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Coronavirus „infects“ the Slovak economy

Macroeconomic Forecast 2020 – 2023

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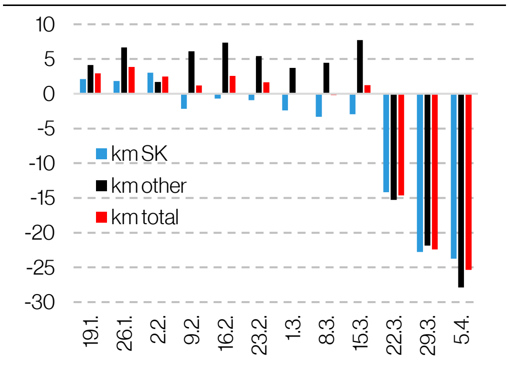
The crisis induced by the coronavirus pandemic will also affect the development of the Slovak economy in the coming years. The contagion rewrites global statistics and changes Slovakia's macroeconomic forecast. Accordingly, we expect the Slovak economy to fall into recession of 7.2 per cent in 2020. In the second half of the year, the economy will gradually recover and GDP growth is set to climb up to 6.8 per cent in 2021. However, the uncertainty about further developments remains high. An extension of the pandemic or its recurrence in the second half of the year would severely deepen the recession.

The global pandemic will pull the world and the Slovak economy down into recession.

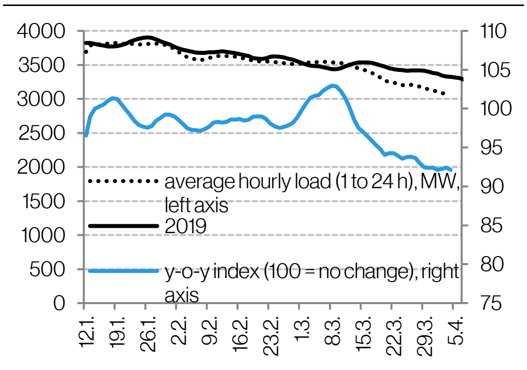
The global pandemic will bring the Slovak economy into recession in 2020 and GDP will fall by 7.2 per cent. Worldwide measures increasing social distance slow down the spread of the virus, yet also the economic activity. Our estimate is based on the assumption that the activity in both the Slovak economy and among its foreign trading partners will remain significantly subdued for two months. The economic performance will sharply decline in the second quarter, across the services, industry and construction sectors. We expect a gradual recovery in the second half of the year, albeit observed unevenly across sectors, as partial constraints may still persist. The economy should catch up with the pre-crisis level by the end of 2021.

Figure 1: Drop in mileage of Slovak and foreign trucks (per cent, y-o-y)



Source: Skytoll, IFP

Figure 2: Electricity consumption is 8 per cent lower than at the end of March last year



Source: SESP, IFP

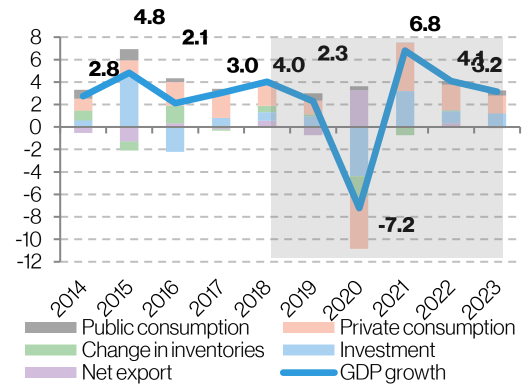
Social distancing policies will limit household consumption

GDP will slump not only due to pro-cyclical investment and the absence of foreign demand in 2020, but also due to weaker domestic consumption. Although household disposable income is not decreasing drastically, household consumption is affected by several channels, like measures to prevent the spread of the virus, fears of contagion and uncertainty about future developments. The dropout in income is partly offset by government measures, so the household savings rate is set to temporarily rise. Investment will fall as deeply as during the 2009 global financial crisis, generating a lot of slack in the economy. Similarly, exports will suffer heavy losses due to the global lockdown. Yet, the trade balance may turn positive, as the decline in consumption will also reduce the amount of imported goods and services. Government spending is expected to mitigate the effects of the crisis.

The recovery will be gradual

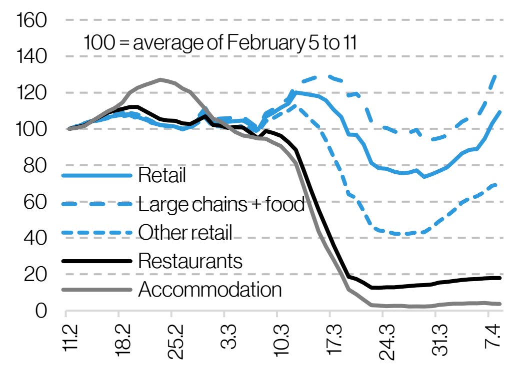
The recovery will continue in 2021 and the economy could reach pre-crisis levels at the end of the year. GDP is projected to increase by 6.8 per cent, supported by domestic and foreign demand. Investment activity should recover as the uncertainty declines. At the end of the forecast horizon, the drawdown of EU funds will support the economy.

Figure 3: Contributions to GDP growth (constant prices in p.p.)



Source: IFP

Figure 4: Decline in household consumption reduces sales in stores, hotels and restaurants



Note: 7-days averages

Source: eKasa, FSSR, IFP

MF SR FORECAST - MAIN ECONOMIC INDICATORS (Apr 2020)

indicator	actual	forecast				diff. from Feb 2020			
(growth in % unles otherwise noted)	2019	2020	2021	2022	2023	2020	2021	2022	2023
Gross domestic product									
GDP, real	2.3	-7.2	6.8	4.1	3.2	-9.4	4.1	1.4	-0.4
GDP, nominal (bn €)	94.2	89.0	95.2	100.5	105.8	-8.9	-7.5	-7.4	-8.8
Private consumption, real	2.2	-8.4	7.8	4.1	2.9	-10.5	5.3	1.8	0.1
Private consumption, nominal	5.0	-6.5	8.0	6.1	4.9	-10.8	3.4	1.6	-0.1
Public consumption	3.8	1.8	0.2	1.8	2.6	1.0	-1.0	0.2	-0.4
Fixed investments	4.4	-20.3	17.0	5.2	5.8	-22.9	13.7	1.8	-3.5
Export of goods and services	1.7	-21.4	17.6	6.5	3.6	-24.8	13.1	2.5	-0.2
Import of goods and services	2.6	-25.5	19.0	6.5	4.0	-28.5	15.4	3.0	0.0
Labor market									
Employment (registered)	1.0	-3.8	1.6	1.0	0.3	-4.0	1.3	0.8	-0.1
Wages, nominal	7.8	1.6	4.0	4.9	4.9	-2.9	-1.2	-0.1	-0.3
Wages, real	5.0	-0.1	3.8	2.9	2.8	-2.3	0.7	0.1	-0.1
Unemployment rate	5.8	8.8	7.7	6.8	6.4	3.0	1.9	1.1	0.9
Inflation									
CPI	2.7	1.7	0.2	1.9	2.0	-0.6	-1.9	-0.3	-0.2

Source: ŠÚ SR, IFP

Employment under pressure

Employment is set to fall sharply in 2020 and the labour market is projected to shrink by 88 thousand jobs. Workers will lose their jobs mainly in selected service sectors (tourism, catering, retail or transport), but also in industry and construction. However, government measures supporting short-term work (the so-called Kurzarbeit) will curtail the rise in unemployment. We assume that without these measures, there would be nearly twenty thousand more persons unemployed. We expect the labour market to recover in the second half of 2020, but only gradually, and the pre-crisis level of employment will not be reached at the forecast horizon. At the same time, **the unemployment rate is set to rise to 8.8 per cent in 2020**. In the coming years it will be slowly declining, yet remaining above the pre-crisis level by the end of the forecasting horizon.

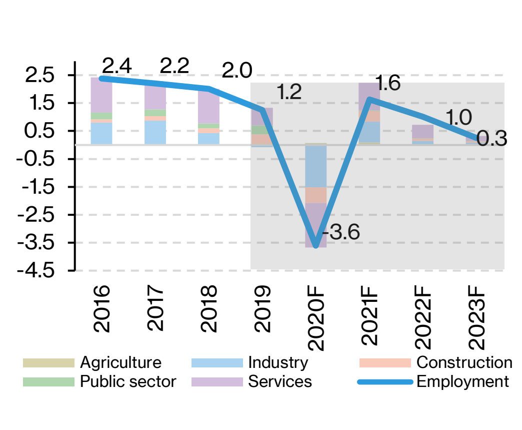
The recipients of nursing and sickness benefits will reduce the average wage.

Average nominal wage growth will cool off in 2020 to 1.6 per cent. Compared to 2019 and the February forecast, this is a pronounced slowdown, particularly in the private sector. The wage growth will be dampened by the large number of recipients of nursing and sickness benefits, as well as by the lower wage resulting from short-time work.[1] The real wage is set to remain flat due to the economic downturn. In the coming years, wage dynamics will recover against the backdrop of labour market strengthening.

The slump in oil prices will dampen the inflation pressures in 2020

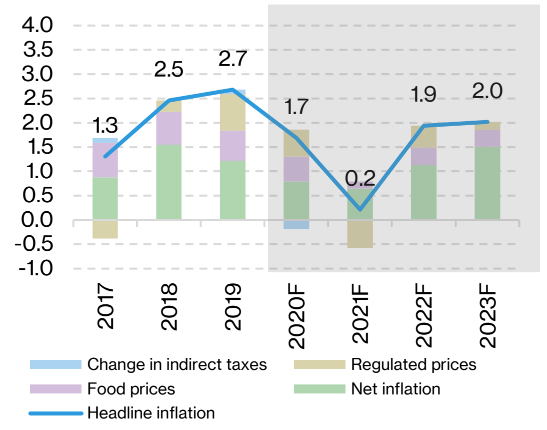
Inflation is projected to ease to 1.7 per cent in 2020. The deceleration is mainly driven by a slump in oil prices for the price war of oil producers. Lower oil prices will further dampen food prices due to lower input prices in agriculture. Prices of services and tradable goods are set to respond to the economic downturn with a delay. Regulated prices have been affected by the increase in electricity prices since January this year.

Figure 5: Contributions to the ESA employment growth (in ppt.)



Source: ŠÚ SR, IFP

Figure 6: Headline inflation and contributions of individual components (p.p.)



Source: ŠÚ SR, IFP

Stable inflation over the medium term

Price growth is expected to be flat next year. Low oil prices and the development of energy commodity future contracts indicate a decrease in regulated energy prices. It will be accompanied by a moderate growth in prices of goods and services due to the economic downturn. In the coming years, we expect a gradual return of demand inflation as the economy recovers. In the medium term, price growth is projected to reach 2 per cent.

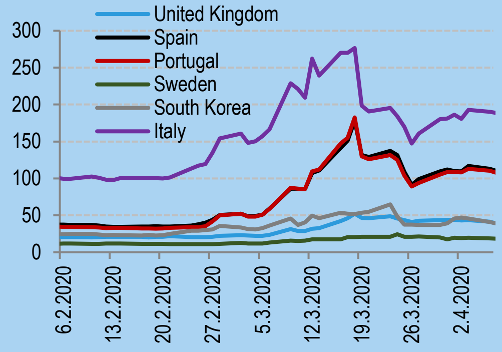
[1] Wage reimbursement paid during the period of receipt of nursing and sickness benefit is not included in the paid wage, but its recipients are still listed as employed. The high increase in both groups of recipients will thus statistically lead to lower growth in the average wage (wages paid in the numerator will fall sharply, but the number of employed in the denominator will decrease at the lower pace).

BOX 1: External Environment Assumptions

The strained situation surrounding coronavirus has led to sell-offs in the global financial markets. Equity markets in the US, the euro area and Japan fell by more than 30 per cent between February 20 and mid-March (adding to losses similar to those in the 2008 financial crisis). The abrupt panic activated the indicators of uncertainty and stress in financial markets and caused an increase in credit premiums.

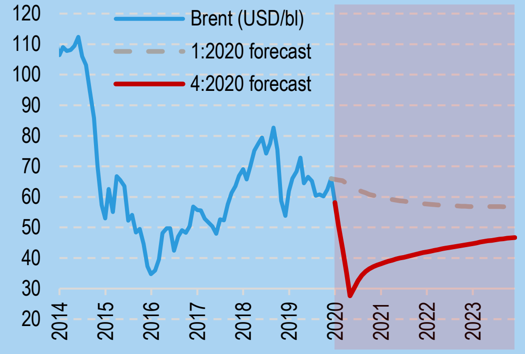
The prompt responses of key central banks helped stabilize the situation. The US Fed lowered its key interest rate from 1.5 per cent to 0 per cent. At the same time, it eased the conditions for collateral and launched unlimited purchases of assets and several lending programs to support firms. The ECB also adopted an extensive package of measures. It released a limit on holding government bonds of one country (formerly 33 per cent) under the EUR 750 billion Pandemic Emergency Purchase Programme (PEPP). It also lowered the risk standard for collateral and promised to buy corporate bonds as well. The impulse also arrives from the fiscal policies of several countries. The set of measures temporarily calmed down the situation in the equity markets, which partially abated the original losses.

Figure A: Risk premiums of periphery increased in response to pandemic (CDS, points)



Source: Bloomberg, IFP

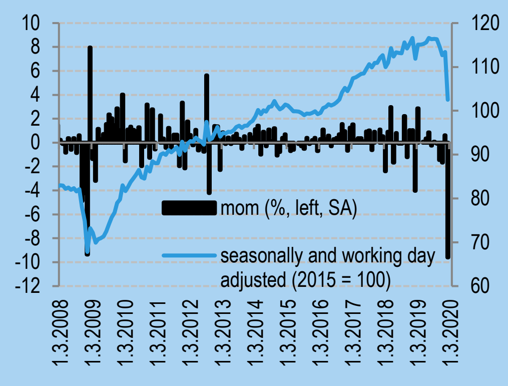
Figure B: Brent oil prices are not expected to rise



Source: Bloomberg, IFP

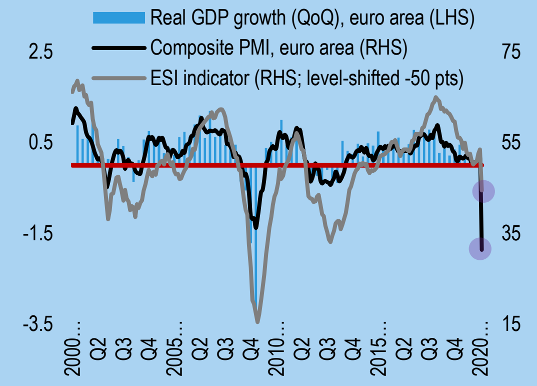
The price of Brent oil has fallen by more than 50 per cent since the beginning of the year. In addition to the decline in global demand, trade disputes between OPEC+ countries contributed to the decrease in commodity prices to USD 27 per barrel (*Figure B*). The foreign exchange markets have also experienced a turbulent period. In particular, the exchange rates of so-called emerging countries weakened, but also the exchange rates of the V3 region. Equally challenging movements have been seen in bond markets as demand for government bonds declined as a result of investors' concerns, and premiums temporarily increased.

Figure C: Global container shipping dropped in February similarly to 2009



Source: ISL, IFP

Figure D: Leading indicators for the euro area point to historical lows

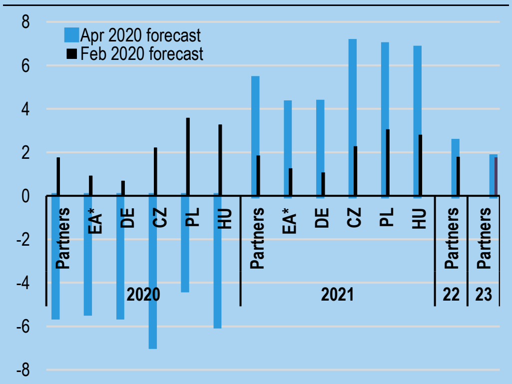


Source: EC, IHS Markit, Eurostat, IFP

The coronavirus outbreak paralyzed the global economy. In February, world container shipping decreased by 10 per cent month on month, similar to the times of the financial crisis (*Figure C*). The number of labour claims in the US has risen by an unprecedented 9 million within 2 weeks. The euro area economy is very likely to have already slipped into recession during the first quarter, which will persist in the second quarter. Closure of borders and social distancing measures hit primarily the aviation industry, tourism, restaurants and hotels, and services in general. The curb in international trade and outages in supply chains will lead to recession in industrial production too. The true magnitude of the damage caused by coronovirus will depend on the duration of the pandemic. **Given the structure of its economy, the Czech Republic should be the most affected country within the V3 region.** On the contrary, a large and relatively closed economy like Poland could weather the crisis with relatively small losses.

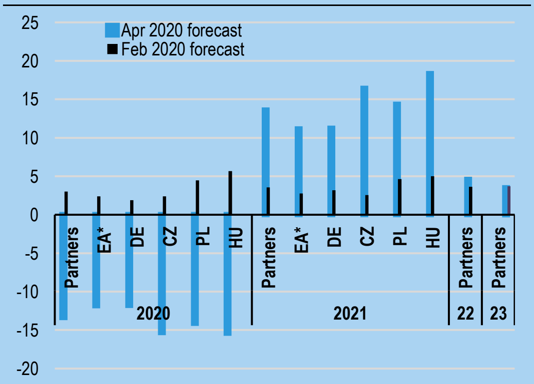
Conjunctural survey readings indicate that the recession will be deeper than the financial crisis of 2008 (*Figure D*). The euro area composite PMI index plummeted to its historic low. Similarly, the economic sentiment indicator (ESI) in the euro area and the Ifo activity index in Germany indicate a similar extent of damage as in 2008. We revise GDP and imports down for all major trading partners of Slovakia, corresponding to approximately two months of economic lockdown (*Figure E and F*). The cut-off date for external environment assumptions, including interest rates, commodity prices, and exchange rates was March 31, 2020.

Figure E: External environment GDP growth forecast



** exports-weighted euro area* *Source: IFP*

Figure F: External environment imports growth forecast



Source: IFP

The risks to the forecast are negative

The risks to the forecast are negative, which we take into account in alternative scenarios to the baseline forecast (Box 2). The uncertain length of the pandemic and the recurrence of the infection may exacerbate the economic downturn. Global supply chains can be disrupted, and their recovery can take longer, resulting in slower recovery. Benefits from international trade may be diminished in the future by calls for self-sufficiency. Last but not least, firms may prefer a liquidity buffer at the expense of investment, and greater emphasis may be placed on the geographical diversification of suppliers.

BOX 2: Risk scenarios to the baseline forecast

Because ot the higher uncertainty of the coronavirus impact, two alternative scenarios were created. In the first scenario, we assume that the pandemic will last one month longer than in the baseline forecast (i.e. a total of three months). This is projected to deepen the slump in GDP to -12.5 per cent in 2020 and the economy will catch up with the 2019 level in the late 2021. In the second scenario, we assume that the pandemic will last only 2 months, yet the economic recovery will be slower than in the baseline forecast due to additional waves of contagion. This will correspond to a recession of -11.4 per cent of GDP in 2020, and by 2023 the economy will still be 2.5 per cent below the 2019 level.

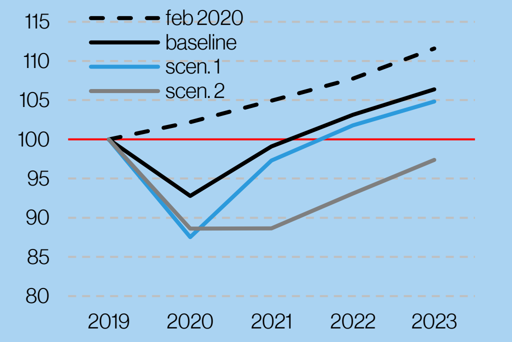
In the first scenario, we assume a deeper economic downturn, corresponding to a pandemic lasting roughly one month longer than the baseline scenario of two months. The restrictions will apply both in Slovakia and our trade partners. However, as there is no deeper disruption of economic chains, the shape of the economic recovery is similar to that in the baseline scenario. In this case, the euro area and V3 countries would catch up with their GDP levels from the fourth quarter of 2019 at the turn of 2022 and 2023.

Slovakia's GDP would fall by 12.5 per cent in 2020 in the first scenario. The structure of the downturn would be similar to the baseline scenario: not only exports through lower external demand would be affected, but so would be investment and domestic consumption due to uncertainty and sales constraints. Employment would decrease by 5 per cent in 2020. In 2021, a relatively fast economic recovery would follow, rising by more than 11 per cent.

In the second scenario, we expect a two-month pandemic as in the baseline forecast, but a recovery would be slower. The recovery may be slower for example because of the recurrence of the infection or due to the unsynchronic restart of foreign trade, as the epidemic hit countries at different times and with different strengths. Supply chains are deeply disrupted and take longer to reconcile. Weakening of international economic linkages, limited investment, or stronger preferences of households to save may result in a growth profile similar to the development after the global financial crisis. In this scenario, the economies of our trading partners would not reach the output levels before the coronavirus outbreak over the entire forecast horizon.

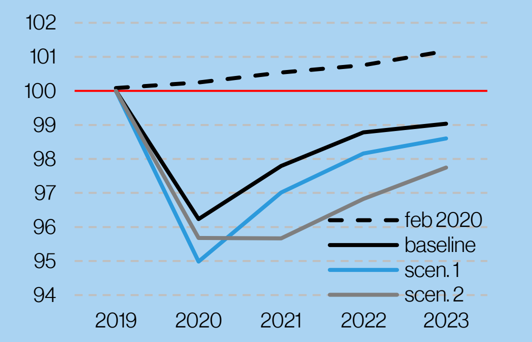
In the second scenario, Slovakia's GDP would fall by 11.4 per cent in 2020. Compared to the first scenario, however, there would not be any partial catch-up, but even in 2021 the economy would stagnate. Only in 2022 would there be a stronger recovery, but the economy would not reach pre-crisis levels even at the end of the forecast horizon. Employment would fall by 4.3 per cent in 2020 and would still be around 2 per cent below the 2019 level in 2023.

Slovakia GDP baseline forecast and scenarios (index, 2019 = 100)



Source: IFP

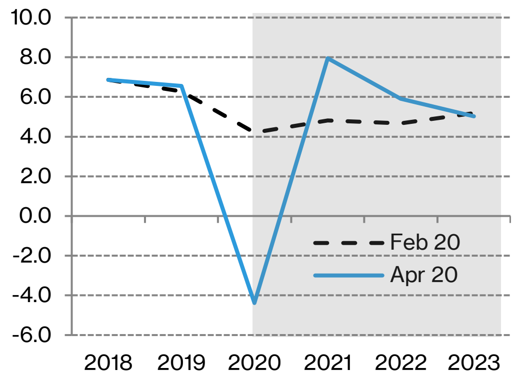
Slovakia employment baseline forecast and scenarios (index, 2019 = 100)



Source: IFP

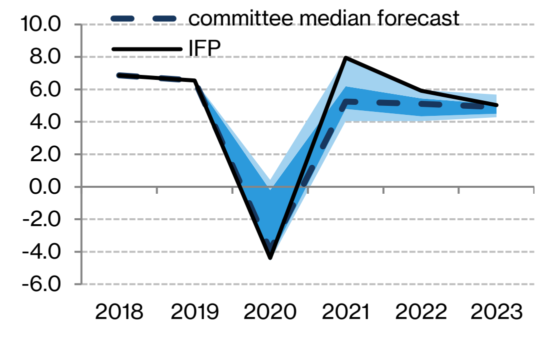
The overall impact of the macroeconomic forecast update on tax bases is negative. All taxes will exhibit a revenue loss. The overall impact of the present macroeconomic forecast on tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee meeting held on April 16, 2020.

Figure 7: Macroeconomic tax bases growth compared to previous forecast



Source: IFP

Figure 8: Comparison of forecasts of macroeconomic bases[2] 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 April 8, 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.

[2] 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 + 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.