June 21st, 2016

Labour market continues to strengthen

Macroeconomic Forecast 2016 – 2019

Branislav Žúdel, Michal Habrman, Libor Melioris

The Slovak economy will grow 3.2 per cent this year, despite the worsening global outlook. The labour market will add 39 thousand new jobs, which will reduce the unemployment rate below 10 per cent. Lower inflation rate will spur the real wage growth. Next year, the economic growth will further expand due to investment activity in the automotive sector and due to highway construction D4 / R7. The main risk of the forecast stems from the Brexit. The forecast has no significant effect on the tax base this year.

FED postpones tightening and ECB expands the asset purchases

The Fed's policy of monetary restriction lags behind the plans. The US central bank has not tightened the monetary policy since the first interest rate hike in December 2015. Due to disappointing labour market results and falling inflation expectations the next hikes are expected in September and November. **The ECB has left the monetary policy unchanged at its June meeting.** The ECB has modified the QE program in March, changing the repo rate by five basis points to zero and deposit rate by ten points to -0.4 per cent. Furthermore it increased the program of sovereign bond purchase by 20 bn. EUR to 80 bn. EUR per month. The portfolio of purchased bonds has been widened since June to include corporate bonds. The new refinancing program TLTRO II has been added to the program as well, albeit with no significant effect on credit growth in the eurozone periphery countries.

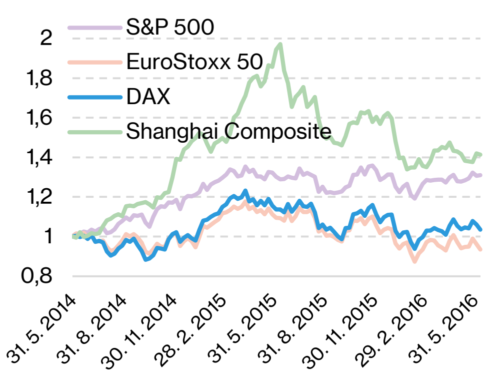
Brexit puts pressure on the financial market

Because of the Brexit possibility, bond yields fall towards lower bounds. Yields of both German 10-year and Swiss 30-year bonds dipped into a negative territory. Global stock markets have recouped the losses from February, yet they remain under pressure. Besides Brexit, the global economic outlook holds back the stock market rally.

Oil prices up due to supply factors

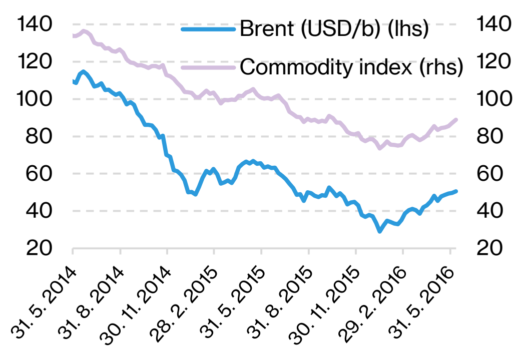
The oil price has reached the peak since October 2015 (52.8 USD/bl). As a result, we increase the forecast by almost 10 USD/bl over the entire horizon. The price increase was influenced by decreased production in non-OPEC countries, especially in US. On the other hand, demand remains insufficient due to weak global economic growth. The commodity index has been growing since February mostly due to rising gold, gas and corn prices.

Fig. 1: Volatile stock market



Source: Bloomberg

Fig. 2: Price of Brent and other commodities



Source: Bloomberg

Growth in the eurozone outperformed USA and Japan

The global economy keeps growing despite many economic-political challenges. The eurozone performed the best among the developed economies. On the other hand the US and Japanese economies lagged behind expectations. Current US labour market data increase the risk of recession in the American economy in the near future. The results from the developing countries were mixed as well. China has for now dealt with challenges it was facing at the beginning of the year and its economic growth was strong again. However the Russian economy remains in recession as well as Brazil, whose problems continue to deepen.

Fast growth in large European economies

The eurozone posted a remarkably strong quarterly growth. European economies performed well despite persistent economic problems and many institutional and political challenges. The growth was distributed evenly among countries, especially the large economies showed a positive surprise. European economies were driven mainly by private consumption and investment. The main problems of the eurozone remain the weak productivity growth and low inflation, which together eliminate further scope for the acceleration of the European economies.

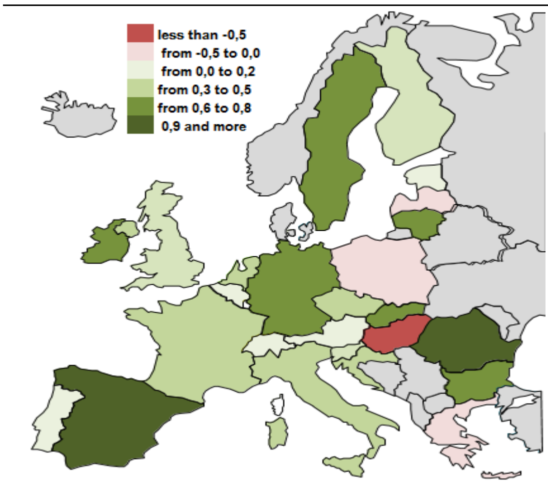
Neighbouring countries outside the eurozone struggle

The neighbouring countries saw weak performances. Hungary has fallen significantly in the first quarter and the Polish economy also dropped slightly. The Czech Republic has grown significantly slower compared to the last year. The first quarter indicated that neighbouring countries will not repeat the last year's strong growths, which were supported by accelerated EU funds absorption.

The growth in the eurozone is not expected to accelerate further. Negative risks for outlook persists

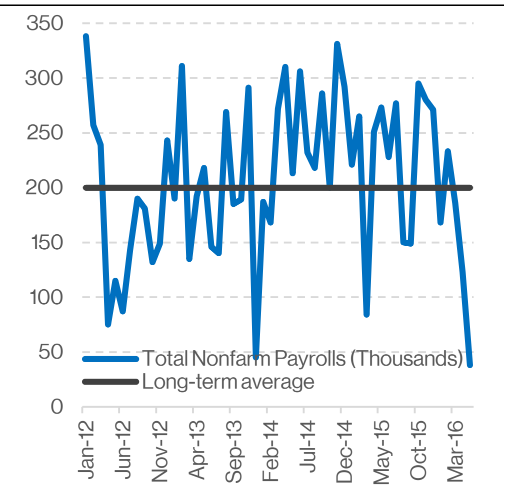
Leading indicators show that growth rate in eurozone will rather stagnate or slow down. Growth of both the eurozone and Germany will remain under 2 per cent this year. Poland and Hungary will return to growth in near future. The Czech economy will continue to expand. The risks are posed by the global economic developments and the escalation of the institutional issues in the eurozone.

Fig. 3: QoQ GDP growth in the EU countries



Source: Eurostat, IFP

Fig. 4: USA stopped adding new jobs



Source: NBER, IFP

Forecast for development in external environment was downgraded

The estimate of the economic growth of Slovakia's main trading partners has been revised slightly downwards. Similarly, the prediction of foreign demand of our European partners has been lowered. The correction was undertaken mainly due to the development in the neighbouring countries (Czech Rep., Poland and Hungary). The revision of the price development reflects the low-inflationary environment in the eurozone. The assumptions related to the external demand were based on the OECD and EC forecasts, taking into account the developments in the first quarter and the very short forecast (nowcasting) in the eurozone. The assumptions related to the external environment, interest rates and commodity prices were based on information available by mid-June 2016.

Table 1: External environment in 2016-2019

	GDP (% growth)					Diff. from February 2016					Import (% growth)					Diff. from February 2016				
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
Important trading partners of SR	2,2	1,9	2,1	2,0	1,9	0,0	-0,3	0,0	0,0	0,0	5,7	5,2	5,0	4,5	4,5	0,0	-0,2	0,1	0,0	0,0
Eurozone*	1,6	1,7	1,7	-	-	0,0	-0,1	0,0	-	-	4,5	3,7	4,5	-	-	0,0	-0,3	0,1	-	-
Germany	1,7	1,6	1,6	-	-	0,0	-0,2	-0,1	-	-	5,3	4,5	5,2	-	-	0,0	-0,6	0,2	-	-
Czech Republic	4,2	2,5	2,7	-	-	0,0	-0,2	-0,1	-	-	8,2	6,5	5,9	-	-	0,0	-0,7	-0,4	-	-
Poland	3,4	3,0	3,4	-	-	0,0	-0,3	0,0	-	-	4,9	6,4	6,5	-	-	0,0	-0,5	-0,2	-	-
Hungary	2,6	2,0	2,5	-	-	0,0	-0,5	0,0	-	-	6,9	5,0	5,1	-	-	0,0	-0,2	0,4	-	-

* Eurozone weighted by volume of Slovak exports

Source: OECD , Bloomberg, IFP

Balanced growth structure in 2016

Slovak economy will grow by more than 3 per cent in 2016 with roughly equal contribution of domestic and foreign demand. The first quarter brought slower growth caused mainly by weaker performance of investment and export. Investment will not repeat the last year's double digit growth. Drop-out of the government investment due to the slower absorption of EU funds, however, will be fully offset by the investment in the private sector with the support of automakers (JLR, VW and PSA) and the construction of Bratislava D4 / R7 bypass. Temporary poor performance of export in the first quarter was affected by strong end of the year.

Household consumption growth at 8-year maximum

Household consumption growth should reach its eight-year peak. Slovak households continue to enjoy positive developments in the labour market and falling prices. At the beginning of the year, though, household consumption continued to grow only moderately. Thus, the pace of household spending will not reach the growth of gross disposable income. The result will be the continuing upward trend of the saving rate.

Gradual acceleration of the economic growth

Economic growth should accelerate to 3.7 per cent in 2017. Export performance as well as the investment activity should improve due to the ongoing construction of JLR, VW factories and highway D4 / R7. Gradual return of inflation should slow real wages dynamics, which should result in the slower pace of households' spending. **In the following years the growth will accelerate towards 4.1 per cent in 2018 and 4.6 per cent in 2019.** Launch of production in factories JLR and VW should boost the export. The pace of investment will decelerate, mainly due to the phasing out of the one-off factors in the automotive industry, as well as the slight drop of public investment in 2018. On the other hand, loose monetary policy will support credit financing, leading growth of so-called core investments[1] getting back to potential growth. Private consumption growth will slightly exceed the disposable income growth on an assumption of a gradual decline of the saving rate.

[1] Investment net of public sector and one-off factors

Fig. 5: Contributions of individual components to GDP growth (p. p.)

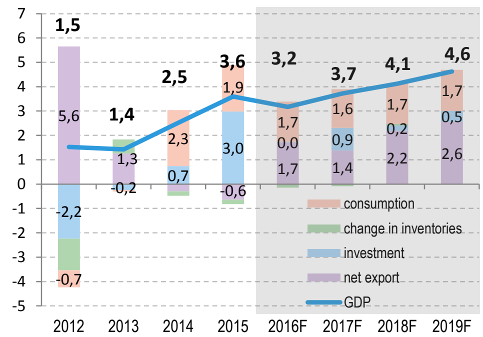
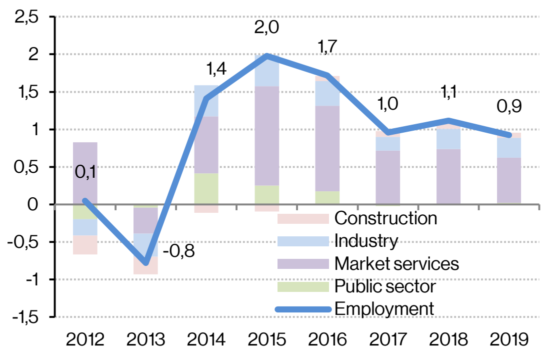


Fig. 6: Contributions to employment growth (in p.p.)



Source: SÚ SR, IFP

Source: IFP

MF SR FORECAST - MAIN ECONOMIC INDICATORS (June 2016)

indicator (growth in % unles otherwise noted)	actual 2015	2016	2017	2018	2019	2016	2017	2018	2019
Gross domestic product									
GDP, real	3,6	3,2	3,7	4,1	4,6	0,0	0,1	0,0	0,0
GDP, nominal (bn €)	78,1	80,4	84,4	89,4	95,5	-0,2	-0,4	-0,8	-0,9
Private consumption, real	2,4	3,1	2,4	2,7	2,9	-0,1	-0,2	0,0	0,0
Private consumption, nominal	2,2	2,7	3,7	4,5	5,0	-0,6	-0,6	-0,3	-0,2
Public consumption	3,4	0,2	1,7	1,3	1,2	0,8	-0,4	0,0	0,4
Fixed investments	14,0	0,1	4,1	0,9	2,0	-0,8	2,7	0,0	0,0
Export of goods and services	7,0	4,2	6,0	7,5	8,5	-0,7	-0,1	0,0	0,0
Import of goods and services	8,2	2,5	5,0	5,8	6,6	-1,1	0,4	0,0	0,0
Labour market									
Employment (registered)	2,1	1,7	1,0	1,1	0,9	0,4	0,1	0,0	0,0
Wages, nominal	2,9	3,2	4,3	4,5	5,1	-0,1	-0,2	-0,2	0,0
Wages, real	3,3	3,4	3,0	2,7	2,9	0,3	0,1	0,2	0,0
Unemployment rate	11,5	9,7	8,7	7,5	6,5	-0,7	-0,8	-0,8	-0,8
Inflation									
CPI	-0,3	-0,3	1,3	1,8	2,1	-0,5	-0,3	-0,3	-0,1

Source: ŠÚ SR, IFP

Unemployment rate down to a one-digit level already in 2016

The labour market continues in a robust growth of 1.7 per cent this year, as 39,000 jobs will be added in the economy. Employment will grow in all the sectors but especially in market services. After many years the construction sector recovers back to growth. In subsequent years a solid growth in employment of about 1 per cent is expected, with a peak in 2018 due to new capacities in the automotive industry. The unemployment rate will fall to 9.7 per cent this year and reach a single digit for the first time since the crisis.

Average wage reaches 911 EUR

The average nominal wage in the economy will grow by 3.2 per cent and reach € 911 this year. At the sectorial level high wage growth (above 4 per cent) is expected in the public sector, industry and construction. On the contrary, wages in the services sector should grow slower compared to other sectors, a development observed already last year. Real wages will rise again at a rate of more than 3 per cent annually, due to low-inflation environment. The dynamics of wages will exceed the growth of productivity till 2018.

Prices will start rising by the year-end

Inflation will grow at the same negative rate as last year. Nevertheless, we expect the inflation to come back to positive numbers by the year-end as the oil and other commodity prices recover. From the beginning of 2016 a mild month-to-month increase can be observed in the food commodities prices (measured by the FAO index). However, this development has not transmitted into the domestic food price dynamics yet. The inflation will be subdued due to energy prices as the gas will become cheaper again in July.

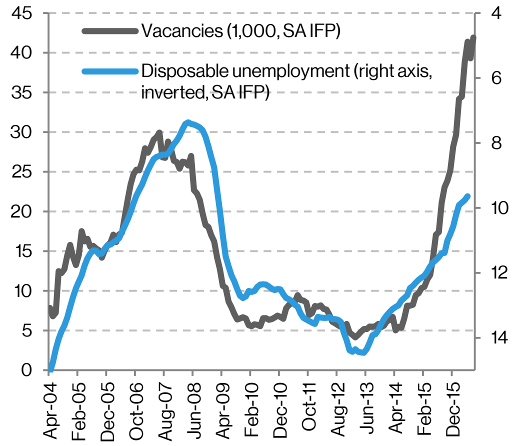
Food prices and services should help inflation to recover

In the upcoming years, the food prices as well as prices of goods and services should accelerate. Based on the development of future contracts, we assume further decline of energy prices by the beginning of 2017. Afterwards, the inflation rate should converge closer to the target level of 2 per cent.

Risks of the macroeconomic forecast are balanced

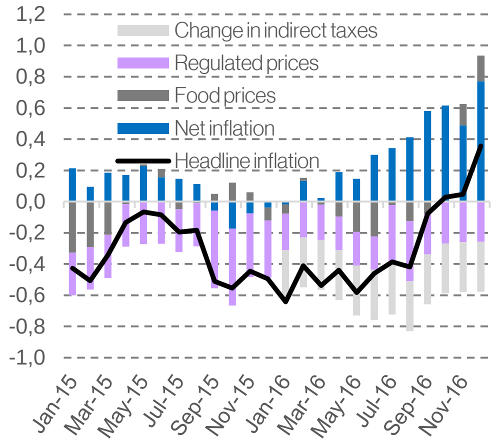
The risks of the macroeconomic forecast are balanced. The most important risk for near term outlook is the Brexit issue. Further risks arises from the performance of US labour market, deepening of the recession in selected emerging markets, migration crisis and potential escalation of the conflict in Ukraine. A positive risk from the external environment is a delayed, yet strengthened, effect of the QE on investment and private consumption in the eurozone. Considering the domestic risks, potential change in the consumer behaviour might further boost the consumption as the level of savings is on the record high. Additional positive risk stems from the tight domestic labour market, which may put pressure on wage growth.

Fig. 7: Development of vacancies and disposable unemployment (with 3 months lag)



Source: SO SR, IFP

Fig. 8: Inflation and contribution of individual components (p.p.)

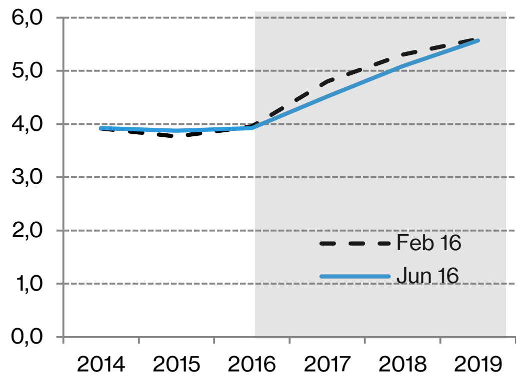


Source: SO SR, IFP

Lower inflation inhibits the growth of tax base

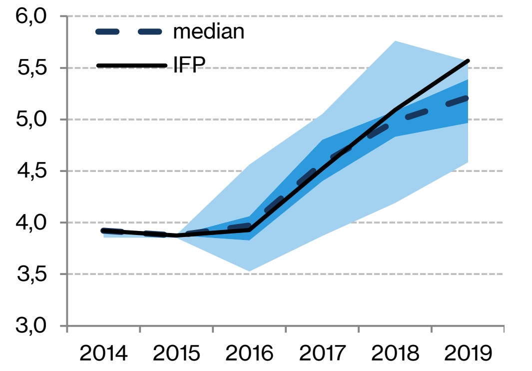
The overall impact of the update of macroeconomic forecast on the tax bases is negative on the entire projection horizon. Positive impact on the tax base growth due to better labour market development throughout all horizon is outweighed by the slower inflation dynamics, which reduces the nominal growth of all economic indicators. The overall impact of the macroeconomic forecast on the estimate of taxes and social contributions will be subject to discussion on the Tax forecast Committee on June 23, 2016.

Fig. 9: Macroeconomic tax bases growth compared to previous forecast



Source: IFP

Fig.10: Comparison of forecasts of macroeconomic bases[2] with the members of the Committee



Source: IFP

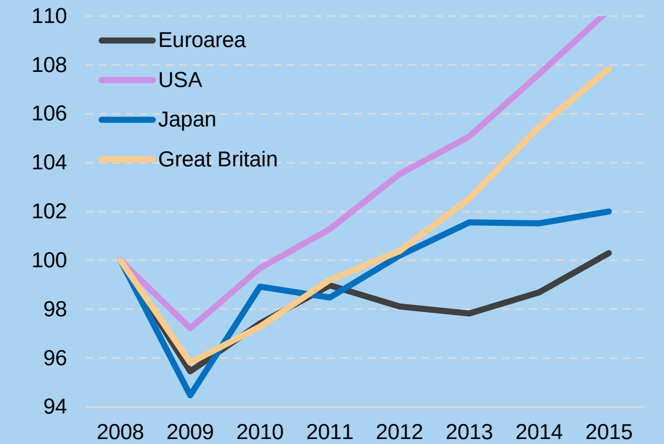
The medium-term forecast prepared by the MF SR was discussed at a session of the Macroeconomic Forecasts Committee on June 15, 2016. The medium-term **forecast was evaluated as realistic by all members of the Committee** (NBS, ČSOB, Infostat, SLSP, Tatrabanka, Unicredit, VÚB a Sberbank). The detailed macroeconomic forecast, as well as the minutes from the meeting and supporting materials are available on the IFP website.

[2] Macroeconomic basis 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%; Nominal private consumption – 25,7%; Real private consumption – 6.6%; Nominal GDP growth – 9.9%; Real GDP growth – 6.7%.

BOX: Low productivity and GDP growth

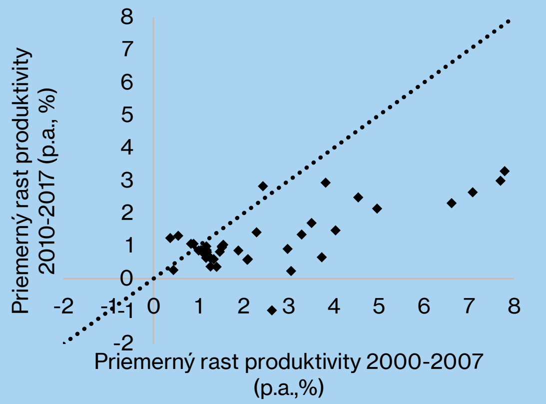
The world economy is experiencing one of the slowest post-crisis recovery (Figure 11). GDP in some euro area countries has not achieve the 2007 levels and the growth lags far behind the pre-crisis trend. International institutions such as the OECD and IMF have identified that the root of this problem is in the low productivity growth (Figure 12). OECD and the IMF warned that the long lasting low productivity growth can undermine the ability of States to reduce public debts and undermine social cohesion[3].

Fig. 11: GDP recovery is extremely slow, especially in eurozone



Index 2008 = 100 *Source: Eurostat*

Fig. 12: Productivity growth slowed down in majority of developed countries (OECD+ EU)



Zdroj: Ameco

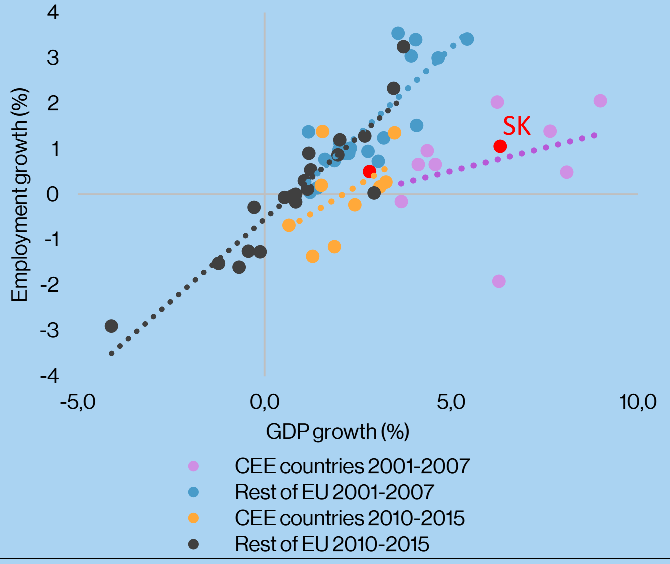
There are two competing hypothesis explaining the poor productivity performance and sluggish GDP growth. The first hypothesis emphasizes the role of structural barriers: aging populations, rigid labour market, a high tax burden, etc. The solution in this case lies in *structural reforms* of the economies. The second hypothesis, on the other hand, focuses on the weak aggregate demand performance. Further, in the environment of zero interest rates and deflation, the short-term effects of demand slack may develop into the *secular stagnation*. A recipe for the economic growth in this case is the *monetary and fiscal stimulus*, which would increase spending, wages and inflation. Ambition of this box is not to resolve the dispute, but only to point out an interesting fact.

The relationship between GDP and employment growth (i.e. modified Okun law) did not change in the Western Europe after the crisis (Figure 13). Moreover, there is no unit elasticity, but with the change in GDP by 1 p. p. employment changes only by 0.75 p. p. Thus, the post-crisis economic slowdown has caused only a mild changes in the employment and as a consequence it lowered also the productivity growth. This suggests that sluggish productivity growth may be rather a *result* of our economic problems and not their cause.

Conversely, the employment-to-GDP relationship in the converging CEE countries (V4, Slovenia, Baltic states, Romania and Bulgaria) changed significantly after the crisis. While before the crisis the relatively high GDP growth lead only to moderate changes in employment, after the crisis the relationship is more balanced. The reason for such a change may be due to large inflows of high-productive FDIs in the pre-crisis period, which became scarce nowadays.

[3] See de Bromhead, Eichengreen, O'Rourke, 2012: Right-Wing Political Extermism in the Great Depression. NBER

Fig. 13 : Relation between GDP and employment growth in the EU countries



Source: Eurostat, IFP