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Four per cent economic growth expected next year

Macroeconomic forecast for 2016 – 2020

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The Slovak economy will expand by 3.3 per cent this year, driven by both private consumption and foreign demand. The labour market will create over 42 thousand new jobs and the unemployment rate is set to decline further. Next year, growth will accelerate to 4 per cent, owing chiefly to investments in the automotive sector. Dynamic growth in real wages and employment will further buttress growth. Risks to the outlook stem from increasing global geopolitical tensions, hard Brexit and the rise of protectionism.

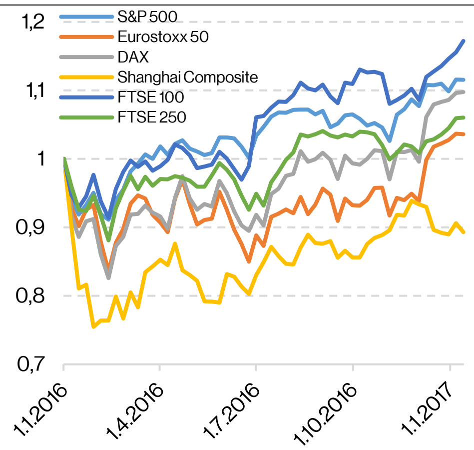
The ECB has recalibrated its QE programme

US monetary policy will continue to normalise. The Federal Reserve has indicated two interest rate hikes this year, while the first one is expected in June. Robust labour market and rising inflation expectations, as well as the planned fiscal stimulus of the new US administration jointly support normalisation of the US monetary policy stance. In the meantime, **the European central bank (ECB) has recalibrated its quantitative easing (QE) programme,** by lowering the amount of monthly asset purchases to 60bn from 80bn EUR and extending the programme by nine months beyond the planned horizon in March 2017. Since the current underlying inflation pressures stem mainly from energy prices, ECB is unlikely to change its monetary policy course in the first half of the year.

European government bond yields on an upward path

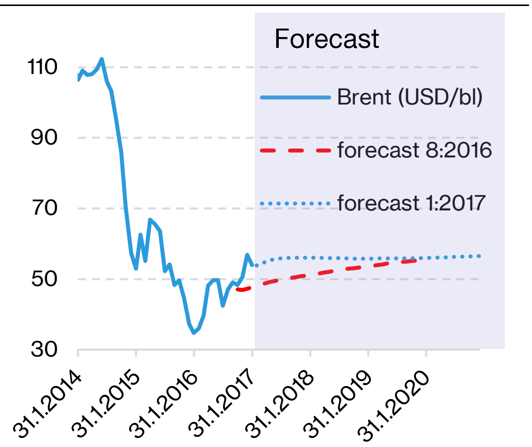
European markets gained in response to the US election results, with the exception of China (Figure 1). Yet, a new wave of protectionism might offset short-term gains in the long run. British pound has plunged to historical lows, trading within the band from 1.2 to 1.27 against the US dollar. European government bond yields have risen due to elevated inflation expectations and on the back of uncertainty surrounding the outcome of the upcoming elections in Germany, France and Netherlands. **The long awaited OPEC agreement in November last year has stabilised the price of oil at 55 dollars for a barrel** (Figure 2), thus reducing the slope of the forecasted oil price in the medium term.

Fig. 1: Soaring stock markets



Source: Bloomberg

Fig. 2: Brent price stabilised



Source: Bloomberg

Euro area growth proved resilient

The global economy continued to expand despite intensifying geopolitical risks. The growth momentum in the euro area proved resilient to weakness in global trade, the unemployment rate had declined under 10 per cent. The expansion continued in the US economy as well pushing up the dollar index to its 15-year high (Figure 4). On the other hand, Japanese real economic activity has continued to show weakness. Emerging market economies stabilised with mild positive signs underway. Russia has continued to contract in the third quarter of 2016, albeit at a slower pace than in the previous quarters. Oil-exporters are expected to emerge out of recessions in the foreseeable future, assisted by higher oil prices following the OPEC agreement. The Chinese economy has continued to grow at a robust pace, but is expected to decelerate slightly over the medium term.

The UK economy grew on a robust pace year-end, despite Brexit

The euro area real economy expanded in the third quarter of 2016 at a steady 0.3 per cent in line with expectations. The growth was underpinned by domestic demand, while net exports contributed negatively. France, however, continued to stagnate on the back of subdued domestic demand. Conversely, growth in Italy surprised to the upside when it outpaced Germany. Spanish economy keeps recovering and the UK economy proved resilient to Brexit so far.

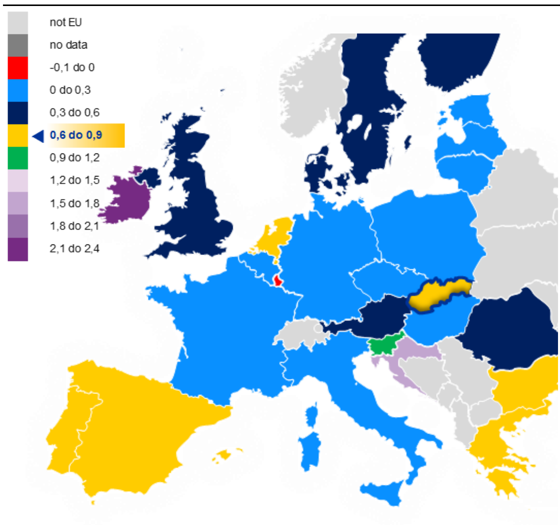
V3 growth disappointing, dragged down by investment

The V3 economies slowed more than expected towards the end of 2016, dragged down by a slowdown in investment stemming from EU structural funds. The Czech Republic was in addition adversely affected by weak net exports. The region is expected to regain its growth momentum later this year, depending on national policies and the ability to effectively absorb EU funds from the new programming period.

...Slovak economy likely to outperform its peers

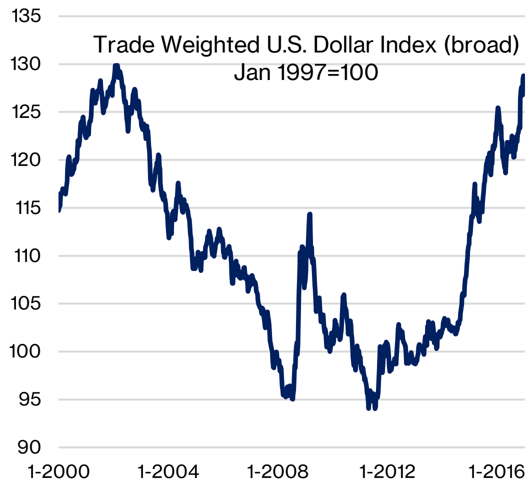
Euro area confidence indicators and survey data have risen to levels not seen in several years, suggesting acceleration in the upcoming quarters. The German economy is set to exceed 1.5 per cent growth this year, while Italy is expected to gain less than 1 per cent. Growth in the V3 region will be subdued at around 2.5 per cent, placing the Slovak pace of expansion at the forefront in the region.

Fig 3: Quarterly GDP growth in EU countries



Source: Eurostat, IFP

Fig 4: US dollar index hits 15-year high



Source: FRED, IFP

External environment forecast broadly unchanged

The weighted GDP growth of Slovakia's major trading partners remains unchanged over the forecast horizon compared to the September 2016 forecast. In 2016 and 2017 a stronger-than-expected performance of the German economy (and later euro area) compensates the disappointing V3 performance. **Moreover, the import performance of Slovakia's major trading partners (except for Poland and Hungary) has been dampened**

by weak global trade in 2016. Aggregate foreign demand has been therefore revised down in 2016 and 2017 by 0.4 p.p. and 0.2 p.p., respectively. Assumptions covering the external environment, interest rates and commodity prices are based on information available by the mid-January 2017.

Table 1: External environment in 2016 – 2020

	GDP (per cent growth)					Diff. from September 2016					Import (per cent growth)					Diff. from September 2016				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
Important trading partners of SR	**1,9**	**2,0**	**1,9**	**1,9**	**1,8**	**0,0**	**0,0**	**0,0**	**0,0**	**-**	**4,8**	**4,6**	**4,4**	**4,5**	**4,5**	**-0,4**	**-0,2**	**0,0**	**0,0**	**-**
Eurozone*	1,7	1,6	1,5	-	-	0,0	0,1	-	-	-	3,4	4,1	3,6	-	-	-0,3	0,1	-	-	-
Germany	1,8	1,7	1,6	-	-	0,2	0,3	-	-	-	3,4	4,4	3,5	-	-	-0,8	-0,3	-	-	-
Czech Republic	2,4	2,5	2,6	-	-	-0,1	-0,2	-	-	-	3,9	5,1	5,4	-	-	-2,8	-0,8	-	-	-
Poland	2,4	2,6	2,8	-	-	-0,8	-0,8	-	-	-	8,2	5,1	5,2	-	-	1,6	-1,3	-	-	-
Hungary	1,6	2,4	2,3	-	-	-0,6	-0,1	-	-	-	8,1	4,8	4,9	-	-	2,8	-0,3	-	-	-

* Eurozone weighted by volume of Slovak exports

Source: OECD , Bloomberg, IFP

Household consumption at a 8-year maximum

The Slovak economy expanded by solid 3.3 per cent in 2016. For the first time in the past two years net exports weighed positively on growth, alongside private consumption. The pace of growth decelerated on the back of lower rate of EU funds absorption in the new programming period. Gross fixed capital formation dropped by 7 per cent as a result. Additionally, the planned construction of JLR plant and D4/R7 highway has been postponed to the first quarter of 2017 from last year. **On the upside, household consumption has grown the fastest since 2008 due to the improving labour market and falling prices.** Nevertheless, export is unlikely to return to its all-time high seen in 2015, as even an exceptional activity in the automotive industry was unable to offset the slowdown in V3 economies.

Economy will grow at 3.3 per cent this year

The Slovak economy will uphold its pace of expansion at 3.3 per cent this year with a broad-based structure, driven by both domestic and foreign demand. The growth of household income and consumption expenditures will be slightly dampened by the normalisation in inflation. Investment will be propelled by the public sector, automotive industry and the construction of the aforementioned D4/R7 highway. In the meantime, the recovery in private "core[1]" investment is expected to remain subdued. Exports are set to accelerate and even exceed the dynamics of foreign demand. However, the expected surge in import-intensive investments will also increase imports, ultimately leading to a lower contribution of net export to GDP.

Automotive sector will boost the economy in 2018 and 2019

In 2018 and 2019, growth will intensify owing to the new production capacities, at 4 and 4.3 per cent respectively. A delay in the construction of JLR plant and D4/R7 highway will provide a boost to gross fixed capital formation next year. The launch of new production capacities will translate into intensified export performance, foreseen at about 7 per cent each year. Private consumption dynamics will be supported by household income growth. Output growth will ease off towards its long-term potential at the end of the medium-term forecast horizon.

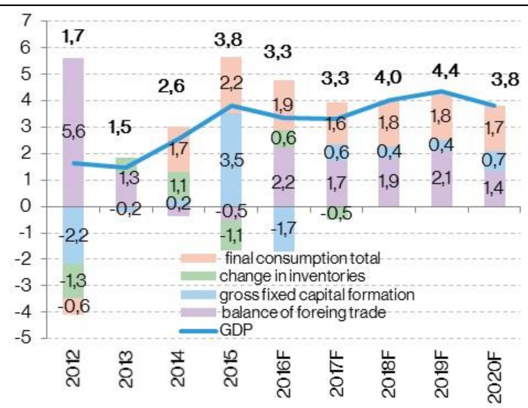
[1] Adjusted for large preannounced investment projects

MF SR FORECAST - MAIN ECONOMIC INDICATORS (February 2016)

indicator (growth in % unles otherwise noted)	actual	forecast					diff. from Sep 2016			
	2015	2016	2017	2018	2019	2020	2016	2017	2018	2019
Gross domestic product										
GDP, real	3,8	3,3	3,3	4,0	4,4	3,8	-0,3	-0,2	0,1	0,0
GDP, nominal (bn €)	78,7	81,0	84,6	89,4	95,1	100,7	0,5	0,6	0,9	0,9
Private consumption, real	2,2	2,7	2,5	2,7	2,9	2,9	-0,2	0,0	0,0	0,0
Private consumption, nominal	2,1	2,3	3,6	4,4	4,8	5,1	-0,1	0,2	0,0	-0,1
Public consumption	5,4	2,6	1,6	2,0	1,9	1,4	0,8	-0,1	0,7	0,8
Fixed investments	16,9	-7,2	3,0	1,9	2,0	3,6	-7,1	-1,0	1,4	0,0
Export of goods and services	7,0	4,4	5,6	7,3	7,7	6,2	-1,1	-0,2	0,0	0,0
Import of goods and services	8,1	2,3	4,2	6,0	6,3	5,5	-1,9	-0,7	0,2	0,0
Labor market										
Employment (registered)	2,1	2,4	1,8	1,1	0,9	0,9	0,3	0,3	0,0	0,0
Wages, nominal	2,9	3,1	3,5	4,4	4,8	5,1	0,3	0,0	0,1	0,0
Wages, real	3,3	3,6	2,4	2,6	2,9	2,9	0,3	-0,2	-0,1	0,1
Unemployment rate	11,5	9,7	8,4	7,6	6,9	6,2	-0,1	-0,1	0,2	0,5
Inflation										
CPI	-0,3	-0,5	1,1	1,7	1,9	2,1	0,0	0,2	0,1	0,0

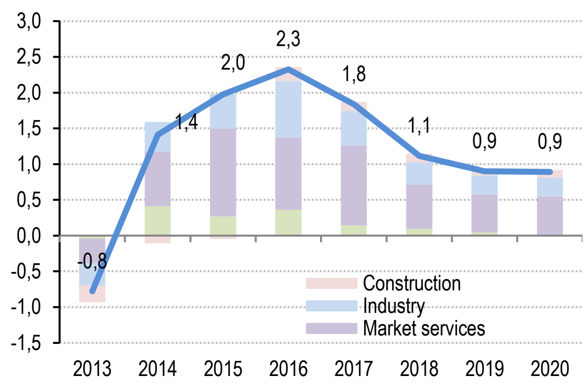
Source: SO SR, IFP

Graf 5: Contributions to GDP (p.p.)



Source: SO SR, IFP

Graf 6: Contributions of sectors to employment growth (p.p)



Source: SO SR, IFP

Employment continues to surprise to the upside

Labour market conditions remain favourable. Employment gains are estimated at 1.8 per cent this year and 1.1 per cent next year. Additionally, over 42 thousand new jobs should be added to the economy in 2017, with 26 thousand generated in the services sector and new jobs springing up also in the recovering construction sector. **The improved labour market will lower the unemployment rate to 8.4 per cent this year.** Unemployment rate will decline at a slower pace at the end of the forecast horizon, owing to an increase in the active population towards the end of the medium-term.

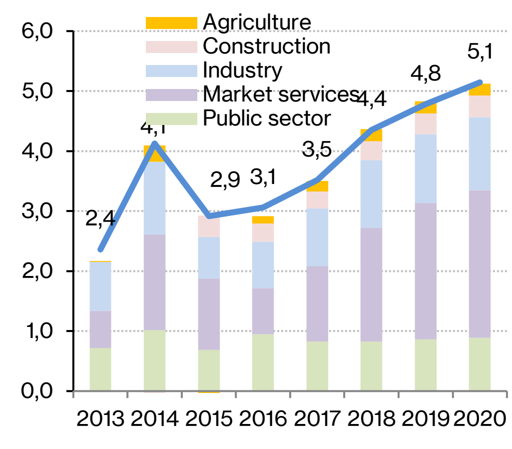
Nominal wage growth at 3.5 per cent

Turning to nominal developments, **the average nominal wage will grow by 3.5 per cent this year.** Average monthly nominal salary is expected to reach 942 EUR for the economy as a whole. Nominal wages should gain across all sectors evenly with the exception of market services, and growth should pick up further to 5 per cent at the end of the forecast horizon. **Real wage growth will settle at about 2.4 per cent this year, and accelerate to 3 per cent in the years to follow.**

Inflation back on track

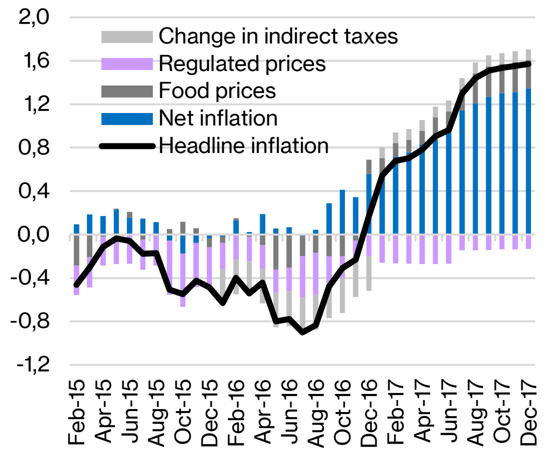
Headline inflation seems to have finally bottomed out, venturing back to the positive territory in recent months. This trend is set to continue throughout 2017, with price growth foreseen at 1.1 per cent, driven mainly by net inflation and energy prices. Higher oil prices – a courtesy of OPEC deal in November last year – will prop up prices of fuel, with second round effects on prices of food and services. Regulated prices will continue to have a dampening effect on the overall price level.

Fig. 7: Contributions of sectors to wage growth (p.p)



Source: SO SR, IFP

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



Source: SO SR, IFP

Towards 2 per cent

We expect that inflation will be driven additionally by intensifying demand-pull pressures in the foreseeable future, exerting commensurate upward pressure on wage growth. Across sectors, prices of market services will expand at the fastest pace. Besides demand-pull factors, energy prices (with gas and heat at the forefront) are expected to rise further, owing to future contracts on European commodity markets. **Inflation is expected to approach the 2 per cent level at the end of 2019.** Inflation will accelerate further thereafter, in line with the expected convergence of the Slovak economy towards the end of the forecast horizon.

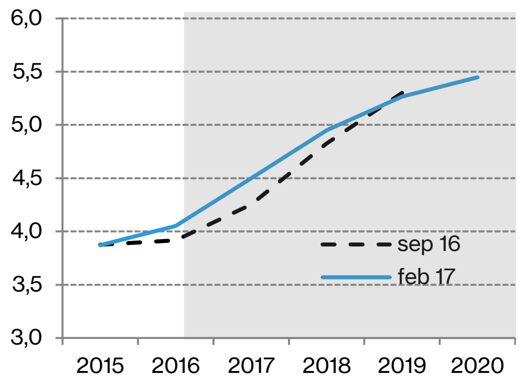
Downside risks dominate

Heightened **political uncertainty in Europe** (courtesy of the upcoming elections in the Netherlands, France and Germany), the rising likelihood of the **"Hard Brexit" scenario**, as well as the rise of anti-globalisation sentiment and **global protectionism** all **pose downside risks to the current forecast.** The unpredictability of the future political steps makes the quantification of those risks impossible. On the other hand, the planned fiscal expansion in the US, as well as an earlier exit from the Czech koruna exchange rate floor against the euro **pose upside risks to the current forecast**. Domestically, upside risks prevail, as the overheating of the labour market may provide additional pressure on wage growth in the private sector, leading to a higher-than-expected inflation.

Labour market pulling up the tax bases

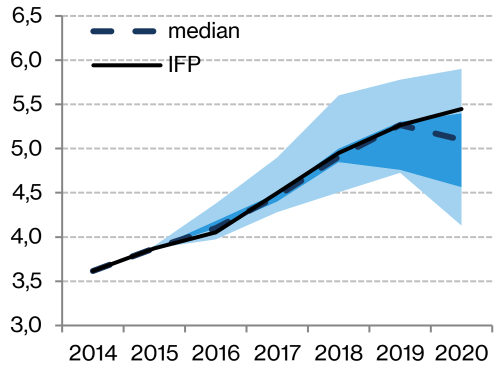
The overall impact of the macroeconomic forecast update on tax bases is favourable, as the upward revision of the labour market outlook compensates for weaker VAT and CIT base growth in 2016 and 2017. Higher projected GDP growth and inflation in 2018 furthermore weigh favourably on these tax bases. The overall impact of the present macroeconomic forecast on the tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee meeting held on February 9, 2017.

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 Macroeconomic Forecasts Committee



Source: IFP

Forecast evaluated as realistic by all Committee members

The medium-term forecast prepared by the MF SR was discussed at the Macroeconomic Forecasts Committee on February 1st, 2017. **The medium-term forecast was evaluated as realistic by all members of the Committee** (NBS, ČSOB, Infostat, SLSP, Tatrabanka, Unicredit, VÚB, SAV and 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 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.