inštitút finančnej politiky

Policy brief 2023/06

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Inflation hits households' consumption

Macroeconomic forecast for years 2023 – 2027

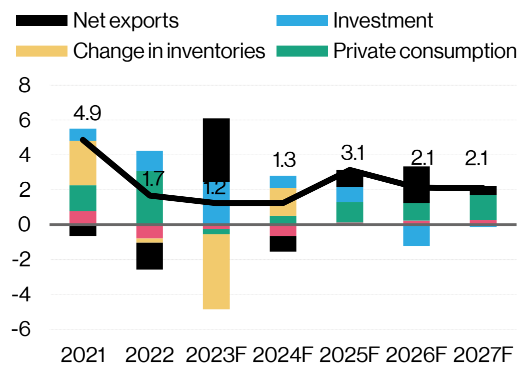
IFP Analysts

The Slovak economy has slowed down as a result of Russia's invasion of Ukraine and GDP is projected to grow by a modest 1.2 per cent in 2023. After the depletion of savings owing to inflationary shock, households will seek to replenish them decreasing their consumption. Despite that real disposable incomes and savings will rise slightly thanks to government measures. Consequently, number of employed people will rise as well. However, foreign demand will weaken, with recovery in European industry lagging behind services. The growth will be supported by EU funding, which will boost capital formation. In 2024, economic growth is projected to accelerate only slightly and real GDP will increase by 1.3 per cent. Economic performance will be dampened by budget consolidation efforts. However, global price pressures will ease and domestic inflation will fall below 5 per cent. In 2025, household consumption will recover and the export will catchiup on lost export market shares. The development of the war and the non-utilisation of EU funds remain risks to the forecast. Finally, as an scenario, we estimate the impact of a balanced budget on the economy.

The negative effects of inflation to fully articulate this year

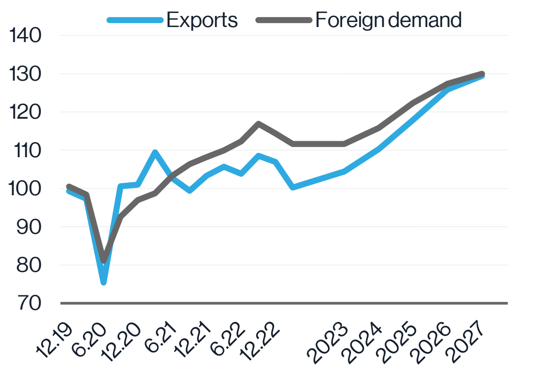
Domestic demand will be hit by high prices in 2023 and GDP growth will slow to 1.2 per cent. Household consumption moderated at the beginning of the year and will fall by 0.5 per cent this year. As the year continues, inflation will ease and households will be able to redirect part of the growth in disposable income to rebuild their savings. The volume of government consumption will fall again year-on-year, as high prices have not allowed the consumption of public goods and services to grow more strongly in real terms. Weaker domestic demand and lower energy imports this year may help to temporarily boost the positive contribution of external demand to GDP. However, the export performance will be dragged down by slow recovery in industrial sectors abroad. The investment will remain the only strong component of the domestic economy. Capital injections from EU funds will peak, with the implementation of the Recovery and Resilience Plan (RRP) starting in the second half of the year. The investment will help to stabilise the unemployment rate and support the wages growth.

Figure 1: Contributions of individual components to GDP growth (constant prices, p.p.)



Source: SO SR, IFP

Figure 2: Export convergence weak in 2022 and 2023 (constant prices, 2019 = 100)



Source: IFP

Foreign trade will weaken in 2023

The forecast of the economic development in our foreign partners indicates a 1.6 per cent decline in trade in 2023. This is mainly due to the receding negative energy prices shock while the supply chain disruptions have not completely disappeared as well. The recovery in the euro area is driven mainly by the service sector so the export-oriented industrial economies will benefit less (more in Box 1).

In 2024, economic growth will accelerate slightly to 1.3 per cent. A gradual recovery in the purchasing power of the population, with real wage growth returning above 2 per cent is expected. The 2023 peak in EU fund absorption will be largely replaced by the stronger implementation of RRP projects in the following year. On the other hand, the lower government expenditure will dampen activity. The budget consolidation to the extent of 1.1 per cent of GDP will reduce the growth of real GDP by 0.8 percentage points in 2024. The possibility of a balanced budget is also in place. However, its impact on the economy would be significantly stronger (more in Box 2).

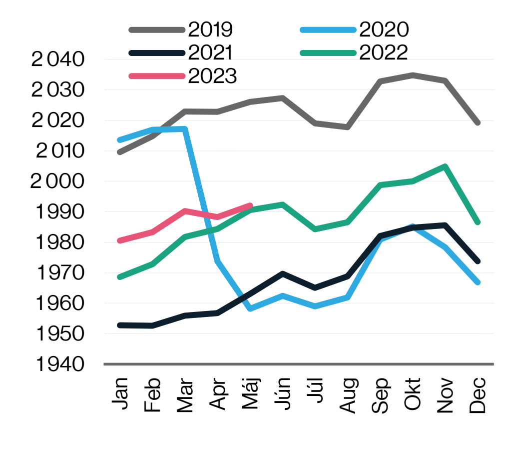
The main impulse for GDP acceleration from 2025 onwards will be a decline of inflation below 3 per cent. Household consumption will return to the strong growth have not seen since the pandemic. The additional increase in the export capacity of the automotive industry from 2026 onwards will also boost the Slovak economy in the years to come. However, imports will also increase due to the renewal of military equipment.

Public finance consolidation is supposed to start in 2024

Risk is balanced

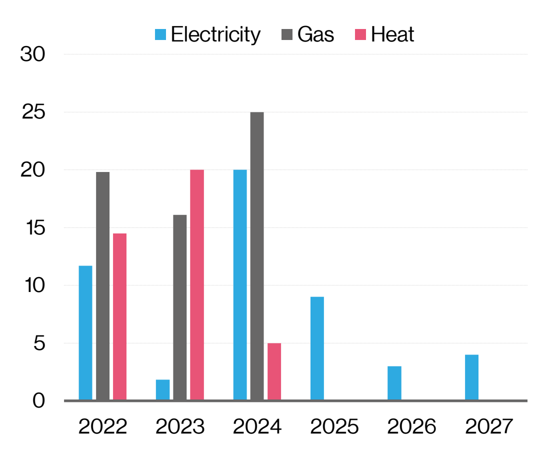
The development of Russia's aggression in Ukraine remains a risk to the forecast. A renewed rise in input prices for the food industry may delay the recovery in consumer spending. On the positive side, there is a risk that foreigners will become more involved in the Slovak labour market and thus fill the shortage of workers in key sectors. The smooth transition to electro-mobility in the context of the introduction of stricter emission rules in Europe is a prerequisite for the successful penetration of Slovak car manufacturers into foreign markets.

Figure 3: Social security records signal weak employment growth this year (employment relations in thousands)



Source: Social Insurance Agency

Figure 4: Energy prices haven't had the last word, we expect them to increase in the following years (y/y growth in %)

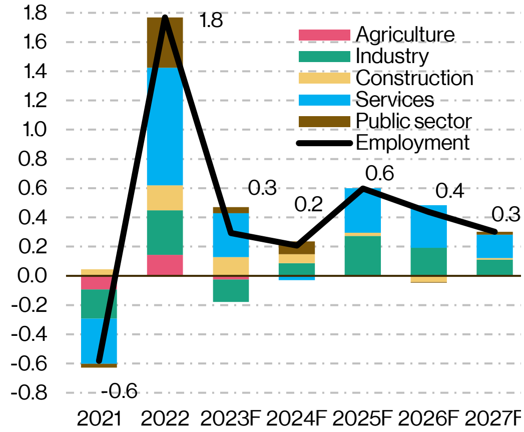


Source: SO SR, IFP

Inflation has passed the peak

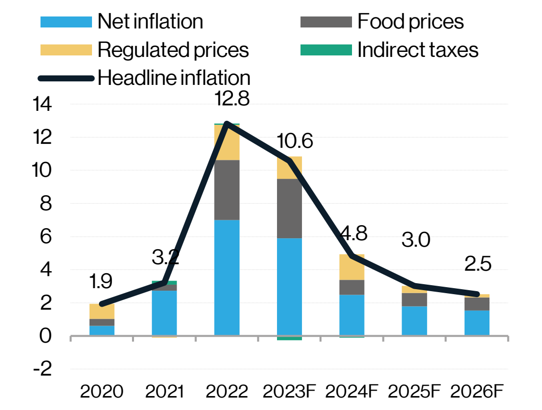
Inflation will reach 10.6 per cent on average in 2023. Year-on-year price growth will be largely influenced by the base effect from the strong price increases at the end of last year. Government measures led to household energy prices rising only slightly in January compared to developments in commodity markets. Prices of agricultural commodities have been decreasing (wheat, oilseeds, dairy products) or have stabilised (meat, eggs), which is reflected in a slowdown in food price growth. Fuel prices have been on the decrease this year as well. Data on both producer prices and inflation expectations suggest that the peak in price growth is behind us. Inflation will reach single digits in the second half of the year and approach six per cent at the end, with growth in goods prices slowing faster than growth in services prices.

Figure 5: Sectoral contributions to ESA employment growth (p.p.)



Source: SO SR, IFP

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



Source: SO SR, IFP

Additional measures to curb energy price inflation are expected

Inflation will slow to 4.8 per cent next year and return close to 2 per cent in the medium term. Food price inflation will normalise, while growth in goods prices and eventually in services prices will also slow down. On the other hand, an increase in energy prices is to be expected. For electricity, we expect a 20 per cent increase in the consumer price mainly due to an increase in distribution and other fees in 2024. In subsequent years, we expect more modest increases in line with the price increases agreed on in the Memorandum with Slovak Power Plants and lower agreed volumes of electricity delivered.

Should an immediate switch to market prices occur in the next year, gas prices would almost double, despite a visible decrease in world market prices. At the same time, heat prices would rise as well. However, we expect that some measures to prevent price increases will be adopted in the years to come. We assume that the gas price will be set to reflect the market price of the commodity that markets now expect in the medium term (2027). This would imply an increase in the final gas price for consumers of almost 40 per cent next year and unchanged prices in subsequent years. The gas price should thus settle at around 50 per cent above 2022 levels in the medium term.

Labour market weaker in 2023

The labour market dynamics will ease this year. The employment rate decreased in the first quarter for the first time in two years. Employers are reacting to high energy prices, rising interest rates and a cooling of external demand. **The economy will add just over 6,000 jobs this year, boosting employment by 0.3 per cent.** The fastest employment growth will be in the construction sector, which will be supported by the absorption of EU funds from the outgoing programming period. Weaker domestic consumption will contribute to a slowdown in services employment. Industry will suffer most from the energy crisis and the fall in foreign demand. In 2024, the effects of the Recovery and Resilience Plan and fiscal consolidation will counteract each other. We expect a more significant recovery in the labour market only from 2025 onwards, when growing employment will be supported by RRP funds and Volvo investment.

Foreigners help fill vacancies

The labour market will continue to be significantly supported by foreigners, of whom more than 93,000 currently work in Slovakia. In addition to those from Ukraine, workers from Serbia, Georgia and India are also coming to Slovakia in greater numbers. Up to 80 per cent of the total number of employed foreigners work in western Slovakia, which has the highest number of unfilled positions and an unemployment rate below 3 per cent. Most of them are employed as unskilled auxiliary workers and machine operators and assemblers. These positions are also the most in-demand and have been a long-term problem to fill. Foreign workers thus help us to fill vacancies more effectively.

Unemployment will stagnate

The unemployment rate (according to the LFS) will remain at last year's level of 6.1 per cent. The moderation of the decline reflects weaker employment trends and at the same time an increase in the working population due to the inflow of Ukrainian refugees which is to be reflected in statistics later this year. The negative trend of active population participation will be partly mitigated by the continuing increased participation of foreign workers together with Slovaks returning from abroad. At the end of the forecast horizon, the unemployment rate will decline to 5 per cent.

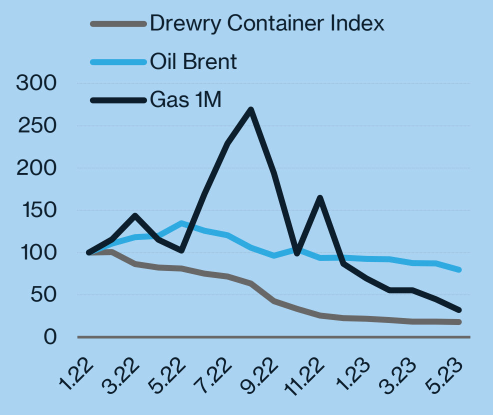
Stellar 10 per cent wages growth

The growth of the average nominal wage will accelerate to 10 per cent in 2023. Wages will rise fastest in the construction sector, which reports the highest worker shortage in 23 years. Public sector employees, whose wage growth lagged the private sector last year, will be better off due to a 10.5 per cent wage indexation. From 2024 onwards, wage bargaining will reflect the lower rate of consumer price inflation. In the public sector, wage increases will be dampened by the consolidation of public finances. Real wage growth will stay negative for the year, but real household incomes will rise thanks to government measures. In subsequent years, wages will grow slightly more than labour productivity, which was a persistent trend before the pandemic.

BOX 1: External environment assumptions

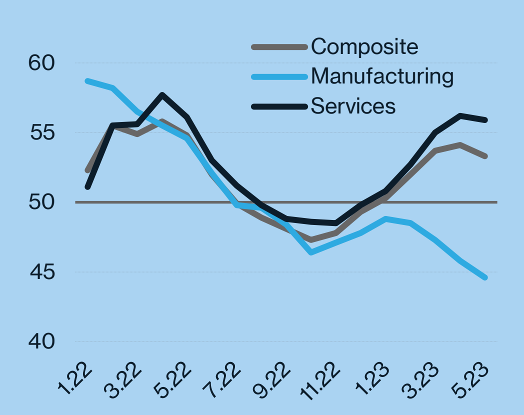
The beginning of 2023 was marked by a recovery in economic activity, but the industry has stumbled back. The recovery was supported by a significant decrease in energy commodity prices as well as warmer weather during the spring months. The more service-oriented economies of the European South, such as Italy and Spain, did particularly well. In contrast, countries with a predominantly industrial sector, such as Germany and the Czech Republic, stagnated or experienced negative growth.

Figure A: Energy commodity prices continue to decline (price inde , January 2022=100)



Source: Bloomberg, IFP

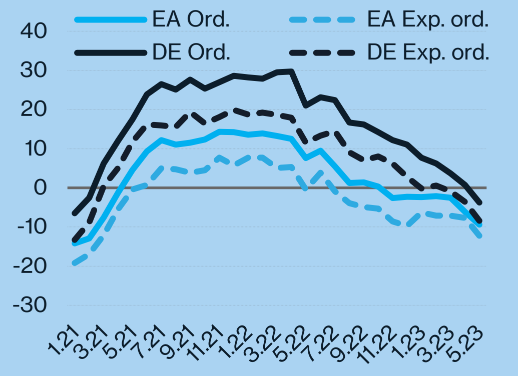
Figure B: Recovery in euro area is driven by services (Purchasing managers index, values above 50 = expansion)



Source: Macrobond, IFP

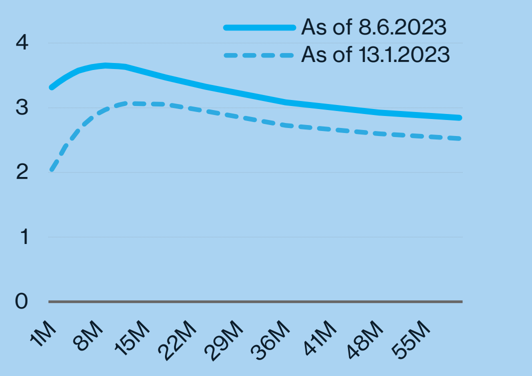
Tight monetary policy is a drag for the economic recovery. The economic surveys suggest a strong recovery in services, while activity in industry remains weak. This is due to the significant tightening of monetary policy that central banks have embarked on over the past year. Industry, which is more sensitive to external forms of financing, is suffering from a high increase in interest costs. The slow recovery in international trade is also contributing to the weaker performance. Despite the post-Covid opening in China, demand for industrial products has remained weak and the recovery has taken place mainly in the service sector, similar to Europe. However, low demand for industrial products has helped to dissolve bottlenecks in supply chains to a great extent, allowing container freight prices to decrease and delivery times to shorten significantly.

Figure C: Domestic and export industrial orders are on the decline (ESI, points)



Source: EC, IFP

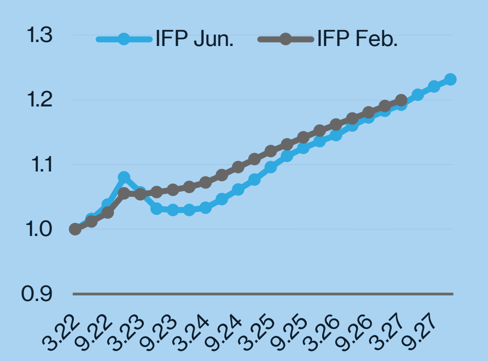
Figure D: Interest rate expectations have risen (interest rate swap curve for €str, %)



Source: Bloomberg, IFP

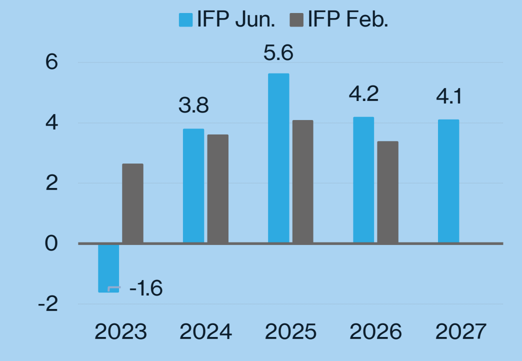
Weak industrial performance abroad will dampen Slovak exports. As a large part of Slovak exports consists of industrial products, foreign recovery in services will not bring additional benefits to the economy. Further tightening of monetary policy will also be a drag. Despite a steady decline in headline inflation, strong demand for services has been keeping core inflation high. This is also the reason why expectations about the future level of interest rates have shifted upwards compared to February. In an effort to return core inflation to acceptable levels, interest rate hikes by the ECB will continue, which will further weigh on industrial performance. For this reason, we have revised down the forecast for external demand for this year in comparison with the February forecast. Industrial performance should start to pick up next year when inflation returns to lower levels and a gradual easing of monetary policy can proceed.

Figure E: External demand will decrease this year (weigh. ind. of ex. dem., level, indexed)



Source: IFP

Figure F: Monetary policy easing will support growth (YoY, weigh. ind. of ex. dem., per cent)

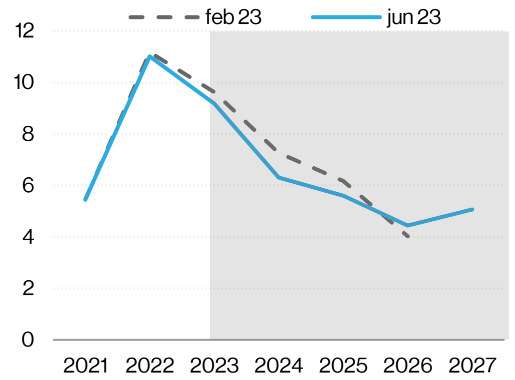


Source: IFP

The overall impact of the macroeconomic forecast update on tax bases is negative over the entire horizon from 2023 onwards. This is mainly due to lower household consumption and fewer jobs created. The exact impact on the tax and levy estimates will be discussed by the Tax Forecasting Committee on 22 June 2023.

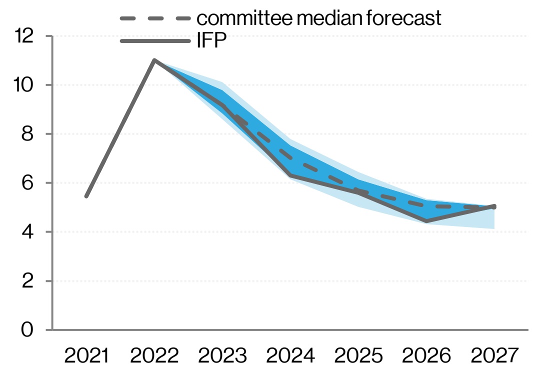
The update of the MoF's macroeconomic forecast was the subject of a meeting of the Committee for Macroeconomic Forecasts on 14 June 2023. **The forecast was assessed as realistic by the majority of the Committee's members present** (RRZ, SLSP, Tatrabanka, Infostat, Unicredit, VÚB and ČSOB), **while the NBS did not vote**. The forecast update, as well as the minutes of the Macroeconomic Forecast Committee and the background materials, are available on the IFP website.

Figure 7: Evolution of macroeconomic bases compared to the previous forecast (growth, per cent)



Source: IFP

Figure 8: Comparison of tax base forecasts[1] by members of the MFC (growth, per cent)



Source: IFP

BOX 2: Balanced budget – alternative scenario

Budget deficit legislation obliges the government currently in charge to prepare a balanced budget proposal for 2024. In the case of a newly elected government, the proposal does not have to be implemented. According to current data, achieving a balanced budget implies a permanent reduction in expenditure or an increase in revenue of 4.8 per cent of GDP. In this scenario, we assume a consolidation plan based on an even mix of revenue and expenditure measures to be taken on several components of the budget. In this case, the economy would slide into recession, real GDP would contract by 4 per cent and employment would decrease by 45 000 people.

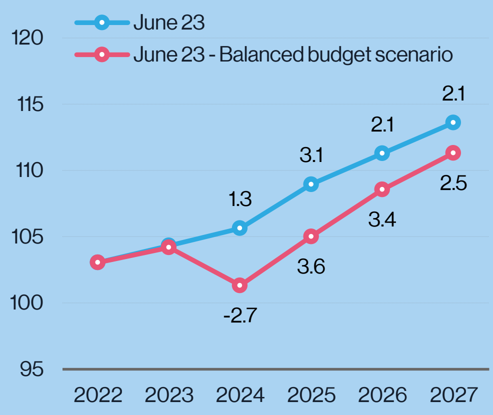
[1] Macroeconomic bases for budget revenues (weight of indicators depends on a proportional share of particular taxes on total tax revenues): Wage base (employment + nominal wage) – 55.9 per cent; Nominal private consumption – 24.4 per cent; Real private consumption – 4.2 per cent; Nominal GDP growth – 10.6 per cent; Real GDP growth – 4.9 per cent.

Table 1: Macroeconomic effects of budget consolidation (% change compared to forecast)

GDP, real	-4.0
Private consumption, real	-6.1
Fixed investment, real	-2.4
Employment	-1.8
Wages, real	-5.3
Inflation	-0.3

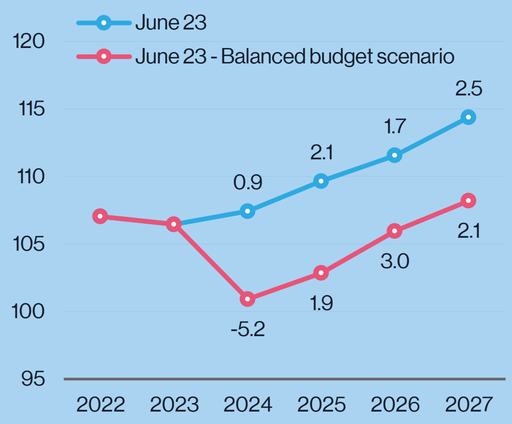
Source: IFP

Figure G: Real GDP in the balance budget scenario (index, 2019 = 100, labels in yoy %)



Source: IFP

Figure H: Real private consumption in the balanced budget scenario (index, 2019 = 100, labels in yoy %)



Source: IFP

MF SR FORECAST- MAIN ECONOMIC INDICATORS (June 2023)

indicator (growth in per cent unless otherwise noted)	2022	forecast 2023	2024	2025	2026	2027	dff. From Feb. 2023 2023	2024	2025	2026
Gross Domestic Product										
GDP, real	1.7	1.2	1.3	3.1	2.1	2.1	-0.1	-0.5	0.4	0.2
GDP, nominal (bn. €)	9.3	10.3	7.7	6.0	4.5	5.4	1.2	0.4	-0.9	0.0
Private consumption, real	5.5	-0.5	0.9	2.1	1.7	2.5	-1.2	-0.2	0.6	0.4
Private consumption, nominal	18.4	9.8	5.5	5.1	4.3	5.2	-0.4	-0.9	-0.8	0.7
Government spending	-4.3	-1.4	-3.8	0.8	1.6	1.7	-3.7	-5.2	0.3	0.6
Fixed investment	5.9	11.9	3.1	3.6	-5.2	-0.6	-2.7	1.9	2.3	-1.9
Export of goods and services	2.3	-1.8	5.7	6.9	6.7	5.0	-3.1	-1.2	0.3	1.3
Import of goods and services	4.0	-5.6	7.0	6.2	4.8	4.8	-9.8	0.8	1.0	1.0
Labour market										
Registered employment	1.7	0.2	0.2	0.6	0.5	0.3	-0.2	-0.3	0.0	0.2
Wages, nominal	7.7	9.9	7.0	5.8	4.4	5.3	-0.6	-1.1	-0.5	0.2
Wages, real	-4.5	-0.6	2.2	2.7	1.9	2.6	-1.2	-0.4	0.7	0.0
Unemployment rate	6.1	6.1	5.7	5.4	5.1	5.0	0.3	0.3	0.2	-0.1
Inflation										
CPI	12.8	10.6	4.8	3.0	2.5	2.6	0.8	-0.5	-1.2	0.3

Source: SO SR, IFP

Preliminary plan of allocating RRP resources (mil. EUR, excl. VAT, ESA2010)

	2022	2023	2024	2025	2026
RRP total	49	969	2 418	2 344	625
Public investment	2	536	1 529	1 484	355
Compensations	29	100	127	125	45
Intermediate consumption	11	48	83	77	30
Soc. transfers in kind	0	8	8	4	0
Social transfers	4	23	23	23	0
GFCG firms	3	120	493	530	120
GFCG households	0	133	155	101	75

Source: IFP