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The economy has bottomed out

Macroeconomic forecast for years 2020 – 2023

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The global pandemic will decrease Slovak output by 6.7 per cent in 2020. Both domestic and foreign demand slump. The labour market weakened, though it turned out to be more resilient than expected. Consequently, the households' consumption will decrease only mildly. In the second half of the year, economic activity will resume owing to the export-oriented industry. The economic recovery will continue in 2021 as GDP is expected to grow by 5.5 per cent. The main risks include the recurrence of the disease and further restrictions to economic activity. On the other hand, resources from the European Recovery and Resilience Plan would provide additional stimulus to the economy in the medium-term horizon.

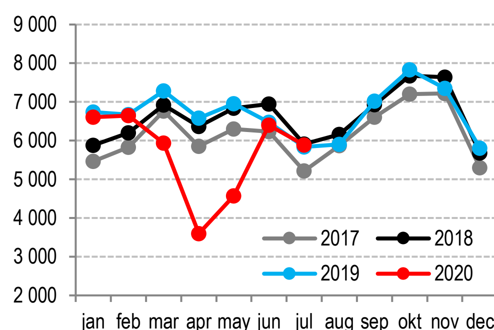
The recession will be milder thanks to a more resilient labour market

The Slovak economy will decrease by 6.7 per cent due to the corona crisis. The significant economic decline during the first half of the year was propelled by weak domestic and foreign demand. Economic activity reached its trough in the second quarter, when industrial production sunk to its historic lows. Yet, the outlook is brighter than in previous forecasts. First, the labour market has so far proved to be more resilient, thus supporting households' consumption and retail sales. Second, foreign demand recovered faster than expected, boosting Slovak exports already in June.

Recovery will be more pronounced due to a faster revival of industrial production

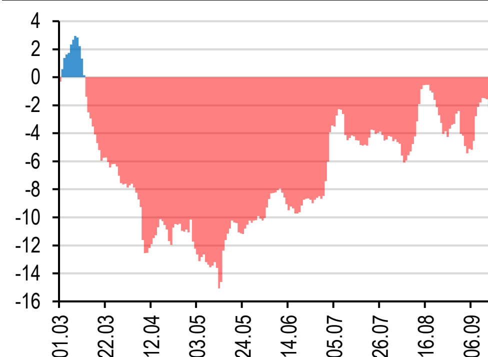
After easing of restrictions, the economy will partly recover in the second half of the year. Car production will resume after a steep decline. Data on electricity consumption and heavy traffic had fully recovered by the summer, signalling a recovery in other industries as well. Increases in eKasa turnover indicate solid growth in households' consumption. The summer season had helped the hospitality sector, yet business tourism will likely continue to lag behind. Elevated uncertainty surrounding the future development of the pandemic will lead to more cautious investment dynamics and hence weaker development in the construction sector.

Chart 1: Export of goods had reached last year's levels by summer (mil. EUR)



Source: ŠÚ SR, IFP

Chart 2: Electricity consumption has recovered (year-on-year change in %)



Source: SESP, IFP

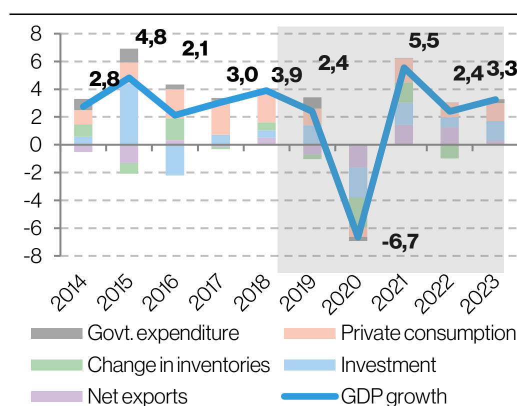
With a milder fall in output, the economic recovery will be more subtle and GDP will rise by 5.5 per cent in 2021. Both household consumption and foreign demand will be on a recovery path. Output will be significantly below its potential with plenty of slack in the economy. In public finances, we expect a decrease in the structural deficit by 0.5 per cent of GDP between 2022 and 2023. This too will dampen economic growth which is projected to

reach 2.4 per cent in 2022. The last minute drawing of EU funds will help investment and GDP at the end of the forecast horizon.

The risks of the forecast are negative

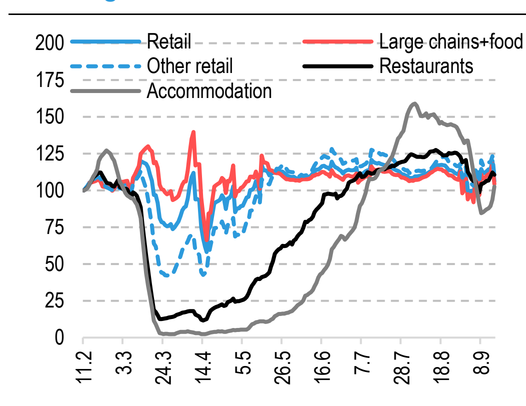
The risks of the forecast are negative mainly on the short-term horizon. The increasing number of new cases during a second wave in many countries may lead to the re-imposition of stricter restrictive measures, which would slow economic activity. However, we presume that new measures will be more effective and targeted than during the first wave and would therefore be relatively less contractionary (Box 2). **The main positive risks of the forecast** are the additional resources from the EU Recovery and Resilience Plan, which, after approval, could support economic growth from 2022 onwards. The invention of a vaccine would be another significant positive impulse for the economy.

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



Source: ŠÚ SR, IFP

Figure 4: Sales in restaurants and accommodation have gradually recovered since the lifting of restrictions



Note: 7-day averages indexed to the beginning of Feb.
Source: eKasa, FSSR, IFP

Employment suffers, yet the outlook improves

Employment will decrease in 2020, cutting 38 thousand jobs. Nevertheless, this is a far better result compared to previous projection. The labour market proved to be more resilient during the pandemic owing partly to government measures enabling short-term work (the so-called *Kurzarbeit*). However, the crisis will cut jobs mainly in service sector (tourism, restaurant, retail and transport), as well as in the manufacturing. **The unemployment rate will rise to 6.8 per cent in 2020** and gradually decline thereafter. We expect the labour market to start gradually recovering in the second half of 2020, though pre-crisis levels of employment will only be reached at the end of the forecasting horizon.

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

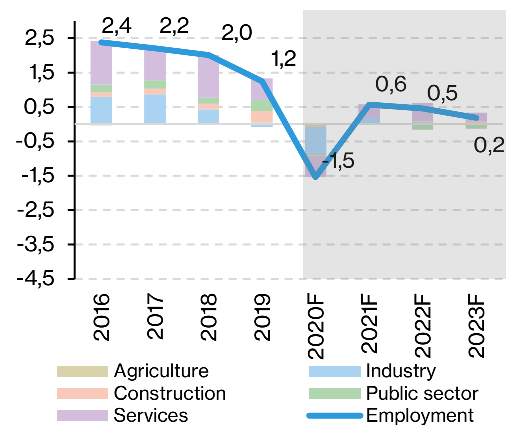
Wage growth will ease off in 2020 and the average nominal wage will rise by 2.6 per cent. Wage growth will be dampened by a large number of recipients of nursing and sickness benefits, as well as by lower income from short-time work.[1] Wage dynamics is set to recover in the coming years on the backdrop of labour market strengthening. The need for fiscal consolidation will also affect the labour market and will have a negative impact on wage development, mainly in the public sector.

The slump in oil prices will dampen inflation pressures in 2020

[1] Data from the second quarter of 2020 confirm this assumption, as wages decreased 1.2 per cent year-on-year. Wage substitution transfers paid out to recipients of nursing and sickness benefits are not included in their wage, while recipients continue to be registered as employed. A significant increase in the number of recipients in both categories will, statistically speaking, result in slower average wage growth (paid out wages in the numerator decline, while the number of employed persons in the denominator remains unchanged). Workers included in the short-time work scheme also contributed to the decline in average wage, as employers received transfers that partially covered wage expenses and employees received lower wages than usual.

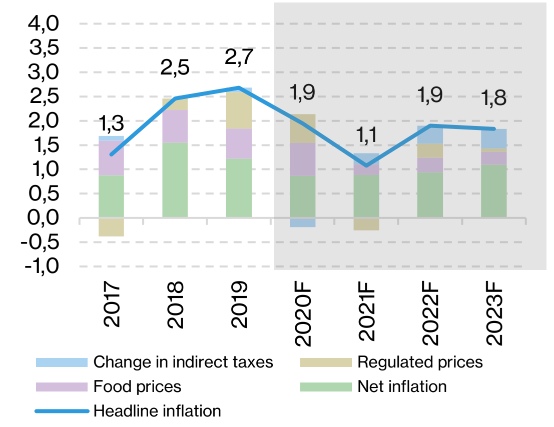
Inflation is projected to slow to 1.9 per cent in 2020. The cool-off is mainly driven by a slump in oil prices and lower global demand for mobility. Lower prices of oil will also dampen food prices in the second half of the year, due to lower input prices in agriculture. On the other hand, food prices increased under the lockdown due to poor harvest as well as rising demand concentrated in supermarkets. Prices of services and tradeable goods are set to respond to the economic downturn with delay. Regulated prices have been affected by the increase in electricity prices since January this year.

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



Source: ŠÚ SR, IFP

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



Source: ŠÚ SR, IFP

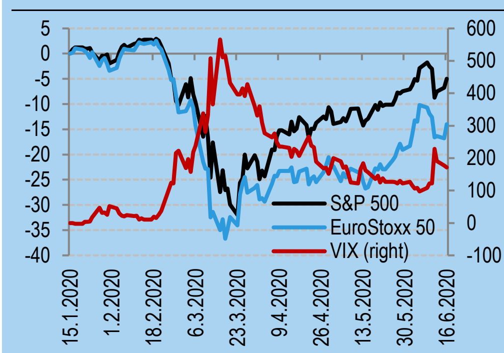
In the medium term, inflation will be dampened by fiscal consolidation

Price growth is expected to decrease to 1.1 per cent next year. Low oil prices and development of energy commodity futures contracts indicate a decline in regulated energy prices. This will be accompanied by slower price growth of goods and services due to an economic downturn and the cyclical position of the economy. The cancellation of free school meals and the increase of tobacco taxes next year will push price growth upwards by approximately 0.4 p.p. In the medium term, price growth is projected to stay below 2 per cent due to the expected slowdown of economic activity caused by fiscal consolidation.

BOX 1: External environment assumptions

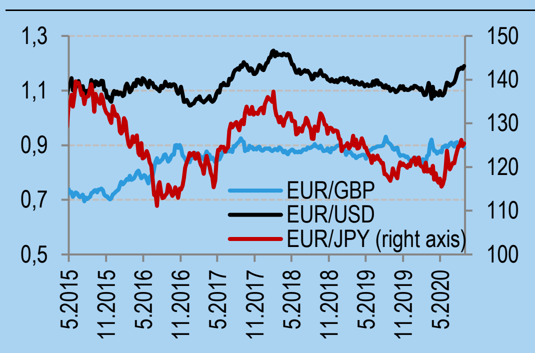
Since their fall in March, financial markets have maintained their bullish trend, abating previous losses and reaching new historical highs (*Figure A)*. The reason behind the positive sentiment among investors could be the promise of extensive fiscal and monetary stimulus, as well as low yields on the bond market, contributing to an increased appetite for risk. Tech giants are proving to be the winners of corona crisis thus far, as their stock prices have risen sharply. Indicators of uncertainty have stabilised despite the resurgence of new daily COVID-19 cases in several regions, protests in the US, the upcoming US presidential elections, increased tension between Washington and Beijing, or the uncertain final outcome of Brexit. The worries of the ECB are exacerbated by the significant appreciation of the euro relative to the US dollar that took place over the summer, which could push inflation down (*Figure B*). More brisk recovery in Europe may have contributed to the increase in the common currency's value. **The price of Brent oil has increased to 46 USD/bl since the drop in March, though it still remains at relatively low levels.** We expect a gradual increase to 50 USD/bl within the forecast horizon.

Figure A: Stock indices abated most of their losses from March (15 Jan = 100)



Source: Bloomberg, IFP

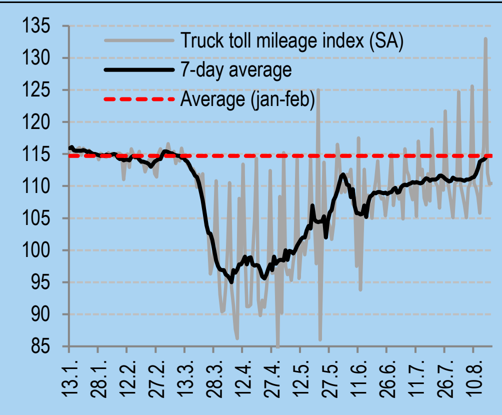
Figure B: The Euro has significantly appreciated against the dollar in summer 2020



Source: Bloomberg, IFP

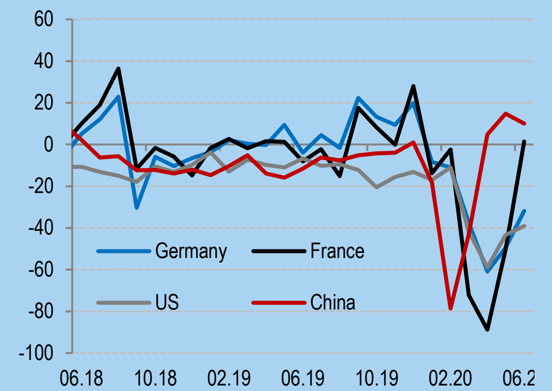
European economies fell into a deep recession in the second quarter of 2020, which was mainly due to weak household consumption and, only to a lesser extent, a fall in foreign demand. The corona crisis mainly hit the hospitality sectors and the aviation industry. The recession has negatively affected the automobile industry, which is crucial for many European economies, and industrial production hence fell more significantly in countries with a higher share of car production on overall industry. On the bright side, the fall in imports of our trading partners in the second quarter was much less significant than previously expected. Most indicators point to a brisk recovery, which should translate into faster economic growth in the third quarter. Truck toll mileage in Germany has reached pre-crisis levels, indicating higher industrial activity (*Figure C*). Car registrations are recovering rapidly in most European countries (*Figure D*) and retail sales continued their recovery in July.

Figure C: Truck toll mileage index for Germany



Source: DeStatis, IFP

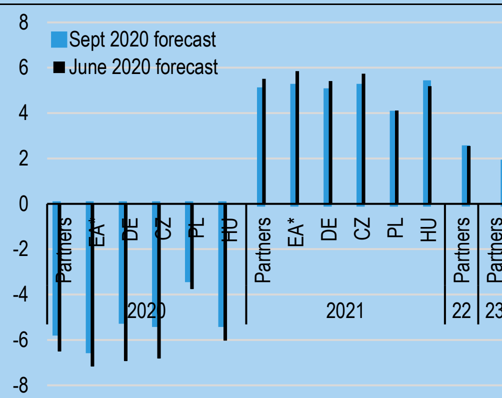
Figure D: Car registrations of main trading partners (year-on-year change in %)



Source: acea.be, IFP

Conjunctural survey readings indicate a solid recovery which could be stronger than previously expected. Economic Sentiment Indicators (ESI) in the euro area, as well as the Purchasing Managers' Index (PMI) point to good performance of the German economy, which has most likely returned to its pre-crisis trajectory. The indicators, however, suggest a milder recovery in services, which can be subdued due to changing consumer preferences. Favourable results for V3 countries in the second quarter, accompanied by a robust recovery, will likely lead to lower economic costs than projected in the June forecast. Consequently, we revise our forecasts of imports and GDP for our main trading partners in 2020 upward, with a somewhat slower growth next year (*Figures E and F*). The cut-off date for external environment assumptions, including interest rates, commodity prices, and exchange rates, was September 1st, 2020.

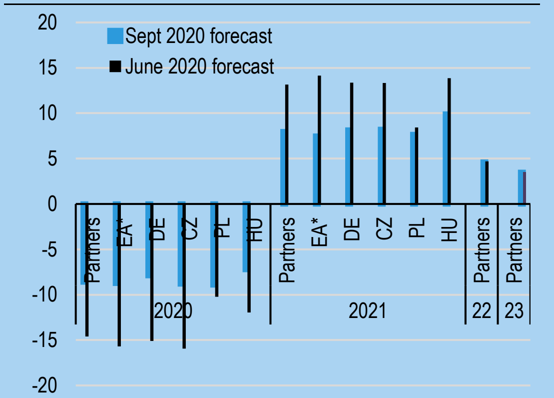
Figure E: GDP growth forecast of the external environment



*Export-weighted euro area

Source: IFP

Figure F: Import growth forecast of the external environment

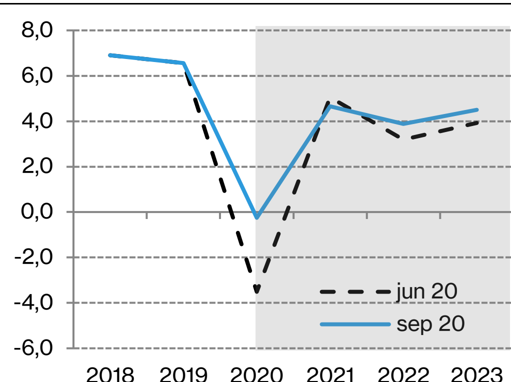


*Export-weighted euro area

Source: IFP

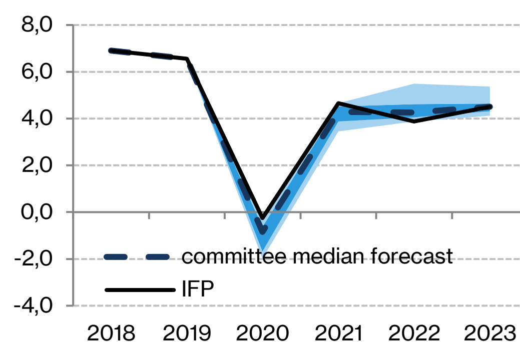
The overall impact of the update of macroeconomic forecast on tax bases is positive. A milder recession with higher output, employment, household consumption and inflation, are the main reasons behind the increase in macroeconomic bases. The overall impact of the macroeconomic forecast on tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee's meeting held on September 24th, 2020.

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



Sources:: IFP

Figure 8: Comparison of forecasts of macroeconomic tax bases[2] by members of the Macroeconomic Forecast Committee



Sources: IFP

The medium-term forecast prepared by the Ministry of Finance was discussed at the Macroeconomic Forecast Committee's meeting held on September 16th, 2020. **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.

BOX 2: The risk of recurrent restrictions of economic activity

A strong negative risk of the forecast is a second wave of the disease, which could lead to another set of measures restricting economic activity. Yet, after the experience with the first wave, we assume the impact of the new measures could be milder on the domestic and global economy thanks to more targeted and efficient restrictions. New restrictive measures would pull down the Slovak economy back into the recession in the fourth quarter of 2020. GDP would consequently fall by 8.4 per cent in 2020, and the rate of economic recovery in 2021 would only reach 4.3 per cent. The labour market losses would be more profound and the employment would not rise until 2023.

The daily numbers of new COVID-19 cases have recently been rising in Slovakia and the neighbouring countries, supporting the hypothesis of a second wave of the coronavirus pandemic. A key assumption of the risk scenario is that countries have learned from the first wave of the pandemic and will consequently introduce more targeted measures which will be less economically demanding. According to the risk scenario, the new wave of closures of European economies would exhibit its impact in the last quarter of 2020, yet we project a milder fall in output than in the second quarter. **A second wave of restrictive measures would push down the weighted GDP of Slovakia's trading partners by 2.3 per cent in 2020, relative to the baseline scenario.** Economic activity would start to recover in the first quarter of 2021. We predict weaker quarterly growth rates thereafter, moving the European regional economy to its potential level.

[2] 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 %..

In case of new measures restricting the economic activity, the real GDP of Slovakia would decline by 8.4 per cent. The structure of the fall of output would be similar to that in the second quarter. Exports would be affected the most through foreign demand, while the fall in domestic demand would be somewhat milder. The uncertainty surrounding future developments would have a negative effect on overall investment. **A second wave of the disease would also affect growth in 2021, with output growing by 4.3 per cent**, compared to a growth rate of 5.5 per cent in the baseline scenario. While overall unemployment this year would only be lower by 0.1 per cent, long-term consequences would have a continued impact on the labour market in 2021, as well as in 2022, when employment would decrease further by 0.6 per cent. Employment would not start growing until 2023, when it is projected to grow by 0.2 per cent.

BOX 3: Drawing resources from the Recovery and Resilience Plan

The European Recovery and Resilience Plan would be a positive impulse for the economy. The utilisation of these additional resources could significantly boost the Slovak economy through the creation of new employment opportunities and productive investments. The economic recovery after the pandemic would speed up and the growth rate could increase to 3.9 per cent in 2022 and 4.3 per cent in 2023. The Recovery and Resilience Plan would have a positive effect on consumption and private investment, as well as labour market recovery.

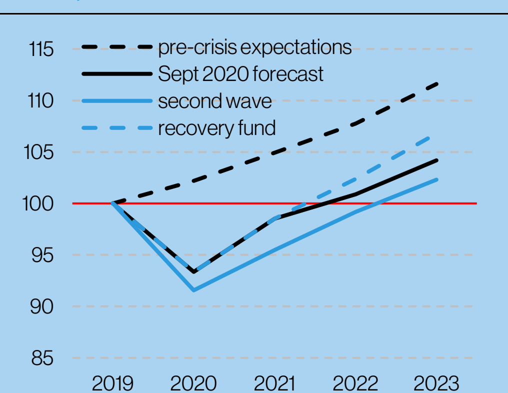
In our scenario, we assume that 5.8 billion EUR will be drawn from the Recovery and Resilience Plan between 2022 and 2024. Of these resources, 1 bn. EUR would be used for the creation and maintenance of employment opportunities, while 4.8 bn. EUR would be invested in the public sector. The scenario assumes the division of resources among individual years as outlined in Table 1. The division is only arbitrary, as the allocation of resources is yet to be decided.

Drawing resources from the Recovery and Resilience Facility

Nominal values in bn. EUR	2022	2023	2024
Public sector compensation	500	400	100
Public sector investment	900	1700	2200

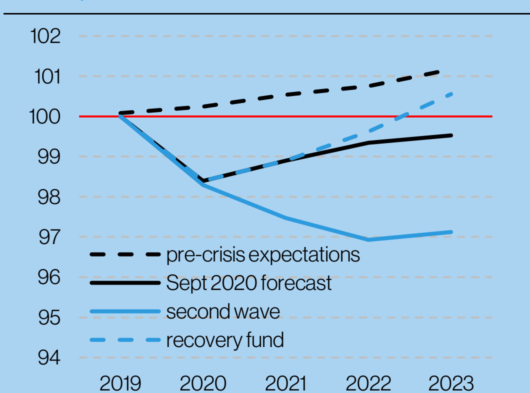
The Recovery and Resilience Plan will boost GDP growth and output is projected to increase by 3.9 per cent in 2022 and 4.3 per cent in 2023. Apart from additional government spending and investment, these resources will contribute to a faster recovery of the private sector and the labour market. Unemployment will reach pre-crisis levels by the end of 2022, when it will grow by 0.2 p.p. faster than in the baseline scenario. In 2023, employment growth will be 0.7 p.p. higher relative to the baseline scenario, as, following the public sector, employment in the private sector will also react to the stimulus.

Slovak GDP in the baseline and risk scenarios (index, 2019=100)



Source: IFP

Employment in baseline and risk scenarios (index, 2019=100)



Source: IFP

MF SR FORECAST – MACROECONOMIC INDIACTORS (Sep 2020)

indicator		forecast				difference from Jun 2020			
(growth in %, unless otherwise noted)	2019	2020	2021	2022	2023	2020	2021	2022	2023
Gross domestic product									
GDP, real	2,4	-6,7	5,5	2,4	3,3	3,1	-2,1	0,6	-0,2
GDP, nominal (bn. €)	94,2	89,6	95,7	99,9	105,3	3,1	2,2	3,3	4,4
Private consumption, real	2,1	-1,2	3,0	1,8	2,3	5,8	-2,4	0,4	-0,1
Private consumption, nominal	4,9	1,0	4,1	3,7	4,1	6,3	-1,4	0,9	0,6
Public consumption	4,6	-1,7	0,0	0,2	1,6	-3,9	1,7	0,5	0,0
Fixed investment	6,8	-9,9	7,6	3,3	6,5	11,8	-5,8	0,6	0,2
Export of goods and services	1,7	-9,3	9,7	4,0	3,6	9,8	-6,8	-2,4	-1,4
Import of goods and services	2,6	-7,9	8,3	2,8	3,4	8,7	-4,3	-1,7	-0,7
Labour market									
Registered employment	1,0	-1,6	0,5	0,5	0,2	0,9	-0,4	0,3	0,1
Wages, nominal	7,8	2,6	4,1	3,9	4,8	0,6	1,0	0,3	0,6
Wages, real	5,0	0,6	2,9	1,9	2,9	0,4	0,2	-0,4	-0,3
Unemployment rate	5,8	6,8	6,8	6,2	5,7	-1,4	-0,6	-1,0	-1,4
Inflation									
CPI	2,7	1,9	1,1	1,9	1,8	0,1	0,8	0,6	0,8

Source: ŠÚ SR, IFP