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From global pandemic to global inflation

Macroeconomic forecast for 2022 – 2025

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Despite intensifying price pressures, Slovakia's GDP will rise by 1.9 per cent this year. Yet, high energy prices weigh on companies' costs and will cause an economic slowdown in the second half of the year, not only in Slovakia but also among our business partners. The dynamics of the Slovak economy will thus decline to 0.6 per cent GDP growth in 2023. A double-digit inflation will hit households' budget right from the next year owing to spike in regulated prices. Real wages will consequently fall accompanied by the slump in households' savings rate and spending. Economic recovery is expected from 2024 onward.

High energy prices will dampen the growth in the second half of the year

The Slovak economy will gain 1.9 per cent in 2022, despite headwinds from reinforcing price pressure. In the second half of the year, the economic growth will be dampened by moderate foreign demand because of the slowdown in the Euro area and the V3 countries. In fact, the Slovak exports have already reflected to the crisis in the second quarter. With weak industrial production in June and July, the decline in exports will likely continue in the third quarter as well. As a consequence of the ongoing supply-chain disruptions, the lost market shares will be regained only after 2023. Strong inflation will weigh on the household consumption in the second half of the year as the households have already used up the savings accumulated during the pandemic. What is more, the savings rate is approaching historic lows and we assume that it will continue to decline in the coming months. In the third and fourth quarter of this year, there will be no more savings to cover rising prices, hence the real household consumption will slump and thus will be more in line with the development of real wages. Aggregate demand will continue to be lifted up by the expenses of people fleeing Ukraine and, in the last quarter, an increased tax bonus, which is part of the pro-family stimulus package. The labour market will respond to the negative impact at the turn of 2022 and 2023 when energy supply contracts for many companies will expire and households will be affected by the spike in regulated prices. Nominal wages will be supported by the valorisation of salaries and a one-time allowance stimulus for employees in the public sector.

The energy crisis increases the risk of recession in the Euro area

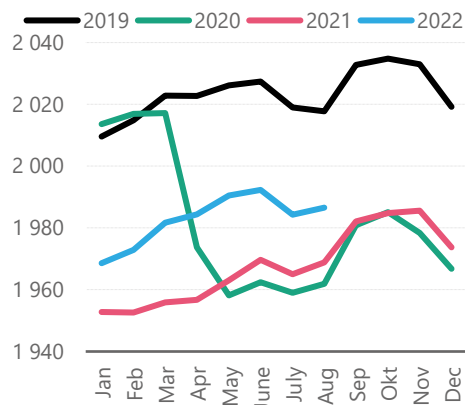
Despite weak third and fourth quarter, the Euro area GDP will grow by 3.0 per cent this year. In line with the forecasts of international institutions, **we expect a notable slowdown in the growth of our foreign trading partners next year, when the Euro area GDP dynamics will lessen to 0.7 per cent.** The restricted flows of natural gas from Russia to Europe is leading to an unprecedented gas and electricity price levels in the EU. The prices of both energy and raw materials are considerably higher in the EU than in the USA and Asia, thus reducing the competitiveness of the EU industry. At the same time, falling economic sentiment in Germany has been pointing to an elevated risk of a recession at the turn of the years. The lower demand for foreign goods and services associated with such a recession in Germany will hamper Slovak exports.

EU resources will compensate for lower household consumption next year

In 2023, Slovak GDP will add 0.6 per cent. A substantially lower dynamics will be caused by sluggish foreign and domestic consumption, as nominal wages will not be able to keep pace with the strong inflation. Yet, the disposable income will be spurred by the pro-family stimulus package and the valorisation of salaries in the public sector. These measures will somewhat mitigate the negative impact of the inflation on consumption.

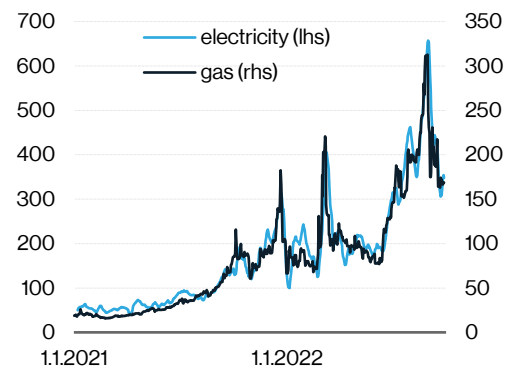
Investments from the Recovery and Resilience Plan and the drawdown of EU structural funds due to the end of the third program period will prop up the economic activity. In the second half of the year, we expect exports to strengthen, but there is a lot of uncertainty regarding the duration of supply-chain disruptions. We expect a more solid revival of exports in 2024. The expected consolidation of public finances will moderate the economic performance throughout the entire forecasted period, with the onset at the beginning of the next year. After peaking in 2023, the EU funds drawings will tumble in 2024. This, together with demographic changes (i.e. lower inflow of youngsters into the labour market), will also weigh on the economy.

Figure 1: Employment continues to grow (employment contracts in ths.)



Source: Sociálna poisťovňa

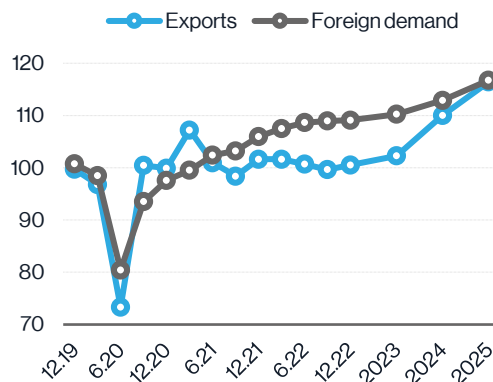
Figure 2: Wholesale energy prices have fallen, but are still higher than at the beginning of the summer (spot prices, EUR/MWh)



Source: ENTSO-E, EEX

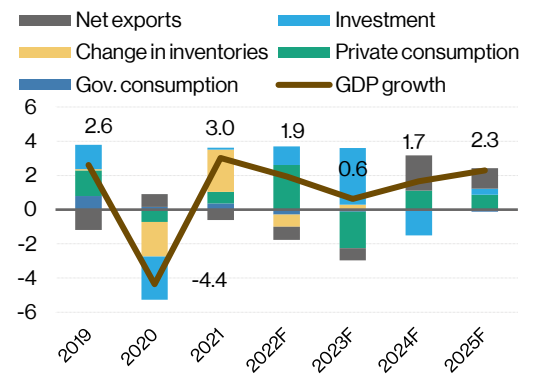
The risks of the forecast are mainly negative. Further increase in the prices of energy raw materials and the limitation of physical supplies of natural gas from Russian Federation remain the main risks for the next periods. A downside risk regarding the supply chains and foreign trade arises from the potentially deteriorating situation in Ukraine. On top of that, new mutations of the coronavirus leading to new pandemic waves in the autumn or winter, requiring the re-introduction of government restrictions, continue to be a risk of the forecast.

Figure 3: Lost market shares will be gradually regained after 2023 (real, 2019=100)



Source: IFP

Figure 4: Contributions to GDP growth (constant prices, percentage points)

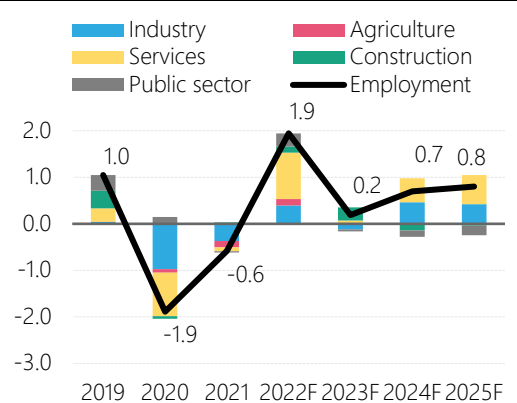


Source: SO SR, IFP

The summer increase in energy prices will drag inflation down to the end of the year

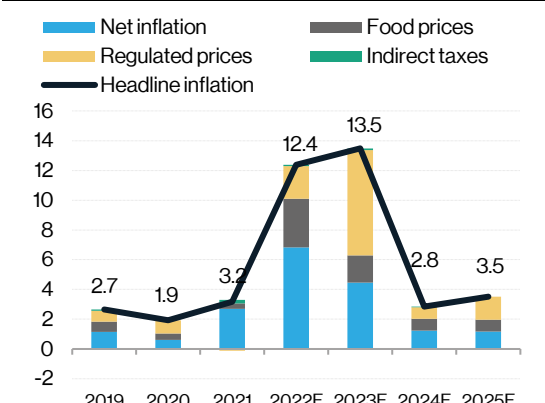
Inflation will rise to 12.4 per cent this year. Global prices of agricultural commodities have declined slightly from the levels to which they were driven by the war in Ukraine. On the contrary, the gas and electricity prices in Europe were growing during this period, even though they no longer reach the extraordinary values observed at the end of August (Figure 2). The growth of the market prices will be reflected in the regulated prices for households by the beginning of the next year, when the usual one-year period of fixed-prices comes to its end, with additional implications for inflation. As the consequence of the higher energy and building materials prices the imputed rents spurred. Fuel prices will rise in total by 25 per cent, in comparison with the last year prices, though they have been decreasing for several months in a row.

Figure 5: Contributions of various sectors to the increase in ESA employment (in p.p.)



Source: ŠÚ SR, IFP

Figure 6: Actual and forecasted inflation, with contributions to price growth (in p.p.)



Source: ŠÚ SR, IFP

Prices will jump by 13.5 per cent in 2023. The war in Ukraine as well as the pandemic-induced rise in demand for goods have significantly boosted the prices of energy futures contracts. Under the standard regulatory framework, this would lead to an increase of the electricity price by almost five times and the gas price by three times in 2023. In this case, the total inflation could exceed 30 per cent. Measures to ensure lower energy prices are being prepared at the European and national levels. However, at the time of the forecasts, specific measures were not known yet. Based on the available information, we expect an increase in electricity price by 40 per cent and the gas price by 60 per cent in 2023. The full impact of the higher wholesale gas price should be reflected in heat prices, which are not supposed to be affected by the price regulation being prepared. In the following years, in line with the proposed regulation, we expect only a moderate rise of prices while the price of electricity will grow again after the expiration of the two-year period settled in the agreement with Slovak Power Plants. In the medium-term horizon, the expected consolidation of public finances should positively influence the price growth.

In the first half of the year, the labour market was determined by post-covid recovery, which resulted in high employment growth. The biggest boost in employment was due to the service sector, which was hit the hardest during the pandemic. The inflow of emigrants from Ukraine, who found their jobs in the first half of the year, also contributed to the increase partly. They occupy mostly low-skilled jobs in the industry and services, which domestic workers have not been showing interest in for a long time. We expect a slowdown in industrial production caused by high energy prices with a negative effect on employment in the second half of the year. In the next year, household consumption, as well as industrial production, should decline due to high energy prices causing a rise

The development of 2023 will depend on the plan to cap energy prices for households

The first half of the year on the labour market was marked by post-covid recovery

in the unemployment rate. At the end of next year, we project a gradual recovery of the economy and a return of employment to the growth trajectory.

In the first half of the year, the unemployment rate decreased by 0.5 percentage points. In the second half of the year, the decline will slow down. Nevertheless, the unemployment rate should not exceed 6 per cent by the end of 2022. We expect an increase in unemployment, which will affect mainly the workers in the energy intensive industries. However, after the energy shock subsides, unemployment should start to fall again due to Recovery and Resilience Plan investments, industrial recovery and the pro-family stimulus package. At the end of the forecast horizon, the unemployment rate will drop below 5 per cent.

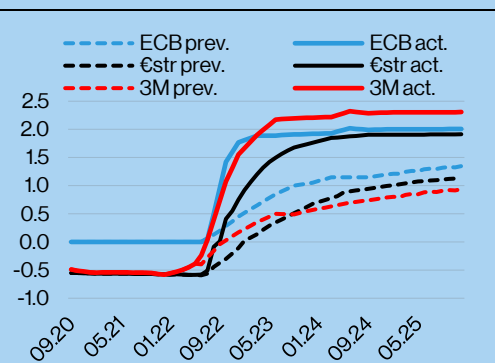
Nominal wages will grow significantly in the following years. However, the growth is expected to be slower than inflation both in 2022 and 2023, resulting in a mild decrease in real wages. Therefore we expect a cumulative decrease of the real wages by more than 6 per cent in 2022 and 2023. The significant stagnation of the wage growth in the public sector will be this year partly mitigated by a 3 per cent valorisation of tariffs (which took place in September) and a one-time allowance of 500 euros. Next year, wages in public administration will be affected by strong salary increases in January (public sector: 7 per cent, education: 10 per cent) and September (public sector: 10 per cent, education: 12 per cent). High growth in nominal wages in the private sector could potentially be at risk due to higher energy costs for companies.

Real wages will only increase in 2024

BOX 1: External environment assumptions

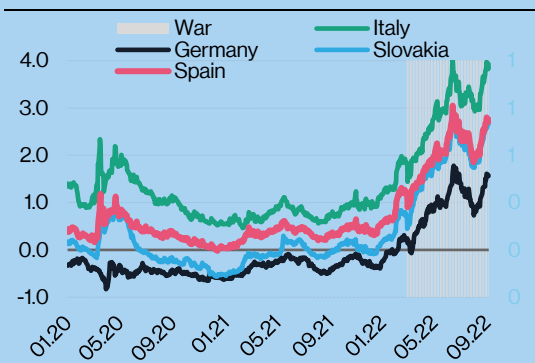
The war conflict in Ukraine caused the increase of commodity and food prices around the world. After the recovery of economic activity from the pandemic, initially disrupted supply chains contributed to higher prices. Europe is currently facing the highest pressure on prices due to insufficient gas supplies from Russian Federation. Strong price growth prompted the European Central Bank (ECB) to increase short-term interest rates (Figure A). The upward pressures on the long-term government bond yields (Figure B) of higher indebted countries have been moderated so far by the actions taken by the ECB due to a new instrument (TPI). This should enable the smooth transmission of monetary policy to all Euro area countries and ensure the stability of the yields even for higher indebted countries. In response to the expected slowdown of the Euro area economy and the tightening of monetary policy, the euro exchange rate declined to parity with the US dollar. In the longer term, forecasts expect oil prices to contract towards \$80 per barrel due to concerns about the weaker performance of the global economy.

Figure A: Euro area interest rates – comparison with previous forecast



Source: Bloomberg, IFP

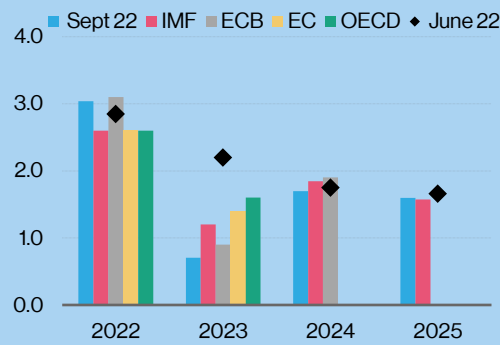
Figure B: 10-year government bond yields (%)



Source: Bloomberg, IFP

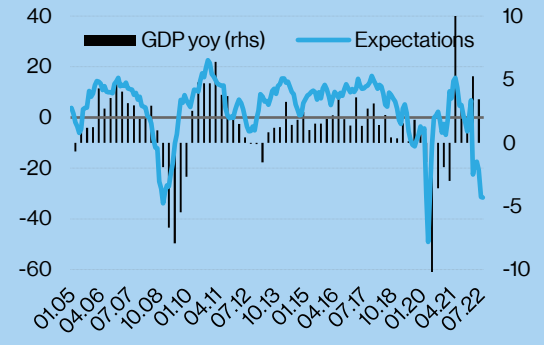
Central banks are expected to respond by further tightening the monetary policy by the end of 2022 followed by the stabilization of the situation. After the easing of pandemic restrictions, the deterioration of financial conditions is gradually moderated due to announced fiscal measures tackling the rise in energy prices for households and businesses.

Figure C: EA growth expectations more pessimistic for 2023 (real GDP, % yoy)



Source: IFP, Eurostat

Figure D: German sentiment indicates risk of recession

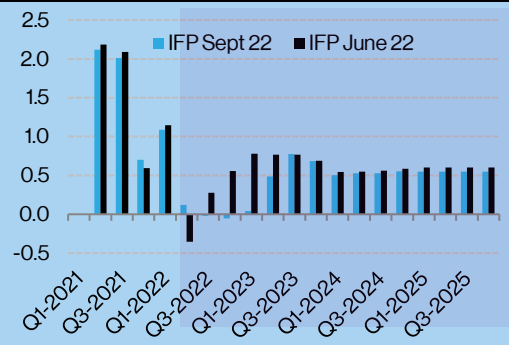


Source: Eurostat, IFO

Strong inflation weighs on expected economic development in the Euro area, especially in 2023 (Figure C). Inflationary pressures and a sharp rise in the prices of production inputs brought a drop in sentiment and the risk of recession in Germany as well (Figure D). The effect of the recovery from the opening of economies at the beginning of the year has faded and the real incomes of residents are shrinking. The downturn in the economy will be driven by a decline in consumer spending. Growing costs of companies due to high energy prices and limitation of production in unprofitable companies will negatively affect economic activity. Higher interest rates will also curb investment activity.

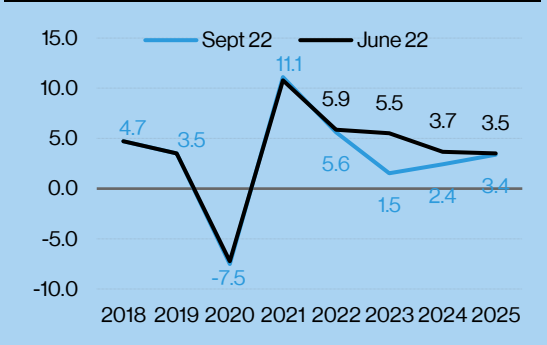
The tensions in the energy market are supposed to ease in the second half of 2023. Households will use accumulated savings and gradually support the economies of our business partners (Figure E). The collapse and subsequent recovery of economic growth will go hand in hand with effective fiscal measures aimed at mitigating high energy prices. In the main scenario, we do not expect a gas rationing system activated for the lack of gas supplies. Effective government policy will prevent high market prices from being fully passed on to businesses and consumers. **The growth of the GDP will be also supported by the drawdown of the EU Recovery Plan funds. The labour market will remain resilient. Due to the limited demand at the end of 2022, supply chain bottlenecks will gradually relax and foreign demand will gradually strengthen (Figure F).**

Figure E: Weighted GDP forecast – EA and V3 (% yoy)



Source: IFP

Figure F: Weighted import forecast – EA and V3 (% yoy)

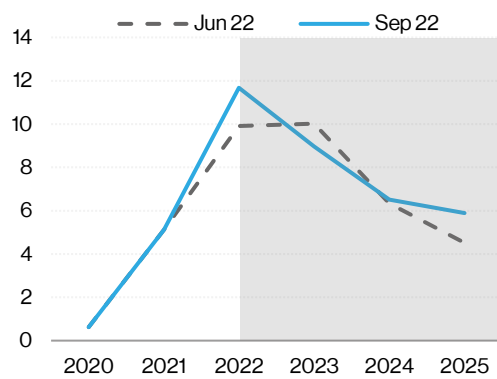


Source: IFP

The overall impact of the updated macroeconomic forecast on tax bases is positive on the whole forecasting horizon. The main reason is higher inflation than forecasted in June 2022. The overall impact of the macroeconomic forecast on tax and social contributions was subjected to further scrutiny at the Tax Forecast Committee's (TFC) meeting held on September 22nd, 2022.

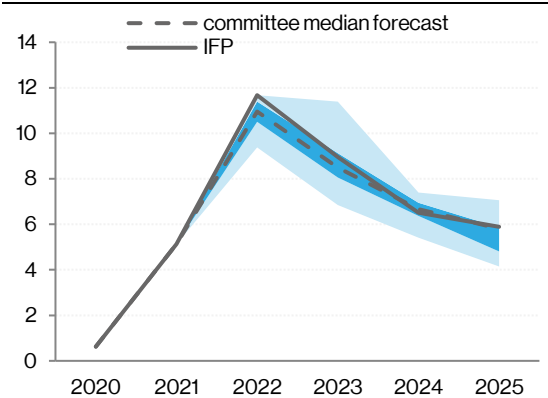
The medium-term forecast prepared by the Ministry of Finance was discussed at the Macroeconomic Forecast Committee's (MFC) meeting held on September 14th, 2022. **The forecast was evaluated as realistic by majority of the members of the Committee** (RRZ, SLSP, Tatrabanka, Infostat, SAV, Unicredit, and VÚB), NBS evaluated the forecast as optimistic. Detailed macroeconomic projections as well as the minutes from the meeting and all supporting documents are available at the IFP's website.

Figure 7: Growth of macroeconomic bases compared to previous forecast



Source: IFP

Figure 8: Comparison of tax base forecasts¹ by members of the MFC



Source: IFP

BOX 2: Alternative scenario – pessimistic development of energy prices for households

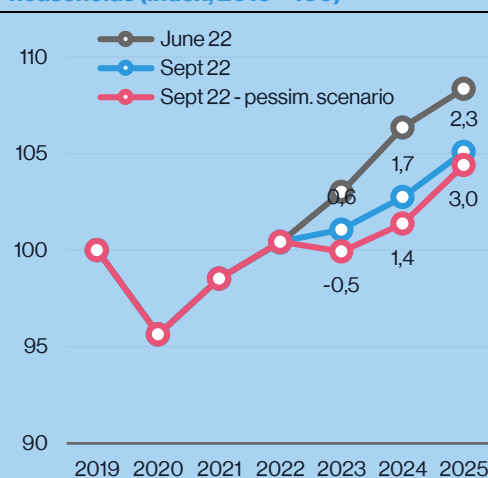
The opening of the economy after pandemic lockdowns has boosted household consumption since the beginning of the year despite higher inflation. However, under the weight of energy prices surge, real household incomes are under severe pressure. This poses a risk of a consumption-driven economic recession in 2023, with a decline of GDP by 0.5 per cent (Figure G). A more pessimistic scenario which assumes an increase in the price of electricity by up to 75 per cent and gas by 160 per cent predicts that household consumption will fall by a little more than 5 per cent year-on-year and inflation will shoot up to 18.5 per cent next year.

Double-digit inflation reduced the savings rate of household to historic lows in the first half of 2022, so the decline in the purchasing power of the population did not turn in significant savings increase. In the absence of a higher propensity to save, we observe stagnation or a slight decrease of bank deposits. Therefore, according to the scenario, we assume that savings will be maintained at the current level and that the increase in nominal wages, which lags behind inflation, will be reflected in a sharper restriction of the consumption of goods and services.

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) – 51.1%; Nominal private consumption – 25.7 %; Real private consumption – 6.6 %; Nominal GDP growth – 9.9 %; Real GDP growth – 6.7 %.

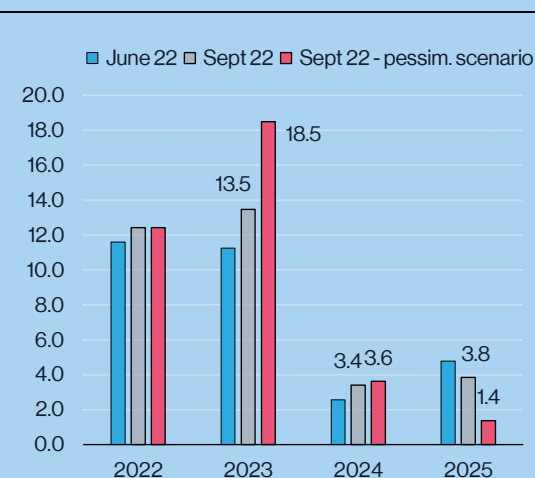
The expected increase of gas prices by 160 per cent according to this scenario is based on the information about the blending of a cheap gas (with a price according to CAL-26 futures, currently approx. 60 EUR/MWh) with gas priced in accordance to the current framework of Regulatory Office for Network Industries for the year 2023 (93 EUR/MWh). In the given scenario, we do not expect a sharp rise in gas prices for companies, while the bargaining position of employees regarding wages will mostly be limited due to the high growth of companies' costs in this period. In addition to consumption, households will also limit investments, reflecting not only higher construction material costs, the uncertainty of energy prices in the future, but also the gradual increase in interest rates on loans. The average growth of regulated prices in 2023 will reach 76 per cent compared to 43 per cent in the base scenario.

Figure G: Real GDP forecast – pessimistic scenario with higher energy prices for households (index, 2019 = 100)



Source: IFP

Figure H: Effect of higher energy prices on inflation (yoy, %)



Source: IFP

MF SR FORECAST - MAIN ECONOMIC INDICATORS (June 2022)

indicator (growth in % unless otherwise noted)	2021	forecast				diff. from March 2022			
		2022	2023	2024	2025	2022	2023	2024	2025
Gross Domestic Product									
GDP, real	3.0	1.9	0.6	1.7	2.3	0.0	-2.0	-1.5	0.4
GDP, nominal (bn. €)	97.1	107.0	120.6	128.3	136.8	1.9	2.3	2.3	2.9
Private consumption, real	1.2	4.6	-3.7	2.0	1.5	1.4	-3.3	-1.3	1.2
Private consumption, nominal	4.5	19.0	9.5	5.7	5.8	3.2	-1.6	-0.4	0.5
Government spending	1.9	-1.5	-0.7	0.0	-0.7	-0.2	0.2	-0.6	-0.3
Fixed investment	0.6	5.4	16.3	-6.4	1.7	-1.1	0.0	-1.7	-0.6
Export of goods and services	10.2	-1.6	1.7	7.6	5.8	-1.0	-1.7	-1.6	0.9
Import of goods and services	11.2	-0.9	2.4	5.5	4.8	-0.4	-1.4	-1.3	1.1
Labour market									
Registered employment	-0.7	2.1	0.2	0.7	0.8	0.3	-0.9	0.0	0.5
Wages, nominal	6.9	8.3	10.4	7.5	6.0	1.0	0.2	1.0	1.6
Wages, real	3.6	-3.6	-2.7	3.9	2.1	0.2	-1.7	0.1	2.5
Unemployment rate	6.9	6.1	6.1	5.6	4.8	-0.1	0.5	0.5	0.0
Inflation									
CPI	3.2	12.4	13.5	3.4	3.8	0.8	2.3	0.8	-1.0

Source: ŠÚ SR, IFP

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

	2022	2023	2024	2025	2026
RRP total	449	1 441	2 098	1 805	446
Public investment	175	844	1435	1235	262
Compensations	69	68	68	65	18
Intermediate consumption	46	59	75	41	15
Soc. transfers in kind	3	6	5	2	0
Social transfers	24	23	14	14	0
GFCG firms	49	329	388	336	71
GFCG households	84	112	112	112	80

Source: IFP