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Household Consumption Shines

Macroeconomic forecast 2017 – 2020

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The pace of economic expansion will reach 3.3 per cent this year, fuelled predominantly by domestic demand. Household consumption will grow at the fastest pace since the crisis, while private investment will also vigorously add to growth. The unemployment rate is set to fall to a historical minimum, owing to the addition of 40 thousand new jobs. Next year, the economy will benefit mainly from export and in 2019 it will reach its post-crisis peak.

Monetary policy divergence is deepening

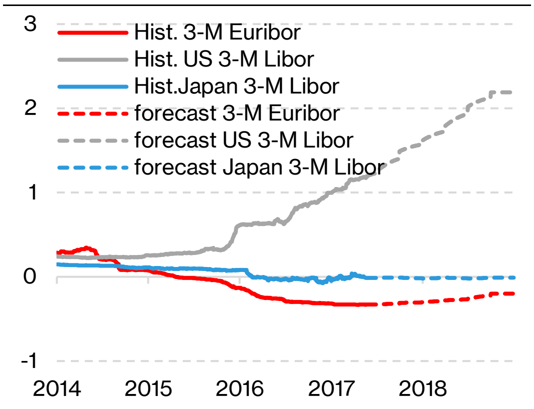
The course of monetary policy of the two major advanced economies is diverging (Chart 1). The US Federal Reserve (Fed) has hiked its key interest rate for the fourth consecutive time in the past two years in June. At the same time, the Fed sees chance to start reducing its balance sheet this year. Further course of its monetary policy will depend on economic activity, employment and price stability. In the meantime, the European Central Bank (ECB) is staying on course with its QE bond buying programme, which runs at least until the end of 2017 at reduced rate of EUR 60 billion per month. Monetary policy normalisation is not expected to take place before the second half of 2018, yet the return of inflation close to ECB's target is a necessary precondition.

The global stock exchange markets follow a gradual upward trajectory. The initial post-election euphoria of the US financial markets has cooled down, in part by more realistic expectations in regards to the impact of the planned fiscal stimulus, in part owing to the concerns related to possible global trade protectionism. The favourable results of the Dutch and French elections have calmed the European markets, resulting in equity gains and government bond yield stabilisation. The Pound Sterling weakened further in response to the UK early election results, currently trading at around 1.27 USD per pound.

Crude oil glut frustrates OPEC price control efforts

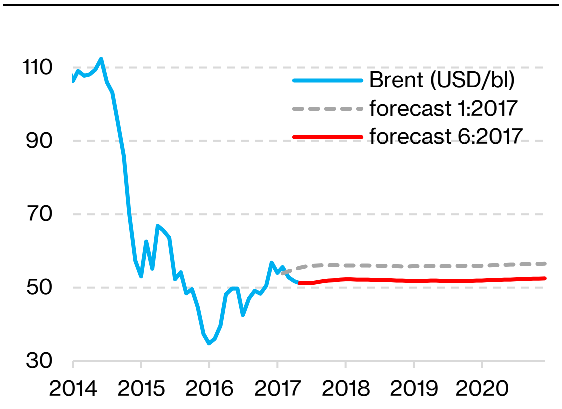
Members of the Organization of Petroleum Exporting Countries (OPEC) extended production cuts by nine months beyond June in the efforts to increase oil prices. The OPEC June decision has nevertheless failed to meet the expected increase in oil prices, which has dropped below 50 USD per barrel (Chart 2). OPEC oil policy is counteracted by surging US production, combined with robust production of non-OPEC countries, leaving global stockpiles near record highs.

Chart 1: Interest rate development



Source: Bloomberg

Chart 2: Brent crude oil price developments



Source: Bloomberg

The global economic activity intensified

Global economic activity intensified since the last forecast. The euro area economy accelerated in line with the world economy, fuelled by domestic demand and improving economic fundamentals. The US economic pace of expansion eased in the first quarter of this year, after last year's strong finish. In the meantime, China grew faster than expected in the fourth quarter of last year, while Russia emerged from a protracted two-year recession. Only the Japanese economy continued in a stagnant growth.

Euro area recovery solid across sectors and countries

The euro area economy accelerated to 0,6 per cent on quarter in the first three months of the year. The euro area recovery has firmed and become broad-based across sectors and countries. Domestic demand remains the key driver of growth, whilst labour markets are improving beyond expectations.

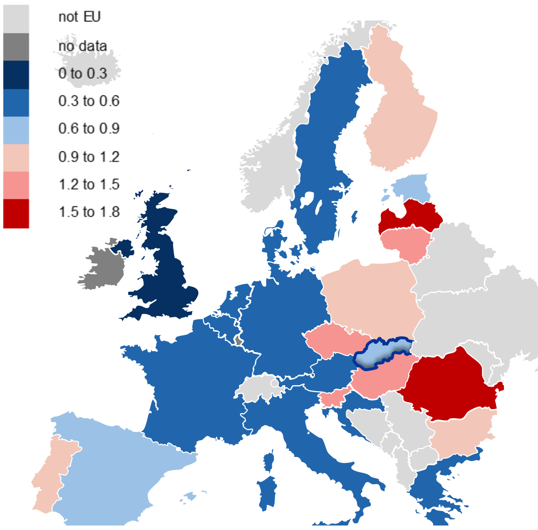
UK growth slows, as France accelerates

Germany and Spain continue to lead the way of euro area recovery (Chart 3). The pace of growth has, however, recently picked up also in economies with weaker fundamentals. The French economy has accelerated despite hightened political uncertainty amid the French presidential election. After being consistently one of the weakest eurozone performers, growth has also bottomed out in Italy. On the other hand, the UK performance disappointed in Q12017 on the back of dampened investment, possibly signalling the effect of the Brexit (Chart 3).

Soft data signal a further acceleration potential

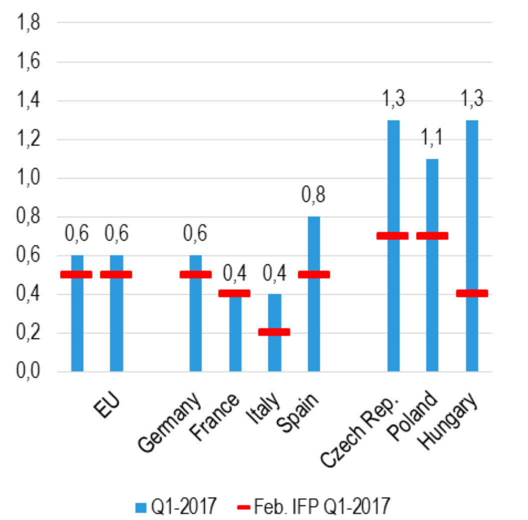
Euro area leading indicators have reached new heights, with the German IFO index at the forefront posting a post-reunification maximum in May. Moreover, euro area nowcasting models indicate further potential for acceleration of economic growth.

Chart 3: EU economic performance in the first quarter of 2017



Source: Eurostat, IFP

Chart 4: IFP forecast versus actual releases in the first quarter of 2017



Source: Eurostat, IFP

The V3 region is set for a strong year

The Visegrad 3 (V4 without Slovakia) region exhibited a better-than-expected economic activity at the onset of the year (Chart 4). Growth in the V3 region was dominated by private consumption, and government spending has additionally aided economic performance in the Czech Republic.

Growth momentum to persist in the euro area

The current forecast assumes a continued momentum of economic recovery in the euro area over the medium term, with Germany at the forefront. Meanwhile, Spain will continue its robust pace of expansion which will ease out somewhat at the forecast horizon. The French economy will continue in its recovery benefitting from both, domestic and foreign demand, whereas the Italian recovery is set to proceed at a more subdued pace. Poland and Hungary are expected to grow at a pace exceeding 3 per cent, while a stable 2.5 per cent growth is projected for the Czech Republic over the medium term.

Foreign demand indicator revised up in 2017 and 2018

Against this backdrop, the weighted GDP indicator of Slovakia's major trading partners has been revised up this and next year. In both years, the Indicator will benefit from an improved performance of the euro area, Germany, as well as our V3 partners, epecially Poland and Hungary. Global trade momentum coupled with the import intensity of public investment in V3 will lift import growth at the medium term forecast horizon. Accordingly, the foreign demand indicator has been revised upwards by 0.4 per cent in both 2017 and 2018. The cut-off date for the external environment assumptions, including interest rates and commodity prices is June 8, 2017.

Table 1: External environment forecast 2017 – 2020

	GDP (% growth)					Difference versus last					Import					Difference versus last				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
Most important trading partners	**2,0**	**2,2**	**2,2**	**1,9**	**1,8**	**0,1**	**0,2**	**0,2**	**0,0**	**0,0**	**4,3**	**5,0**	**4,8**	**4,5**	**4,5**	**-0,4**	**0,4**	**0,4**	**0,0**	**0,0**
eur area*	1,7	1,8	1,8	-	-	0,0	0,2	0,3	-	-	3,7	4,4	4,2	-	-	0,3	0,3	0,6	-	-
Germany	1,8	1,8	1,7	-	-	0,0	0,1	0,1	-	-	3,7	4,6	4,4	-	-	0,3	0,2	0,9	-	-
Czech Rep.	2,3	2,6	2,6	-	-	-0,1	0,1	0,0	-	-	3,0	5,3	5,4	-	-	-0,9	0,2	0,0	-	-
Poland	2,6	3,3	3,1	-	-	0,2	0,7	0,3	-	-	8,9	6,5	5,7	-	-	0,7	1,4	0,5	-	-
Hungary	1,8	3,0	3,1	-	-	0,2	0,6	0,8	-	-	5,7	5,8	5,5	-	-	-2,4	1,0	0,6	-	-

* Export-weighted euro area indicator

Source: European Commission, IFP

Household consumption as main growth driver

The Slovak economy is projected to expand by 3.3 per cent this year, on the back of domestic demand, especially household consumption and investment. In particular, household consumption is set to grow at the fastest pace since the crisis, owing to the improving labour market and despite inflation acceleration. Investment activity will rebound thanks to private investments in the automotive industry, while the beginning of the D4/R7 investment is foreseen in the last quarter of 2017. The improved external environment for the Slovak economy will support Slovak exports; although not adding much in terms of net exports contribution to growth, given the commensurate increase in imports, and owing to the higher import intensity of the economy.

Growth further accelerates due to automotive investments

The economy is expected to advance further to 4.2 per cent next year, benefiting from a broad-based structure. The external sector contribution to growth recovers, while dynamics of household consumption and investment activity remain high. Export performance will improve significantly on the back of new production in the automotive industry (Volkswagen from the beginning of next year; Jaguar Land Rover towards the end of next year).

Post-crisis peak followed by a return to the potential

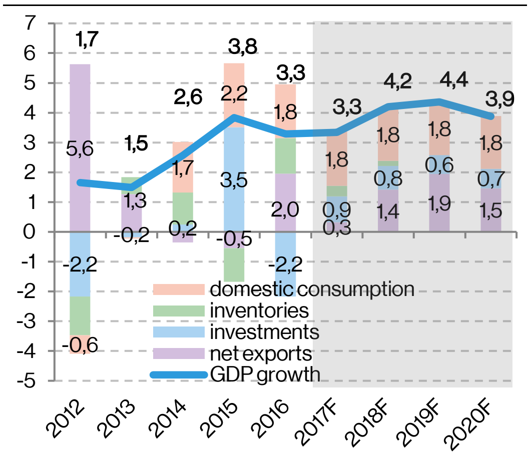
The economy is foreseen to gather speed further to 4.4 per cent in 2019, easing closer to its potential at 3.9 per cent in 2020. Economic growth in 2019 will be driven by the contribution of new production in the automotive industry to exports, also reaching a post-crisis high. Meanwhile, investments will decelerate as JLR plant construction is completed. The economy will return closer to its potential at the end of the medium term.

MF SR FORECAST - MAIN ECONOMIC INDICATORS (June 2017)

indicator (growth in % unless otherwise noted)	actual 2016	forecast 2017	2018	2019	2020	diff. from Feb 2017 2017	2018	2019	2020
Gross domestic product									
GDP, real	3,3	3,3	4,2	4,4	3,9	0,0	0,2	0,0	0,1
GDP, nominal (bn €)	81,0	84,6	89,6	95,3	101,1	0,0	0,2	0,2	0,4
Private consumption, real	2,9	3,1	2,8	2,9	2,9	0,6	0,1	0,0	0,0
Private consumption, nominal	2,5	4,5	4,5	4,8	5,1	0,9	0,1	0,0	0,0
Public consumption	1,6	1,4	2,0	1,9	1,8	-0,2	0,0	0,0	0,4
Fixed investments	-9,3	4,2	3,8	3,1	3,2	1,2	1,9	1,1	-0,4
Export of goods and services	4,8	6,0	7,7	7,7	6,3	0,4	0,4	0,0	0,1
Import of goods and services	2,9	6,1	6,8	6,3	5,4	1,9	0,8	0,0	-0,1
Labor market									
Employment (registered)	2,5	1,8	1,2	1,0	1,0	0,0	0,1	0,1	0,1
Wages, nominal	3,3	3,6	4,6	4,8	5,2	0,1	0,2	0,0	0,1
Wages, real	3,8	2,2	2,9	2,8	3,0	-0,2	0,3	-0,1	0,1
Unemployment rate	9,6	8,2	7,5	6,9	6,2	-0,2	-0,1	0,0	0,0
Inflation									
CPI	-0,5	1,3	1,7	1,9	2,1	0,2	0,0	0,0	0,0

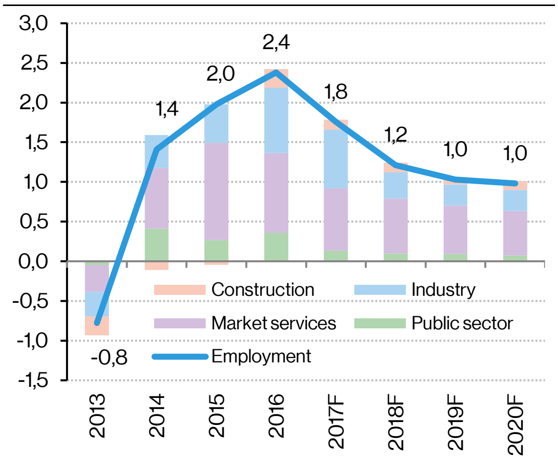
Source: STATISTICAL OFFICE, IFP

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



Source: SO SR, IFP

Chart 6: Contribution to employment growth (p. p.)



Source: SO SR, IFP

Outstanding employment growth

The Slovak economy will add an estimated 40 thousand jobs, increasing employment by 1.8 per cent. In terms of structure, the employment growth will be dominated by industry and market services, jointly creating around 35 thousand new jobs. In the meantime, construction will continue on its upward trajectory commenced last year. The participation of foreign workers in the domestic labour market will persevere, and help satiate the exceptional labour demand. Nevertheless, a deceleration of employment growth towards 1 per cent is projected across all sectors in the years to come.

Unemployment rate will reach a historical low this year

The healthy shape of the labour market is further corroborated by the falling unemployment rate, which has fallen to a nine year low at the onset of the year (according to the LFS methodology) and is expected to fall further. In fact, we expect it would reach an all-time low at 8.2 per cent in this year, further falling to 6 per cent at the end of the projection horizon.

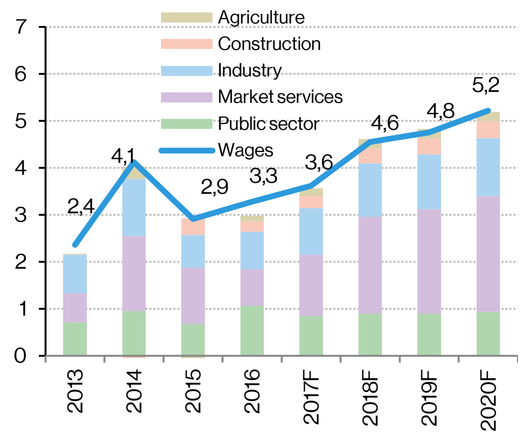
The average nominal wage to rise by 3.6 per cent

Turning to nominal developments, the average nominal wage is projected to grow by 3.6 per cent this year, breaking the thousand euro threshold at the end of the year. Nominal wages would advance most rapidly in industry, and in services to a lesser extent. Wage pressures are expected to intensify over the medium term owing to the envisaged shortage of skilled labour. In real terms, wage growth is forecasted to reach 2.2 per cent in 2017, and to be counteracted by reflation somewhat. Real wage growth is, however, expected to gradually gain traction towards 3 per cent in the years to come.

Prices recover

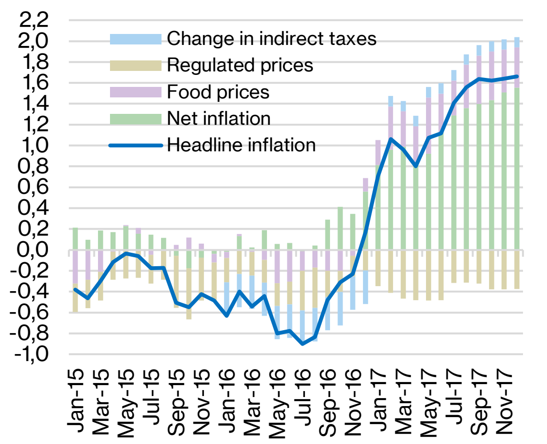
Inflation will return to the positive territory, averaging 1.3 per cent in 2017. The recovery in the growth of consumer prices has been facilitated by a slower onset of low fuel and food prices from the global markets, which is now expected to dissipate. The first months of the year were also marked by a renewed link between prices and wages in the economy, which is expected to result in the acceleration of prices of services. Counteracting these developments is the Regulatory Office energy price policy introduced in January this year.

Chart 7: Contribution to the nominal wage growth (p.p.)



Source: STATISTICAL OFFICE, IFP

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



Source: STATISTICAL OFFICE, IFP

Inflation will exceed 2 per cent owing to brisk growth of the economy

We expect inflation to be driven by intensifying demand-pull pressures in the foreseeable future. Across sectors, prices of market services will expand at the fastest pace. Expected rise in the energy commodity prices in the world markets and also based on European commodity futures, will prop up regulated energy prices next year. Owing to the brisk pace of expansion of the Slovak economy, inflation will exceed the 2 per cent towards the end of the medium term forecast horizon.

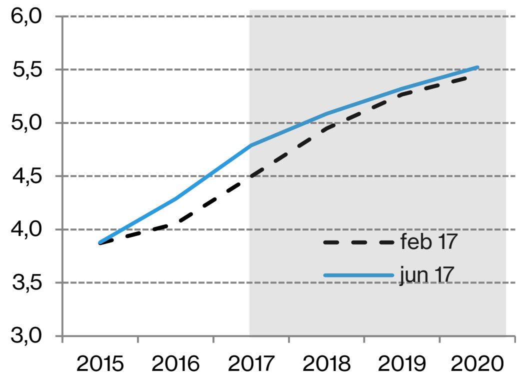
The risks to the forecast are broadly balanced

The risks to the current forecast are broadly balanced. Hard Brexit, the threat of global trade protectionism and retaliations, and fragile banking sector in Italy all pose downside risks to our forecast. On the other hand, leading and confidence indicators could translate into a stronger-than-expected performance of our main trading partners, which poses a new upside risk to our forecast. In addition, the US fiscal stimulus could also positively weigh on the prospects of the global economy, posing an additional upside risk to our baseline albeit to a lesser extent. On the domestic scene, a swifter-than-foreseen acceleration of wages at the overheating labour market – fuelled by a shortage of qualified labour – pose another source of upside risks.

Labour market propping up the tax bases

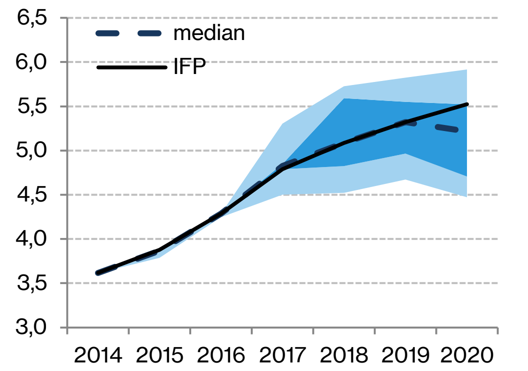
The overall impact of the macroeconomic forecast update on tax bases is favourable, owing to the stronger labour market and robust household consumption. The latter two are offset by withholding tax base and bank levy, as well as weaker-than-expected growth of CIT base this year. Better labour market performance and stronger consumption weigh favourably on these tax bases in 2018. 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 June 22, 2017.

Chart 9: **Macroeconomic tax bases growth compared to previous forecast**



Source: IFP

Chart 10: **Comparison of forecasts of macroeconomic bases[1] 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 June 14, 2017. The medium-term forecast was evaluated as realistic by all members of the Committee (NBS, ČSOB, Infostat, SAV, SLSP, Tatrabanka, Unicredit, VÚB). The detailed macroeconomic forecast, as well as the minutes from the meeting and supporting materials are available at the IFP website.

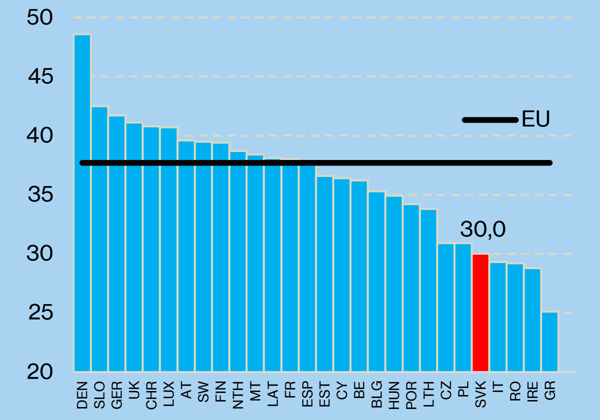
[1] Macroeconomic basis for the budget revenues (weight of indicators depends on the proportional share of the particular tax on the total tax revenues); Wage base (employment x nominal wage) – 51,1 per cent; Nominal private consumption – 25,7 per cent; Real private consumption – 6.6 per cent; Nominal GDP growth – 9.9 per cent; Real GDP growth – 6.7 per cent.

BOX. Wage growth in Slovakia: Too Rapid or Too Slow?

Considering the size of the Slovak economy, the volume of paid out nominal wages stands at a very low level compared to the EU average, lagging behind by almost 8 percentage points. It is easy to fall under the impression that nominal wage growth is currently slow amid the tight labour market, and when compared with the pre-crisis period. In fact, however, the growth of nominal wages has been outpacing its underlying fundamentals, such as productivity and inflation since 2014. This is true especially for the public sector and high-skill services sector, not necessarily for industry which has remained competitive in this respect. Notably, the pace at which nominal wages grow over time is also reduced by a higher participation of low-income workers and the long-term unemployed.

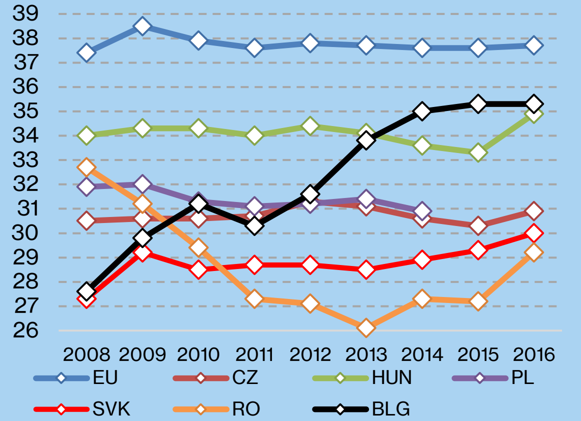
Upon a closer look, the **share of wages as a per cent of GDP in Slovakia has actually grown at a second fastest pace within the EU since the crisis**. Wages in per cent of GDP have increased by 3 percentage points cumulatively since 2008 (Chart B), while in the Czech Republic or Hungary this share has increased by below 1 percentage point, and has even dropped in Poland. The EU average has stagnated at around 38 per cent of GDP over the same period.

Chart A: Wages and salaries in the EU (as a share of GDP in per cent)



Source: EUROSTAT

Chart B: Wages and salaries growth (as a share of GDP in per cent)



Source: EUROSTAT

The Slovak nominal wage growth has been outpacing its underlying fundamentals since 2014 at the whole economy level. The long-term link exhibits a less pronounced reaction of wages to a change in the labour productivity – a phenomenon typical to the region of Central and Eastern Europe (CEE) pre-crisis. In the pre-crisis period, between 2002 and 2009, foreign investors brought substantial increases in labour productivity, but in order to attract labour they only had to offer incrementally higher wages compared to its local, less productive counterparts. This has contributed to a discrepancy between the actual and equilibrium wage, which can be observed at the entire estimation horizon (Chart C). While between 2002 and 2013 (except 2009 which was marked by an adverse productivity shock) wages stood marginally below their equilibrium level, they have been outpacing it since 2014. Moreover, the short-term fluctuations in wage dynamics are additionally impacted by the changes in inflation dynamics. Still, the nominal wages AR(1) appears to have the most explanatory power.

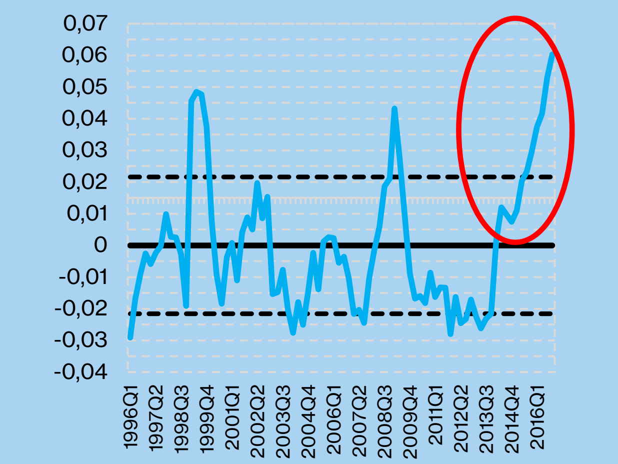
Error Correction Estimations

	Long-term relationship 1	Short-term relationship	Long-term relationship 2	Short-term relationship 2
Explanatory variables	Wage in whole economy		Wage in private sector	
Response variables				
Productivity in private sector (nominal)			0,920***	
Productivity in whole economy (nominal)	0,940***			
Constant	4,664***		4,732***	
Post-crisis dummy	0,068***		0,053***	
Correction term		-0,181**		-0,203**
Change in productivity in private sector (real)				0,158***
Change in productivity in whole economy (real)		0,172***		
Inflation		0,101**		0,148***
AR(1)		0,794***		0,765***
R^2	0,997	0,859	0,996	0,854
D-W statistics	0,351	2,345	0,503	2,341

Note: The analysed period covers quarters from 1997-2016. We estimated year-on-year changes of nominal wage as they are less volatile compared to the quarter-on-quarter changes. We have identified a structural break since the beginning of the 2009, which we approximated by the level shift dummy variable.

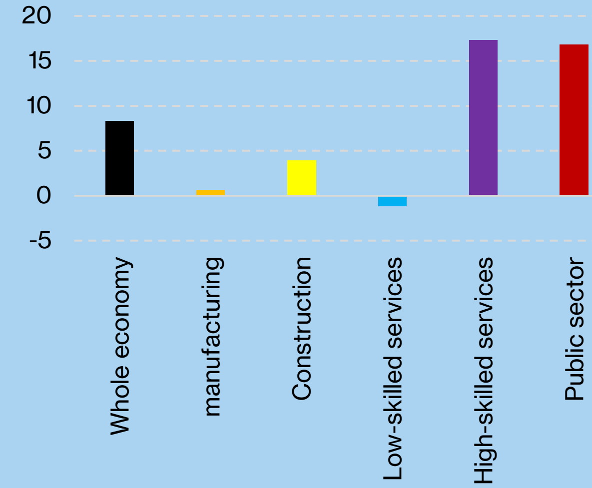
The gap between nominal wages and their equilibrium level does not adversely weigh on the competitiveness of the Slovak industry. While, industry employees and those in the high-skilled Services and Public Administration have recorded largest wage gains within the labour market, it was Public Administration, Real Estate, Informatics and Information and Communication sectors that have exhibited largest positive gaps between productivity and wage growth. To the contrary, Industry and low-skilled Services sector wages are well in line with their underlying productivity growth. Consequently, the wage growth/productivity growth misalignments do not threaten the Slovak competitive advantage.

Chart C: Actual versus equilibrium wages (standard error denoted by dashed line)



Source: IFP

Chart D: Wage growth versus its fundamentals in 2014 to 2016 (in nominal terms; percentage points)

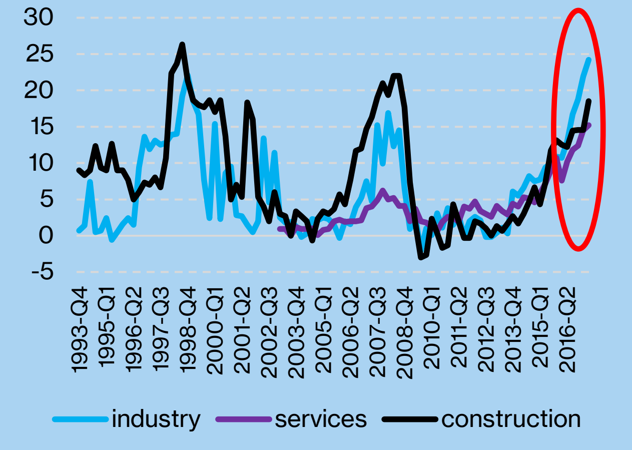


Source: Statistical Office, IFP

The dynamic wage growth is in line with the current overheating of the Slovak labour market. The unemployment rate has fallen to a single digit level for the first time in ten years, the long-term unemployed have dropped to a historical low in 2016, and the private sector is experiencing a shortage of qualified workforce. In fact, according to recent survey data, labour shortage has been flagged as an obstacle to production by the historically largest number of employers. A similar trend can be observed in the construction sector (Chart E).

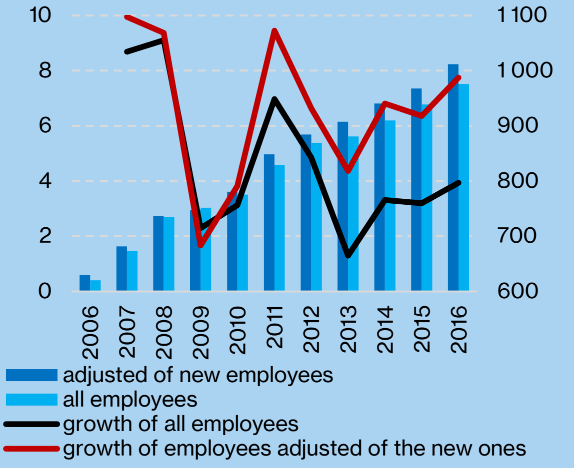
Average nominal wage growth is also dampened by new workers entering the labour force, as these workers' wages typically underperform the average. This has been true over the entire time horizon examined, with the exception of 2009 when incoming workers actually had an opposite effect on the aggregate wage growth. Nevertheless, the structural discrepancy between wage growth of permanent and newer workers has become more palpable in the recent years. According to the Social Insurance Agency data, the wages of workers who have been employed at least for two consecutive years have grown twice as fast compared to the average of employees at an aggregate level (Chart F). The share of increasing participation of low-income workers and the long-term unemployed represents an important structural shift in the labour market.

Chart E: Share of firms limited by a shortage of workforce



Source: Statistical Office.

Chart F: Aggregate wages[2] versus wages less new employees (per cent, eur right-hand-side)



Source: The Social Insurance Agency.

[2] Employees adjusted of entries to the labor market are employees registered with the Social Insurance Company, except for those who were missing in the register last year. At the same time, the employees in both categories are all cleansed for those who have dropped out of the record in the following year. We tracked only TPP employees with a wage cost base of over EUR 180 per month.