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Second wave hinders economic recovery

Macroeconomic forecast for 2020 – 2024

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The second wave of the pandemic will mitigate the output growth to 3.3 per cent this year. The impact is milder when compared to the first wave, affecting mainly household consumption, while exports will continue to support the economy. The labour market will remain stable, adding new jobs in the second half of the year. With the pandemic easing off, the economy will grow by a strong 6.3 per cent in 2022, owing also to the EU´s Recovery and Resilience Plan. The last-minute drawing of EU funds will boost output in 2023. Negative risks include a stricter lockdown and logistical issues concerning the vaccination process. In contrast, generous stimulus packages in the US and the EU could spur Slovak export.

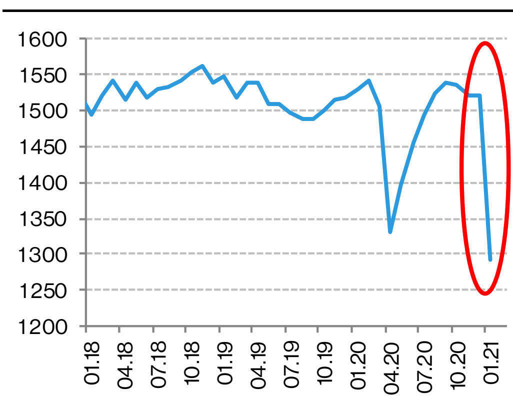
The second wave will hinder economic recovery

Slovak GDP will rise by 3.3 per cent in 2021. The reasons behind slower economic growth compared to the previous forecast are twofold. Firstly, the economy had already recovered from most of the losses caused by the first wave in 2020. At the same time, output in the first quarter of this year will be dampened by the second wave of the pandemic. The main driver of the decrease in economic output is lower household consumption. The labour market remains stable, allowing a gradual recovery in economic activity in the quarters ahead, supported by the easing of restrictions and a rising proportion of the population being vaccinated.

Consumption falls, exports remain strong

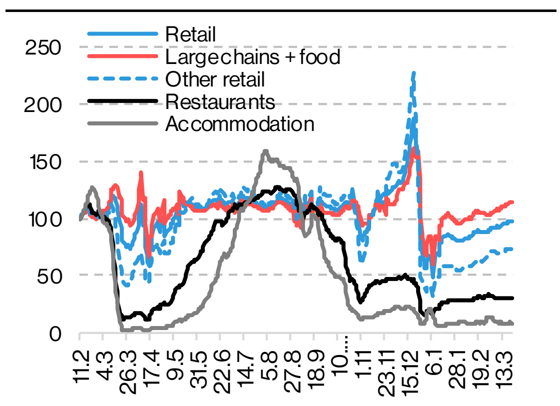
The main drivers of growth will be net exports, while household consumption will be under pressure. That is the inverse trend of what we saw during the first wave of the pandemic. Despite no significant changes in the labour market, retails sales fell substantially in January, and eKasa sales data suggest significantly lower consumption in both February and March. Yet higher government transfers, already incorporated into this forecast, are a positive factor from the perspective of domestic demand. Foreign demand remains resistant, with car production particularly strong. New industrial orders of European purchasing managers grew in winter, giving hope for an expansion of exports in the first half of the year. Services and construction activity will continue to lag behind, owing to restrictions and ongoing uncertainty regarding future development.

Figure 1: Retail sales fell drastically in January (seas. adjusted, constant prices, mil. EUR)



Source: ŠÚ SR, IFP

Figure 2: The second wave pulled down sales below first wave levels (current prices)

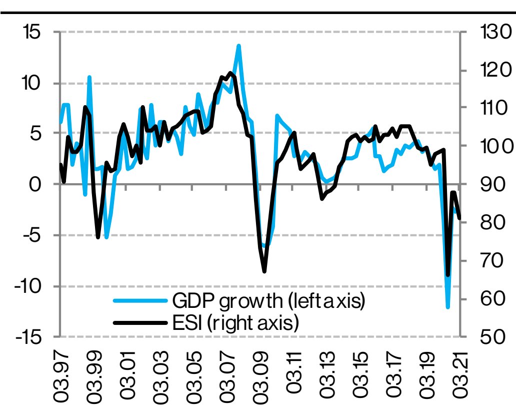


Note: 7DMA indexed to the beginning of Feb 2020. Source: eKasa, FSSR, IFP

RRP will boost growth in 2022

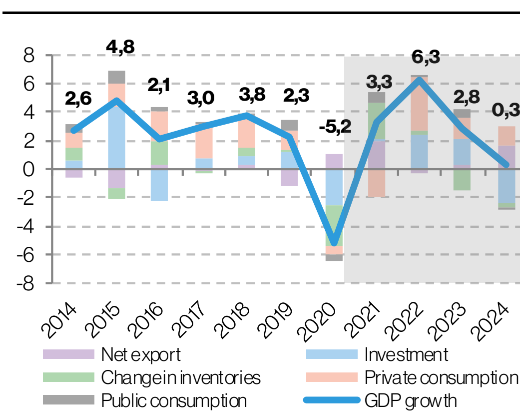
In 2022, the Slovak economy will grow by 6.3 per cent, partly thanks to additional funds from the EU´s Recovery and Resilience Plan (RRP). With the pandemic retreating, consumer confidence will revive and so will domestic demand. The uncertainty in the economy will decrease, boosting private investment. Public investment funded by the RRP will also boost output by more than 1 bn. EUR. These funds will remain a contributor to growth until 2026, with the economy benefiting from a total of 6.1 bn. EUR of extra resources.

Figure 3: ESI indicates a year-on-year decrease in output of around 5 per cent in Q1 2021



Source: ŠÚ SR, IFP

Figure 4: Contributions to GDP growth (constant prices, in percentage points



Source: FSSR, IFP

Growth in 2023 will also be aided by EU funds. The drawing of EU funds from the current programme period will culminate in 2023. The forecast assumes that resources from the EU will help compensate for the contractionary effects of fiscal consolidation by 1 p.p. each year from 2022 onwards. The drawing of funds from the new programme period is expected to begin only gradually, which will slow down capital formation towards the end of the forecasting horizon.

The forecast has both positive and negative risks

We acknowledge both positive and negative risks to the forecast. Positive risks mainly include a more favourable development abroad. Slovak exports could potentially benefit from a massive fiscal stimulus in the United States and greater economic activity in the EU through the RRP. Negative risks that may potentially influence the forecast concern the imposition of a stricter lockdown to curb the spread of the virus, as well as logistical problems that may affect vaccine production and distribution. The economic costs of a stricter lockdown are outlined in Box 2.

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

	2021	2022	2023	2024	2025	2026
RRP Total	117	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 RRP will support the labour market

The labour market will remain stable in 2021. Compared to the first wave of the pandemic, the second wave will have a significantly smaller impact on employment. The number of employed people will decrease mildly at the beginning of the year, mainly in the services and construction sectors. **The unemployment rate will increase to 7.1 per cent in 2021**, but will gradually decrease thereafter. The labour market could start recovering in the

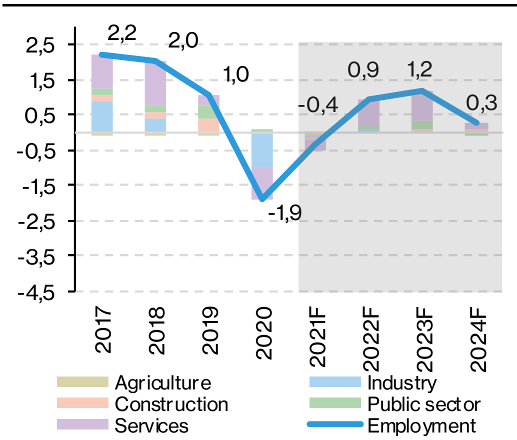
second half of the year, on the back of more favourable development of the pandemic, the relaxation of restrictions, and faster vaccination. The labour market will also benefit from a strong impulse provided by the RRP in 2022, which will allow for the renewal and creation of new jobs.

The average nominal wage will increase by 4.9 per cent in 2021 and its development will be affected by many opposing factors. The base effect, as well as the strong year-end result in 2020 are pulling the year-on-year growth rate upward, despite many employers being incapable of providing significant wage raises in the midst of economic hardship. On the other hand, wages will be affected by a growing number of recipients of nursing and sickness benefits this year. In addition, pay cuts in the public sector may negatively affect wage development in 2021. In the following year, wage dynamics should renew accompanied by economic recovery and new job creation.

Lower energy prices will dampen inflation this year

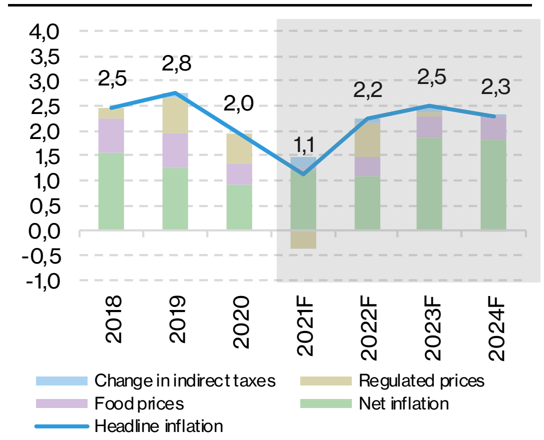
Inflation will slow to 1.1 per cent in 2021. The main drivers behind the slowdown are the decrease in regulated energy prices since January this year, as well as the base effect affecting food prices. Price growth of goods will not change significantly, while the prices of market services will decrease only mildly as the current restrictions limit supply rather than demand. Rising oil prices at the beginning of the year raised the price of fuels. Moreover, the increase in excise tax of tobacco products from February onwards will also contribute to overall inflation.

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



Source: ŠÚ SR, IFP

Figure 6: Actual and forecasted inflation, with contributions to price growth (in p.p.)



Source: ŠÚ SR, IFP

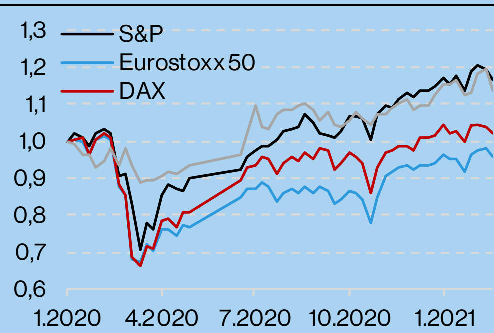
Economic recovery will bring about price increases

Price growth will exceed 2 per cent next year. Global demand will recover and pull the prices of energy futures contracts up, leading to an increase in regulated prices. Demand inflation will rise in the medium-run, supported by economic growth motored by RRP funds. The expected fiscal consolidation will have an opposite effect on prices, however. In 2023, prices will rise further following another round of consumption tax rises concerning tobacco products.

BOX 1: External environment assumptions

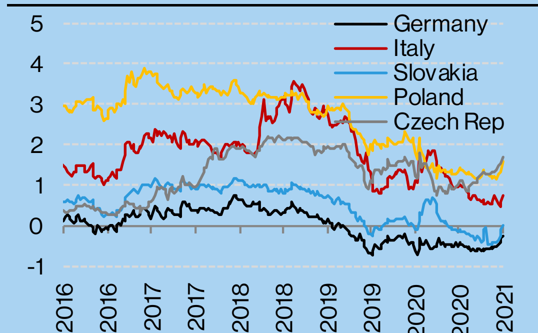
Stock markets climbed to their historical peaks at the beginning of the year, which was followed by a moderate correction in March (Figure A). The reasons behind the increased interest of investors include monetary and fiscal stimulus packages, as well as an expected improvement in the future development of the pandemic brought about by rapid vaccination in the U.S. and the U.K. Both accommodative monetary policy and the successful inauguration of the new U.S. president, and a positive outlook for the future have contributed to an increase in inflation expectations. This led to a mild increase in long-term government bond yields at the beginning of March (Figure B). Bond yields, however, still remainn close to historical lows. Faster vaccination and a more favourable development of the epidemic in America have affected the value of the euro, which depreciated against the U.S. dollar in early March. As a result of positive expectations about the future, as well as limited production by OPEC+ members, **the price of Brent oil increased to 70 USD/bl in March**. At the forecasting horizon, we expect oil prices to stabilise around 45 USD/bl.

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



Source: Bloomberg, IFP

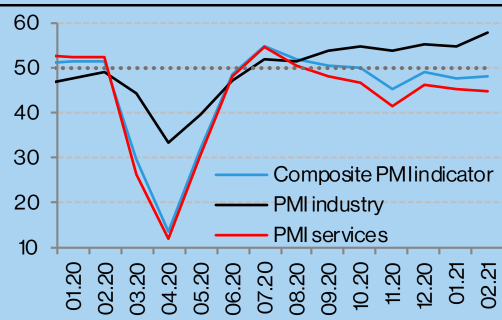
Figure B: 10-year government bond yields increased in March



Source Bloomberg, IFP

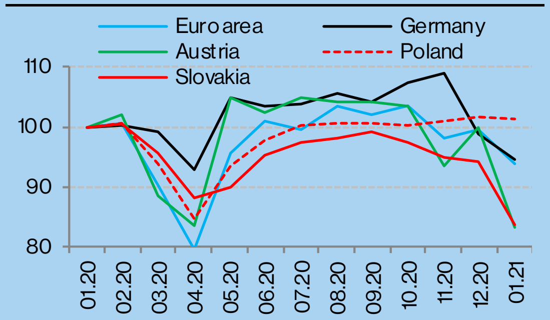
Following strong performance in the third quarter, most European economies contracted in the final quarter of the year. The second wave of the pandemic brought about significantly lower economic costs than the first wave. The German economy even expanded slightly at the end of the year. European countries benefited from solid world trade fuelled to a great extent by demand from Asia. Demand for cars produced in Europe contributed to foreign demand and helped industrial activity stay intact (Figure C). Unfavourable development of the pandemic in many countries resulted in prolonged closures of those sectors of the economy, which require personal contact. Services are the most affected and hinder overall economic growth (Figure C). Catering services, tourism and accommodation sectors were hit hardest by the COVID crisis, and retails sales too fell sharply in many countries at the beginning of the year (Figure D).

Figure C: The Eurozone economy is in a two-speed mode (PMI index)



Source: IHS Markit, IFP

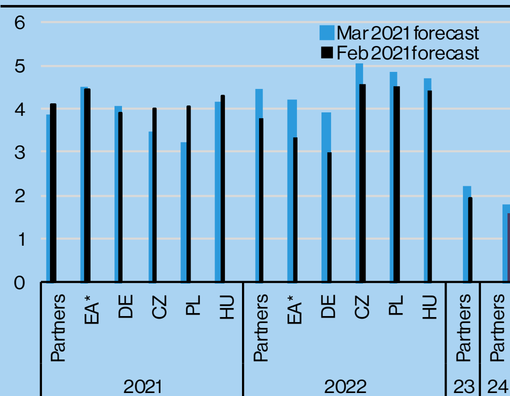
Figure D: Retail sales indicate lower consumption in the first quarter (100 = jan 2020)



Source: Eurostat,, IFP

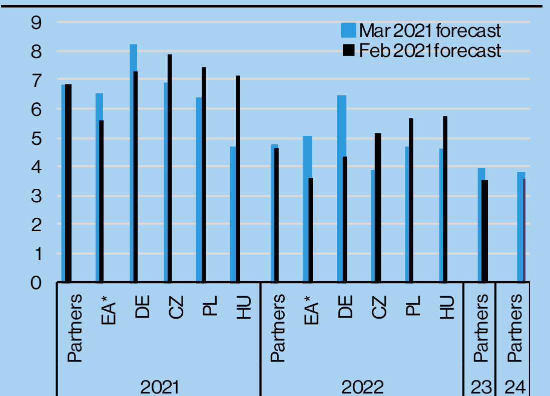
Economic survey readings indicate stagnation or a mild recession driven by the services sector. Economic sentiment indicators (ESI) for the Eurozone, as well as the Purchasing Managers´ Index (PMI) point to solid growth of industrial production in Germany. At the same time, they indicate a weak development in services, which limits overall economic activity. Trading partners in V4 have performed better than expected, though their leading indicators are still below pre-crisis levels. Longer lasting lockdowns will likely postpone economic recovery to the end of this year. Therefore, we revise our projections for output and imports of Slovakia´s trading partners in 2021 downward. This will be followed by stronger growth next 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 March 3rd, 2021.

Figure E: GDP growth forecast of the external environment



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

Figure F: Import growth forecast of the external environment

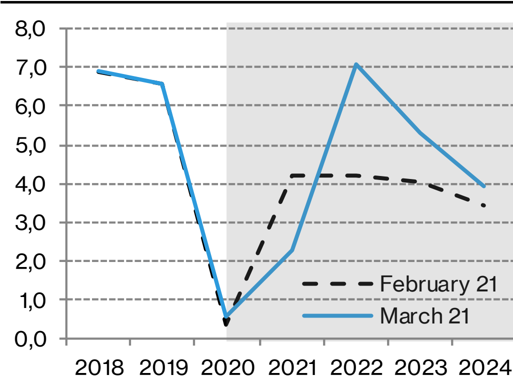


Source: IFP

The overall impact of the update of macroeconomic forecast on tax bases is mixed. In 2021, the bases are lower mainly due to the second wave and lower household consumption at the beginning of the year. From 2022 onwards, however, they increase thanks to a stable labour market and more rapid economic recovery. 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 March 25th, 2021.

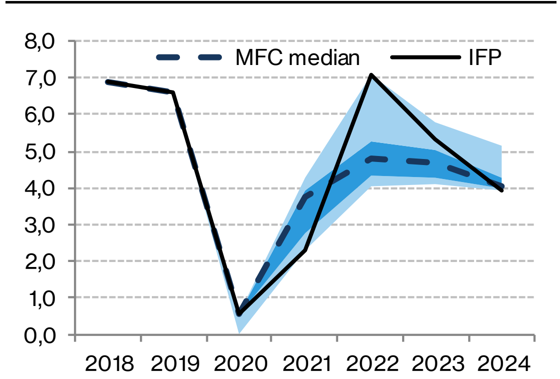
The medium-term forecast prepared by the Ministry of Finance was discussed at the Macroeconomic Forecast Committee's (MFC) meeting held on March 17th, 2021. **The medium-term forecast was evaluated as realistic by all members of the Committee** (Infostat, NBS, SLSP, VÚB, Tatrabanka, Unicredit, and SAV). The detailed macroeconomic forecast as well as the minutes from the meeting and all supporting documents are available at the IFP website.

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



Source: IFP

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



Source: IFP

BOX 2: The risk of a stricter lockdown and the shut-down of industry

At the time of writing, the introduction of a stricter lockdown, including the closure of factories, was contemplated in order to curb the spread of the virus. Given the current epidemic situation, this scenario is now less likely than a few weeks ago. Under such circumstances, output would increase by only 1.4 per cent this year, while the labour market would weaken and employment would contract by 10 thousand jobs.

In the scenario with a stricter lockdown, we assume the introduction of a three-week closure of the economy, including industry. As a result, the OSI stringency index would increase to 92.5. Compared to the current state, this would entail the closure of all schools, the re-introduction of stricter border controls and limiting public transport in a way similar to the measures taken during the spring wave of the pandemic. Restrictions would also affect the workplace, including industrial production. The effect of the restrictions on economic activity is calibrated in accordance with the development during the first wave of the pandemic. Even though there were no specific restrictions in place banning industrial activity during the first wave, the disruption to supply and demand chains caused serious complications in the production process. Hence, this period serves as a good base to approximate the economic impact of a potential strict lockdown. After the three-week-long lockdown, restrictions would be relaxed with the same trajectory as in the baseline scenario.

In the event of a stricter lockdown, real GDP would increase by only 1.4 per cent this year. That is almost 2 p.p. lower than in the baseline scenario. A significant part of the decline would be of a longer-term character – GDP in 2024 would be 1.5 per cent lower than in

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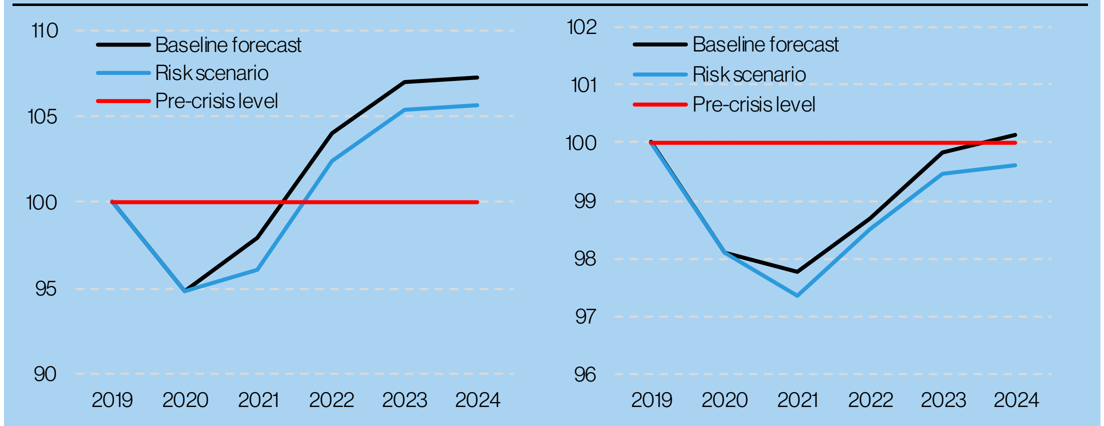
[1] Macroeconomic bases for budget revenues (weight of indicators depends on a proportional share of particular taxes on total tax revenues): Wage base (employment + nominal wage) – 51.1 %; Nominal private consumption – 25.7 %; Real private consumption – 6.6 %; Nominal GDP growth – 9.9 %; Real GDP growth – 6.7 %.

the baseline scenario. The risk scenario would also see a significantly weaker labour market with employment decreasing by 0.8 per cent in 2021. **Consequently, employment would decrease by 10 thousand jobs relative to the scenario without a stricter lockdown.** This shock would negatively affect potential output at the long-term horizon, through the employment and productivity channels. As a result, overall employment would be lower by 0.5 per cent in 2024, relative to the baseline scenario.

Figure G: GDP in the baseline and risk scenarios (index, 2019 = 100)

Figure H: Employment in the baseline and risk scenarios (index, 2019 = 100)



Source: IFP

Source: IFP

MF SR FORECAST – MACROECONOMIC INDICATORS (Mar 2021)

indicator (growth in %, unless otherwise noted)		forecast				difference from Feb 2021			
	2020	2021	2022	2023	2024	2021	2022	2023	2024
Gross domestic product									
GDP, real	-5,2	3,3	6,3	2,8	0,3	-1,0	2,4	0,3	-0,4
GDP, nominal (bn. €)	91,1	95,4	103,5	109,3	112,4	-0,4	2,0	2,9	2,8
Private consumption, real	-1,1	-3,3	6,8	2,7	2,4	-5,6	4,7	1,6	0,6
Private consumption, nominal	1,1	-2,0	9,1	5,3	4,8	-5,2	4,8	2,2	1,2
Public consumption	-2,3	3,6	0,9	3,7	-0,7	4,7	1,2	1,6	-0,6
Fixed investment	-11,9	0,8	11,9	8,4	-10,9	-2,5	3,5	1,1	-3,4
Export of goods and services	-7,2	10,6	4,8	4,2	3,6	-0,4	0,0	0,5	0,1
Import of goods and services	-8,5	8,8	5,3	4,1	2,0	-2,2	1,2	0,8	-0,1
Labour market									
Registered employment	-1,8	-0,3	0,9	1,2	0,3	-0,1	0,2	0,7	0,2
Wages, nominal	3,8	4,9	5,0	4,7	4,1	0,1	1,6	0,3	0,2
Wages, real	1,8	3,7	2,7	2,2	1,8	0,1	1,5	-0,1	-0,3
Unemployment rate	6,7	7,1	6,5	5,4	4,7	-0,2	0,0	-0,2	-0,2
Inflation									
CPI	1,9	1,1	2,2	2,5	2,3	-0,1	0,0	0,5	0,5

Source: ŠÚ SR, IFP