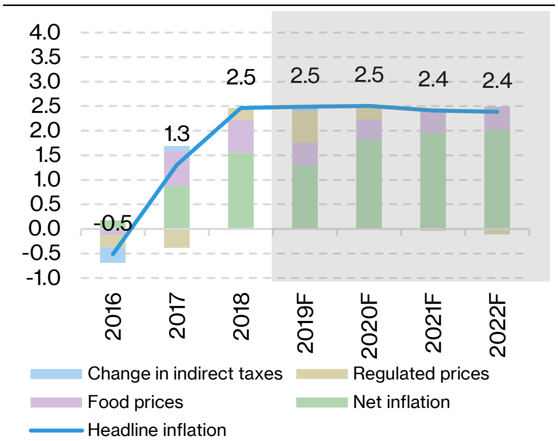
Prices will grow by 2.5 per cent this year, similarly to the previous one. Prices of services, which remain a main driver of the inflationary development in 2019, are pushed upwards by an overheating labour market. Food prices will accelerate in the second half of the year due to the fade-out of the base effect from strong growth in the beginning of 2018. Regulated prices increase mainly due to raised energy prices from the beginning of the year, but this is counteracted by the introduction of free lunches in pre-schools, joined also by primary schools from September. Fuel prices will fall in the second half of the year following the oil price. Rise of prices of tradable goods will mirror the inflation development 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

Inflation will ease off slightly in the following years. In 2020 regulated prices will increase mainly due to the expected sharp raise of electricity prices. On the other hand free lunches in primary schools will lower regulated prices even in 2020. Prices of services will continue to reflect the overheating labour market and high wage growth related to it. In fact, dynamics of the prices of services will keep the overall inflation at 2.4 per cent in the medium term.

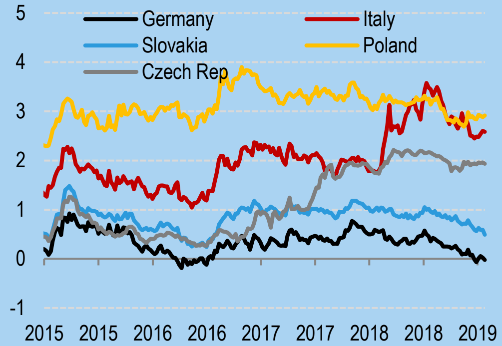
BOX 1: External Environment Assumptions

In the first quarter, global equity markets were partially revitalized after the market break seen at the end of last year. After exchanging negative signals between Washington and Beijing, however, the equity markets were hit by another wave of market sell offs. Investors reassessed their risk preferences and transferred capital to safer government bonds, which resulted in a higher price of debt instruments and a decline in yields. **The German 10-year government bond yield thus reached negative values** (Figure 5), approaching the historical lows of 2016.

Central banks have intensified dovish signals in response to the weaker outlook for the global economy. US Fed suspended its program of monetary tightening. The key interest rate is therefore very likely to decrease from the current level of 2.5 per cent by the end of 2019. The ECB announced shortly after the end of its quantitative easing program that it is considering another TLTRO asset purchase program and once again postponed the first hike of its key interest rate. **Economic slowdown is also indicated by the yield curves in both America and the euro area**. While the US yield curve has inverted even more on its short maturities, the yield curve of the euro area has become flatter. Empirical experience suggests that the negative slope of the yield curve is a relatively reliable indicator of the forthcoming economic slowdown.

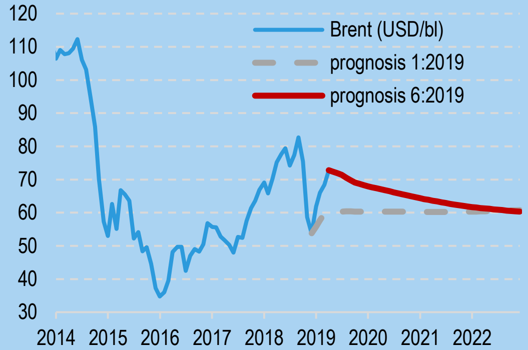
The deterioration in euro area economic performance has led to a weakening of the euro to EUR 1.11 / USD. The threat of sanctions against Iran, coupled with OPEC's production limitation, contributed to the rise in oil prices above USD 70 per barrel (Figure 6). The increase in commodity inventories, together with weakening demand, creates the conditions for a drop in the oil price in the short-term.

Figure 5: Decline in bond yields



Source: Bloomberg

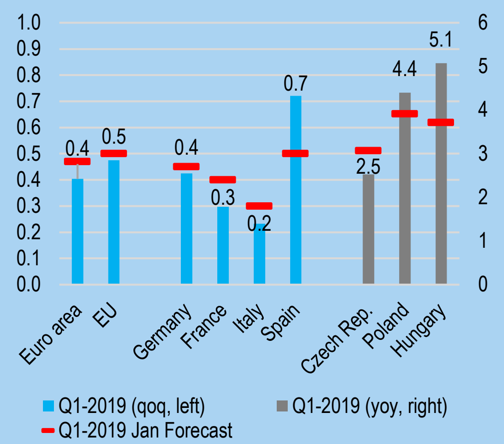
Figure 6: Brent crude oil prices (USD per barrel)



Source: Bloomberg

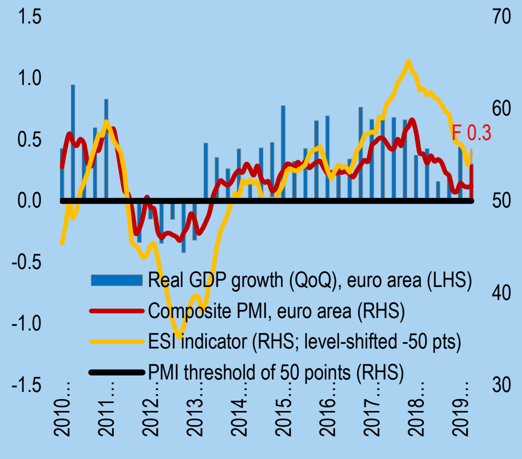
The performance of the global economy slowed in the first half of the year. The primary factor of deceleration is the trade tensions between the US and China. As a result, the degree uncertainty raises and investment activity remains subdued at a global level. The negative impact has been reflected in both the the US and Chinese economies. **However, among the large economies, the euro area dynamics slowed most significantly,** growing at 0.4 per cent qoq in the first quarter. In addition to foreign demand, the blackout in the automotive industry in Germany, which also spread to other sectors and neighboring countries, has contributed to the overall economic downturn. Italy grew at a slow pace and it, unlike most countries, faces even a decline in domestic consumption and reduced investment activity. Strong labour markets, wage growth and the new jobs creation are the main upbeat factors. **The shaky performance in the euro area has been offset by the vigorous growth in the V3 region**, where Hungary and Poland achieve outstanding results (Figure 7). Economic growth in the UK reached 0.5 per cent in the first quarter despite uncertainty surrounding Brexit.

Figure 7: The V3 countries achieve robust growth



Source: IFP, Eurostat

Figure 8: Leading indicators in the euro area point to a slowdown



Source: IFP, Markit, EC, Eurostat

Conjunctural survey readings for the euro area and Germany indicate slow but still positive economic growth (Figure 8). The euro area economy is therefore expected to rise by 0.3 per cent on quarter in the second quarter of 2019. In 2019, we revise GDP and imports down for almost all the most important trade partners of Slovakia (Table 1). The cut-off date for external environment assumptions, including interest rates, commodity prices, and exchange rates is May 28, 2019.

Table 1: The External Environment Assumptions 2018 – 2022

	GDP (per cent growth)					Difference vs. last					Import (per cent growth)					Difference vs. last				
	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022
Most important trade partners	2.8	2.1	2.1	1.8	1.7	0.1	-0.1	0.0	0.0	-0.1	4.9	4.1	4.0	3.9	3.9	0.4	-0.1	-0.2	0.0	0.0
Euro area *	1.9	1.1	1.4			0.0	-0.5	-0.1			3.1	2.9	3.6			0.2	-0.4	-0.3		
Germany	1.5	0.7	1.3			0.0	-0.7	-0.2			3.4	2.9	3.3			0.1	0.0	-0.5		
Czech Rep.	2.9	2.6	2.3			0.0	-0.1	-0.3			6.0	4.2	3.5			0.4	0.0	-0.3		
Poland	5.2	4.4	3.7			0.1	0.9	0.4			7.2	5.7	5.3			0.7	-0.2	0.4		
Hungary	5.0	4.6	3.1			0.3	1.1	0.1			7.1	6.8	5.1			0.1	0.5	0.2		

* exports-weighted euro area

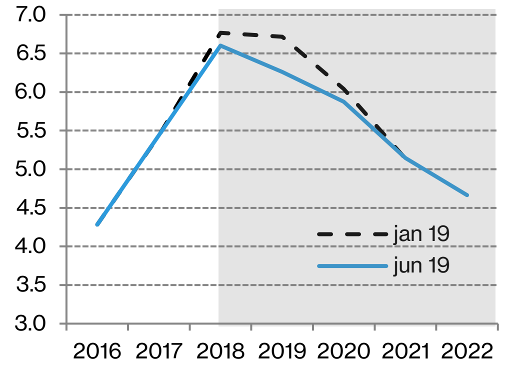
Source: IFP, EC.

The balance of risks remains tilted downward

The balance of risks to the baseline forecast remains tilted downwards. Downside risks prevail in the external environment, such as the more pronounced slowdown of the euro area economy, escalating protectionism in international trade and hard Brexit. In the domestic environment, a potential correction of household consumption shortfall in the beginning of the year creates an upside risk. Likewise, a government stimulus would affect the economy beyond the assumptions currently included in the forecast. A stronger labour market response to slowing euro area performance may have negative consequences.

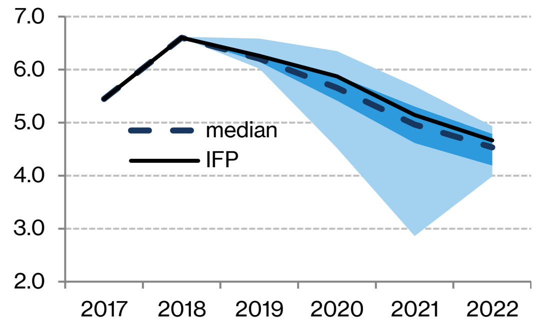
The overall impact of the macroeconomic forecast update on tax bases is negative. The slower pace of tax bases growth is the result of lower GDP growth, but also the less tax-profitable structure of this growth. The most significant factor is the decrease in household consumption dynamics due to its unexpected outage in the first quarter. The overall 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 June 20, 2019.

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 June 12, 2019. **The medium-term forecast was evaluated as realistic by most members of the Committee** (ČSOB, Infostat, NBS, SAV, SLSP, VÚB), while two members assessed the forecast as optimistic (Tatrabanka, Unicredit). The detailed macroeconomic forecast, as well as the minutes from the meeting and all supporting documentation are available at the IFP website.

BOX 2: View of the IFP Forecasts Accuracy

The predictions of IFP for the vast majority of relevant macroeconomic indicators for one year ahead did deviate from the observed values. Exceptions were labour market indicators. Wage and employment growth tend to be underestimated. However, with a longer time horizon, the deviation increases upwards. The medium term forecasts for four years ahead were overestimated by 3.5 p.p..

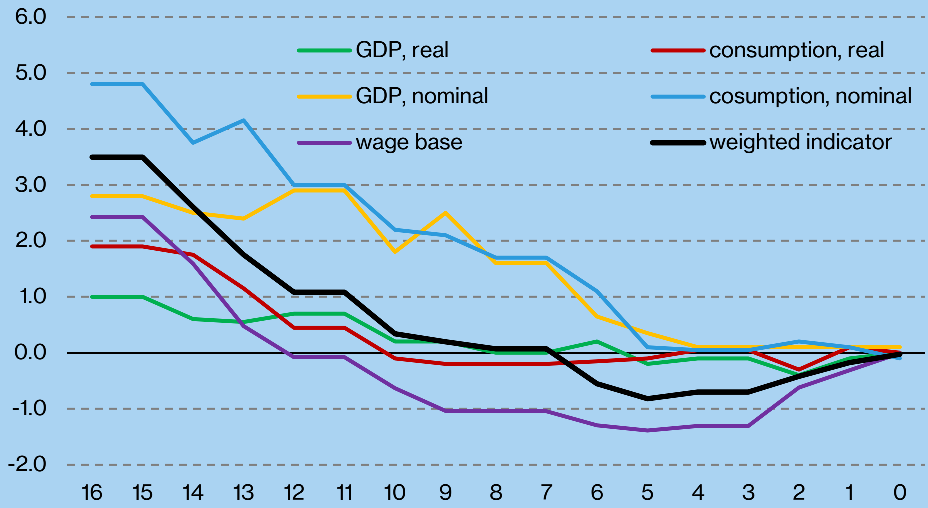
The predictions from 2004 to 2018 of IFP for most macroeconomic variables relevant for tax revenue did not significantly deviate, taking into account the time horizon of 5 quarters and less until final data value release. The exceptions were the forecasts of the labour market indicators, particularly the growth of wages and employment. They were forecasted somewhat lower than was the actual value for the given period. The weighted forecast indicator[2] thus tends to be underestimated within one year. Its median error for five quarters ahead was -0.8 p.p.. Yet, as the time horizon grows, the deviation increases upwards. The medium-term forecasts for four years ahead were overestimated by 3.5 p.p..

The forecast deviation from the reality was, however, not the same for all relevant macroeconomic tax bases. In the medium term, the median estimate of real GDP is the least overestimated variable. A similar deviation was also observed in the case of the inflation forecast. By contrast, the employment growth forecast was underestimated, with a median error of around 1 pb over the forecast horizon. In the short term the wage

[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.
[2] Under the weighted indicator in the following text we will understand the growths of macroeconomic tax bases weighted by their relevance for tax revenues (see Figures 9 and 10).

growth showed up to be underestimated, while in the longer term the devation has increased. Most overestimated were forecasts of nominal variables, in particular GDP, consumption and wages.

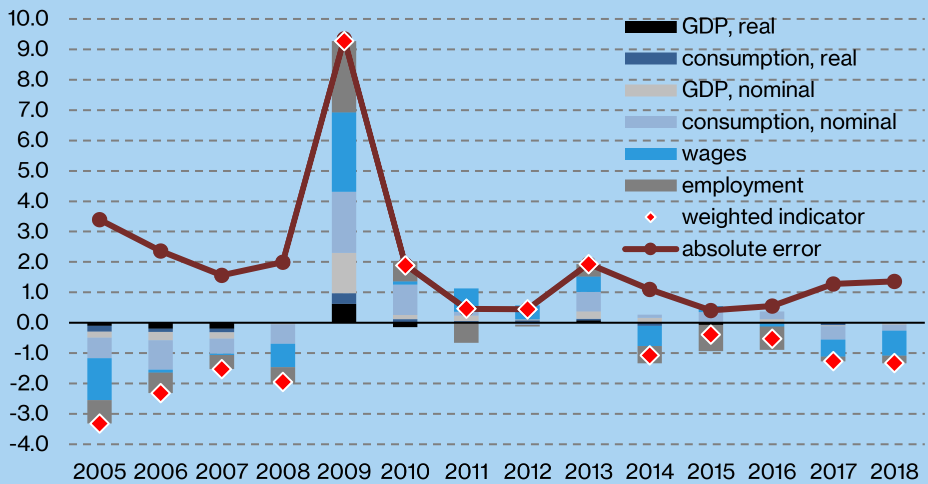
Figure 11: Median forecast error of macroeconomic tax bases based on time until the first real value release (2004-2018)



Source: IFP

For the public administration budget is relevant horizon of five quarters, which corresponds to the September forecast of the previous year. IFP estimates were rather countercyclical in these forecasts: they tended to be conservative in good times, while during the recessions they overestimated the development of the macroeconomic tax base. In recent years, the forecasts underestimation has been driven mainly by labour market developments. At the beginning, a positive surprise stemmed from employment, while in 2017 and 2018 it was replaced by wages.

Figure 12: The contributions of individual macroeconomic tax bases to the overall forecast error of the weighted indicator over 5 quarters.



Source: IFP