

June 22nd, 2020

The economy holds its breath

Macroeconomic forecast for 2020 – 2023

Richard Priesol, Branislav Žúdel

The Slovak economy will shrink by 9.8 % in 2020 due to the coronavirus pandemic. Domestic and foreign demand will fall and firms will postpone investment. The labour market will contract significantly as unemployment rises and wage pressure subsides. Government consumption will be the only factor pushing output upward. The economy will gradually start to recover in the second half of the year, leading to GDP growth of 7.6 % in 2021. The economy will remain below its potential during the entire horizon of the forecast and will reach its pre-crisis levels only at the end of 2022. The forecast is based on budget objectives introduced in the Stability Programme. The main downside risk to the forecast is a recurrence of the disease which would deepen the economic recession. In contrast, the EU Recovery and Resilience Facility would boost economic growth.

The Slovak economy will shrink by unprecedented 9.8 % in 2020, due to the coronavirus crisis. In light of the development of the pandemic, affected countries have adopted measures limiting social contact. These measures have protected the health of the population but have also brought about significant economic costs. Economic activity in Slovakia slowed down in the first quarter which saw a drop in investment activity and an unusually steep fall in foreign trade. We expect economic activity to reach a trough in the second quarter when household consumption declines similarly to industrial production and construction output. Accommodation and restaurant sectors will be the most affected by the drop in consumption, as indicated by preliminary data from eKasa and retail trade in April. Sales of cars and apparel have also declined significantly while the restrictions were in place. Lower spending will be partially offset by higher sales in supermarkets, drugstores and pharmacies, as consumers' routines shifted from the workplace and schools to the households, adjusting their consumption habits.

The easing of restrictions around Europe should bring about gradual economic recovery in the second half of 2020. However, the return to normal functioning will be uneven across sectors. While retail sales on eKasa have exceeded their February levels since mid-May, sales in restaurants and accommodation facilities in mid-June remain 10 per cent and 60 per cent below their pre-crisis levels, respectively. Recovery in export-oriented industries will also be gradual. Cross-border mobility was still subdued at the beginning of June, as number of kilometres travelled and number of border crossings by trucks were year-on-year lower by 13 per cent and 20 per cent, respectively. Free capacity in the economy is being utilised only gradually, as indicated by electricity consumption which was on average 10 per cent lower than during the same period last year.

Economic recovery will continue in 2021 and GDP will increase by 7.8 %. Household consumption as well as foreign demand will revive. Investment will rise only slowly, as the economy will still be significantly below its potential with plenty of unutilised capacity. Regarding public expenditures, we assume that fiscal consolidation will take place to fulfil the objectives of the Stability Programme between 2021 and 2023.¹ This will limit the pace

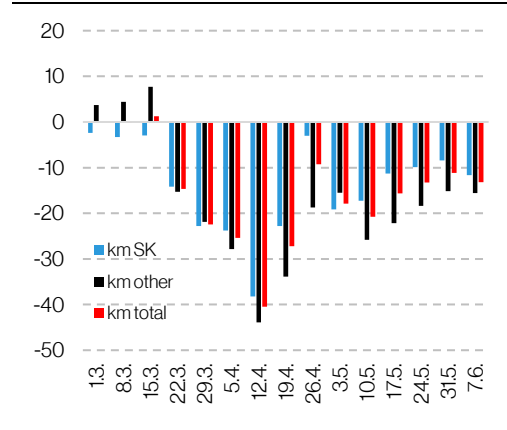
¹ The fiscal objectives of the approved Stability Programme for 2020-2023 indicate public deficit of 4.9 % of GDP in 2021, 3.7 % in 2022, and 2.9 % in 2023. This would stabilise gross public debt at 60 % of GDP. The fiscal consolidation designed to reach these objectives is modelled equally between income and expenditure components (50:50) and respects the structure of taxes and expenditures in 2019.

The pandemic will pull the world and the Slovak economy into recession

The economy will start to recover in the second half of 2020, even though only gradually

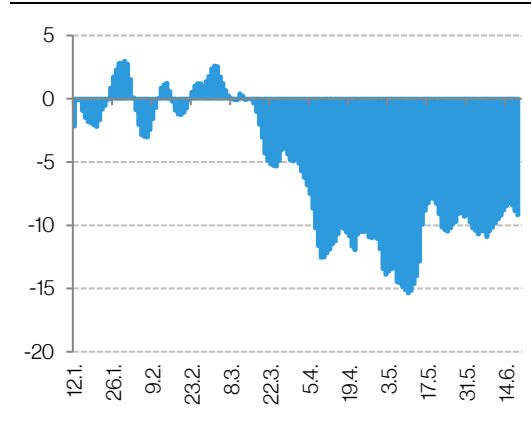
of economic growth to 1.8 % in 2022. At the end of the forecast horizon, the last-minute drawing of EU funds will have a positive impact on growth. The economy is expected to reach its pre-crisis levels in 2022.

Figure 1: Drop in km travelled by Slovak and foreign trucks (% , y-o-y)



Source: Skytoll, IFP

Figure 2: Change in electricity consumption (% , y-o-y)

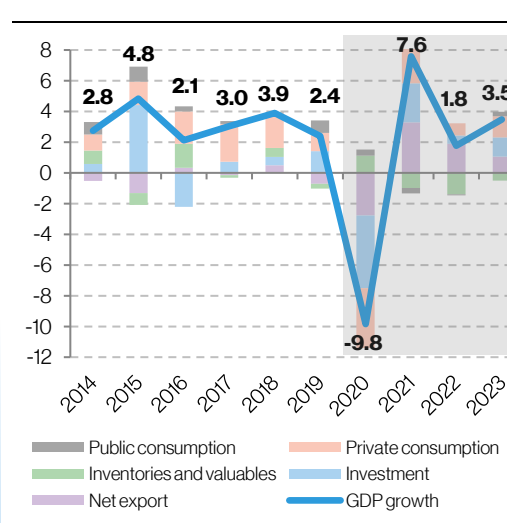


Source: SESP, IFP

The risks to the forecast are mostly negative

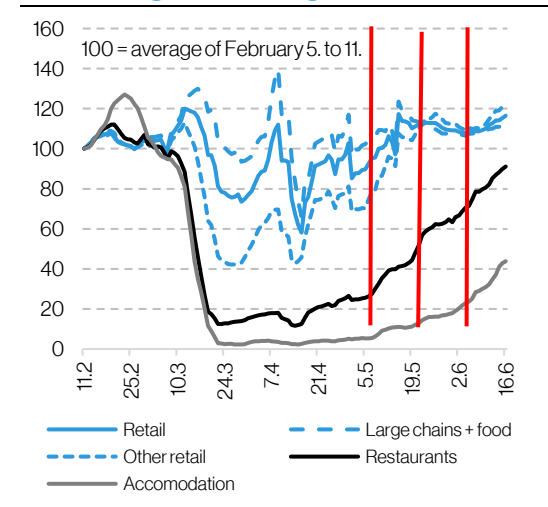
The risks to the forecast are mostly negative. Uncertainty surrounding duration of the pandemic and a recurrence of the disease could hinder economic recovery, what we analyse in a risk scenario presented in the Box 2. Global supply chains can be disrupted and their restoration could take longer, resulting in slower recovery. Benefits from international trade may be diminished in the future by calls for self-sufficiency. Last but not least, firms may prefer a liquidity buffer at the expense of investment, while greater emphasis may be placed on geographical diversification of suppliers. **The main positive risk** to the forecast is an extra funding through the EU Recovery and Resilience Facility which, if approved, would provide additional support to the economy from 2022 onwards. The invention of an effective vaccine against the virus would also give a significant boost to the economy. The debated measures to support domestic investment and demand could potentially stimulate output even this year.

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



Source: Statistical Office, IFP

Figure 4: Sales in restaurants and accommodation have been gradually recovering since lifting the restrictions



Note: 7-day averages
Source: eKasa, FSSR, IFP

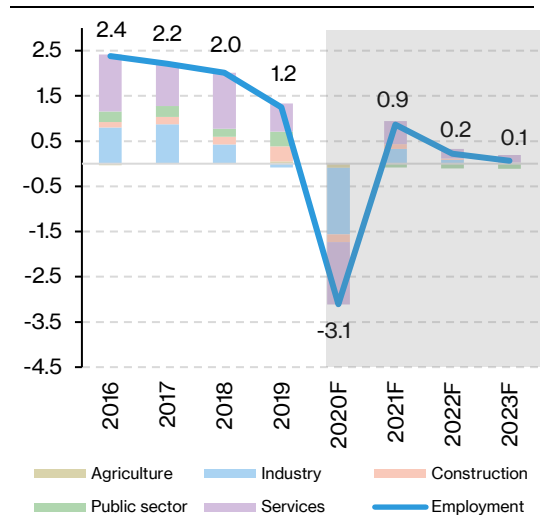
Employment is under pressure

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

Employment will decrease significantly in 2020 and the labour market will shrink by 76 thousand jobs. Workers will lose their jobs mainly in selected service sectors (tourism, catering services, retail and transport), but also in manufacturing and construction. Government measures enabling short-time work (so-called *Kurzarbeit*) will curtail the rise in unemployment and save approximately 35 thousand jobs as some layoffs will be prevented. We expect the labour market to gradually recover in the second half of 2020, though pre-crisis levels of employment will not be reached by the end of the forecast horizon. At the same time, **the unemployment rate is set to rise to 8.2 %** and decrease slowly in the coming years, while remaining above its pre-crisis level.

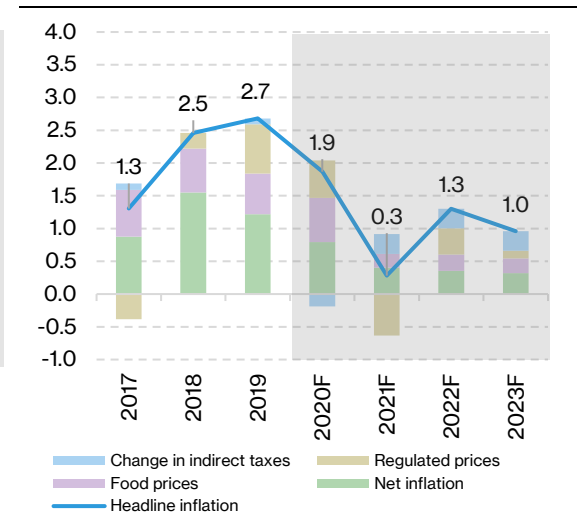
Average nominal wage growth will slow down in 2020 as wages will only rise by 2 %. The wage growth will be dampened by a large number of recipients of nursing and sickness benefits as well as by lower wages resulting from short-time work. Wage dynamics is set to recover in the coming years on the backdrop of labour market strengthening. The need for fiscal consolidation will affect the labour market as well and will have a negative impact on development of wages, especially in a public sector.

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



Source: Statistical Office, IFP

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



Source: Statistical Office, IFP

The slump in oil prices will dampen inflation pressures in 2020

Inflation is projected to ease to 1.8 % in 2020. The deceleration is mainly driven by a slump in oil prices and lower global demand for mobility. Lower prices of oil will 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.

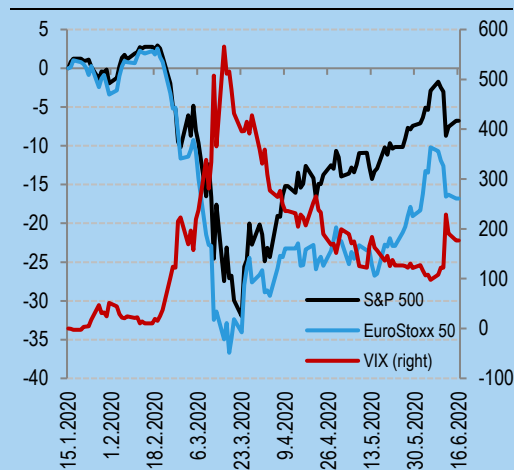
In a medium term, inflation will be dampened by fiscal consolidation

Price growth is expected to decrease to 0.3 % 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 a cyclical position of the economy. In a medium term, price growth is projected to reach approximately 1 %.

BOX 1: External Environment Assumptions

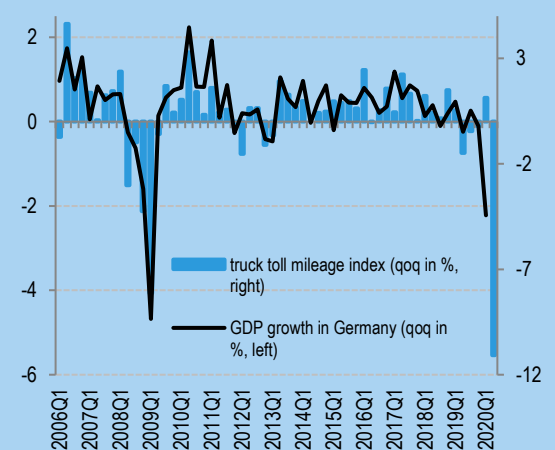
The sharp sell-offs in global financial markets in March have gradually ceased and most financial indices have abated their original losses (Figure A). The reason behind the positive sentiment among investors was a promise of extensive fiscal and monetary stimulus to counteract economic consequences of the pandemic. Fragility of confidence is demonstrated by a sudden slump in June when fears of a potential second wave have increased, following a rise in a number of new COVID-19 cases in China, Japan and the USA. The indicators of uncertainty were also disturbed by renewed signs of protectionist rhetoric and protests for minority rights in the USA. The Fed's promise to purchase a broad portfolio of corporate bonds calmed down the situation. The purchase programme of corporate bonds by the American central bank put a halt to appreciation of the American dollar, as a loss of risk aversion increased investors' demand for more risky currencies. The EUR/USD exchange rate appreciated to 1.14. **The price of Brent oil has increased since March, but still remains at low levels.** We expect a gradual increase to 50 USD/bl within the forecast horizon.

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



Source: Bloomberg, IFP

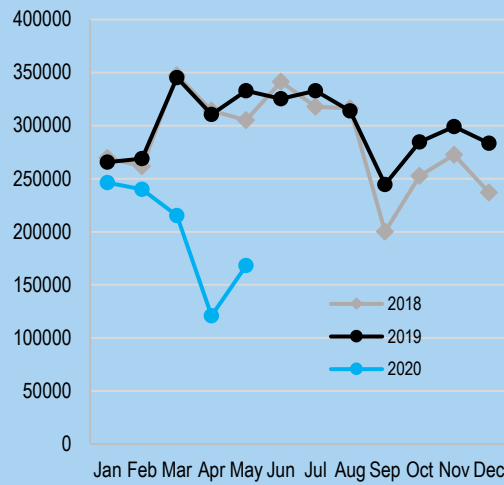
Figure B: The truck toll mileage index for Germany has reached a historic low, indicating a deep recession



Source: Destatis Statistisches Bundesamt, IFP

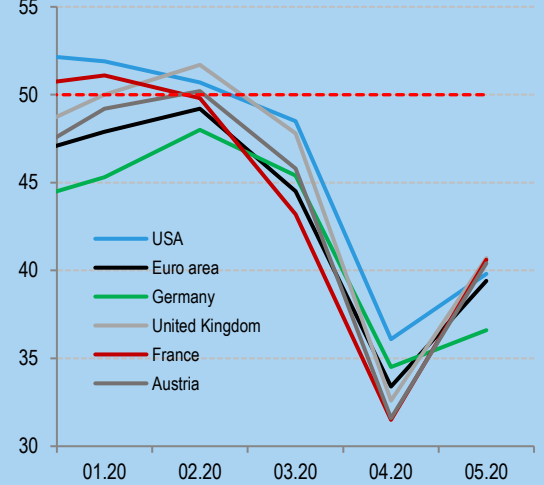
Social distancing measures paralysed economic activity in the second quarter of 2020. Restrictions were most felt in the aviation industry as well as restaurant and accommodation services. The paralysis of supply chains and mobility of population was reflected in a drop in truck mileage which, in Germany, was even more dramatic than in 2007 (Figure B). In general, manufacturing proved to be somewhat more resilient. Registration figures of new automobiles in Germany fell sharply in April, followed by a mild recovery in May when a number of newly registered vehicles reached 50 % of their level from previous year (Figure C).

Figure C: Car registrations in Germany hit a trough in April but still remain well below average



Source: Kraftfahrt-Bundesamt, IFP

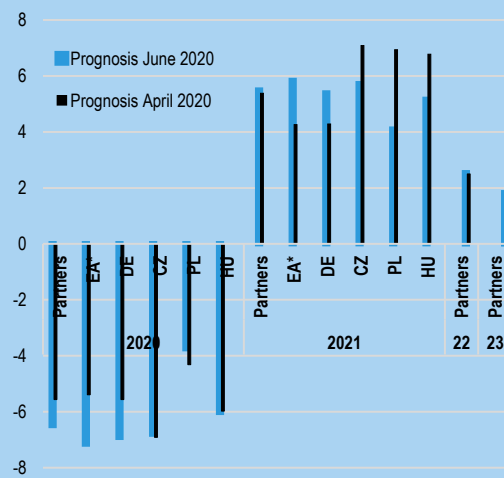
Figure D: Manufacturing PMI points to a recovery in May, but the economies are still in a recession



Source: Bloomberg, IHS Markit, IFP

Conjunctural survey readings indicate a slight improvement of the situation in May but remain below the growth threshold (Figure D). Services have suffered more relative to the manufacturing sector. Economic sentiment indicators (ESI) for the euro area and Ifo, an indicator of economic activity in Germany, also suggest a moderate recovery. Lower household consumption and investment were the main reasons for economic contraction in the euro area. First quarter data for the V3 countries indicate a milder recession in Hungary and Poland, while the Czech Republic was hit by a stronger negative shock. We revise our forecast for GDP (Figure E) and imports (Figure F) of Slovakia's trade partners in the euro area downward, while trade partners within the V3 countries will be somewhat better off than previously predicted. The cut-off date for external environment assumptions, including interest rates, commodity prices, and exchange rates, was 1 June 2020.

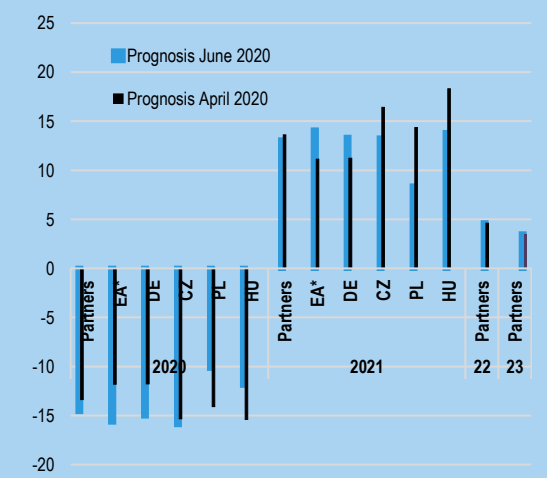
Figure E: GDP growth forecast of the external environment



*Export-weighted euro area

Source: IFP

Figure F: Import growth forecast of the external environment



*Export-weighted euro area

Source: IFP

BOX 2: Risk scenario to the baseline forecast

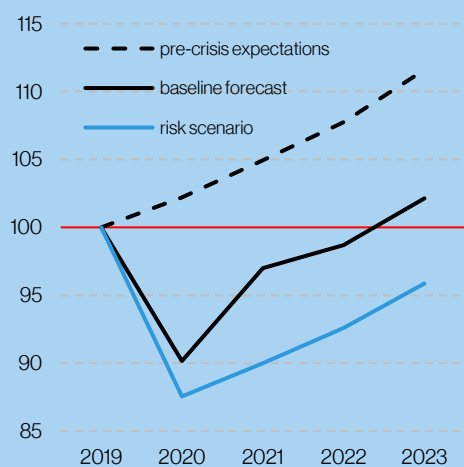
The greatest uncertainty surrounding the forecast is associated with development of the coronavirus pandemic. A second wave of the disease at the end of this year would pull the Slovak economy back into a recession in the fourth quarter. However, the economic consequences could be milder this time, as new measures are likely to be more efficient and targeted, due to the experience with the first wave of the disease. Overall, GDP would contract by 12.4 % in 2020 and the economy would recover by only 2.8 % in 2021. A bleaker economic outlook would increase the need for fiscal consolidation even further.

Given that China and several states in the USA have seen daily increases in new COVID-19 cases, Europe is also considering the probability of a second wave of the coronavirus. In the risk scenario, we assume that Slovakia and its major trading partners are exposed to a second wave of the disease in the final quarter of 2020. In order to reduce social costs of the pandemic, countries will re-introduce preventive measures which will be more targeted and less economically demanding thanks to the experience with the first wave. An impact of the second wave on European economies should be thus more moderate in the fourth quarter than it was in the second quarter during the first wave of the disease. The emergence of a second wave at the end of this year would decrease weighted GDP of Slovakia's trade partners by 2 % in 2020, relative to the baseline forecast. Economic recovery would be postponed until 2021, when an effective vaccine might be available.

In the event of a second wave, GDP of Slovakia would decrease by 12.4 % in 2020.

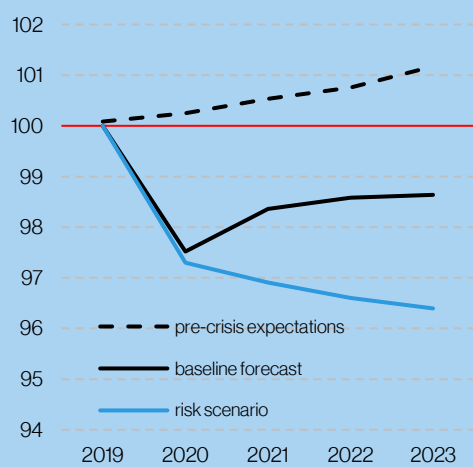
Structure of the economic contraction would be similar to the baseline forecast, export would fall due to lower foreign demand, while household consumption and investment would decline as a result of uncertainty, concerns, and restrictions on sales activity. The greatest impact of the second wave will not be felt until 2021, where we see a significantly slower recovery with the economic growing by only 2.8 %. Employment would decrease by 3.3 % in 2020 and continue to decline by 0.4 % in 2021. This negative economic development would put a strain on public budget balance, thus requiring greater fiscal consolidation in the coming years.

Slovak GDP under the baseline forecast and the risk scenario with a second wave (index, 2019 = 100)



Source: IFP

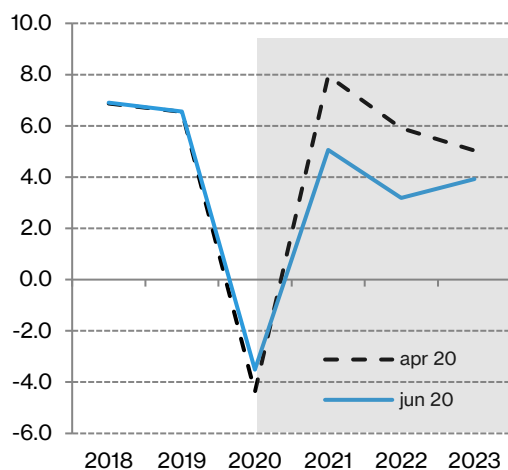
Slovak employment under the baseline forecast and the risk scenario with a second wave (index, 2019=100)



Source: IFP

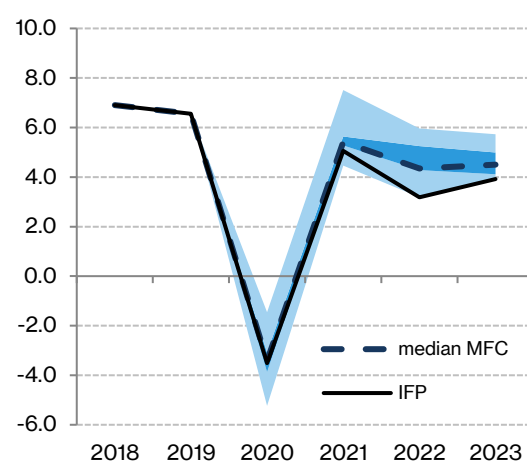
The overall impact of the update of macroeconomic forecast on tax bases is negative from 2021 onwards. The reason behind the decline in macroeconomic bases is a new assumption about fiscal consolidation. The overall impact of the macroeconomic forecast on tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee's meeting held on 25 June 2020.

Figure 7: Growth of macroeconomic tax bases compared to a previous forecast



Source: IFP

Figure 8: Comparison of forecasts of macroeconomic tax bases² with the members of the Macroeconomic Forecasts Committee



Source: IFP

The medium-term forecast prepared by the Ministry of Finance was discussed at the Macroeconomic Forecast Committee's meeting held on 17 June 2020. **The medium-term forecast was evaluated as realistic by all members of the Committee** (NBS, Infostat, CSOB, SLSP, Tatrabanka, VÚB, 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.

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 %.

MF SR FORECAST – MACROECONOMIC INDICATORS (June 2020)

Indicator	Actual	Forecast				Diff. from Apr 2020			
	2019	2020	2021	2022	2023	2020	2021	2022	2023
(Growth in % unless otherwise noted)									
Gross domestic product									
GDP, real	2,4	-9,8	7,6	1,8	3,5	-2,6	0,8	-2,3	0,3
GDP, nominal (bn €)	94,2	86,5	93,5	96,6	100,9	-2,5	-1,7	-3,9	-4,9
Private consumption, real	2,1	-7,0	5,4	1,4	2,4	1,4	-2,4	-2,7	-0,5
Private consumption, nominal	4,9	-5,3	5,5	2,8	3,5	1,2	-2,5	-3,3	-1,4
Public consumption	4,6	2,2	-1,7	-0,3	1,6	0,4	-1,9	-2,1	-1,0
Fixed investment	6,8	-21,7	13,4	2,7	6,3	-1,4	-3,6	-2,5	0,5
Export of goods and services	1,7	-19,1	16,5	6,4	5,0	2,3	-1,1	-0,1	1,4
Import of goods and services	2,6	-16,6	12,6	4,5	4,1	8,9	-6,4	-2,0	0,1
Labour market									
Registered employment	1,0	-2,5	0,9	0,2	0,1	1,3	-0,7	-0,8	-0,2
Wages, nominal	7,8	2,0	3,1	3,6	4,2	0,4	-0,9	-1,3	-0,7
Wages, real	5,0	0,2	2,7	2,3	3,2	0,3	-1,1	-0,6	0,4
Unemployment rate	5,8	8,2	7,4	7,2	7,1	-0,6	-0,3	0,4	0,7
Inflation									
CPI	2,7	1,8	0,3	1,3	1,0	0,1	0,1	-0,6	-1,0

Source: Statistical Office, IFP