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Wages on the rise

Macroeconomic forecast 2017 – 2021

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Slovak economy will speed up and gain 4.1 per cent in 2018. The boost is expected to be driven by household consumption and private investment. Nominal wage growth is set to be the fastest since the crisis, thus adding to the inflation pressures. 40 thousand new jobs will push the unemployment rate below 7 per cent. In the coming year, the economic growth will further accelerate as the automotive sector takes over the role. The new macroeconomic forecast has a positive impact on tax bases throughout the medium-term horizon.

Economy is driven by domestic demand...

The economy of Slovakia will strengthen and gain 4.1 per cent in 2018. Firm household consumption will be supported by exports and, particularly, by investments. Exports will surge against the backdrop of new SUVs production in the VW plant. Yet, JLR will launch assembly lines at the end of the year, thus affecting this year's export figures only marginally. Investments will contribute strongly, owing to the peak of the economic cycle. In addition a basis effect will add to the performance of investments in the first half of this year.

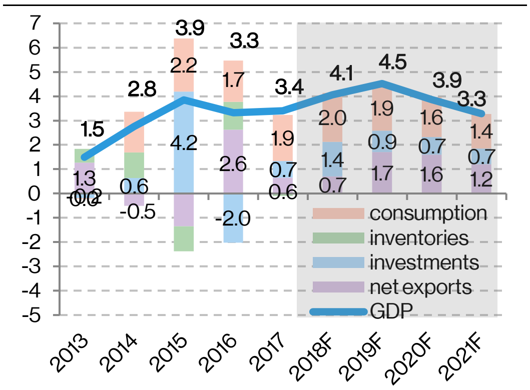
...supported by net exports in 2019

In the coming year the economy will expand by 4.5 per cent. Households' consumption growth will be steady above 3 per cent. Car manufacturers will boost exports as the JLR production gains momentum and VW output continues to rise. Investments are projected to ease off slightly after new capacities in the automotive industry are completed. Yet, core private investments will soar. Import dynamics shall lag behind exports', due to the slowdown in import-intensive investments. Consequently, net exports' contribution to GDP will be the largest. The economy is going to overheat slightly, mainly because of the tight labour market.

The slowdown will be only gradual

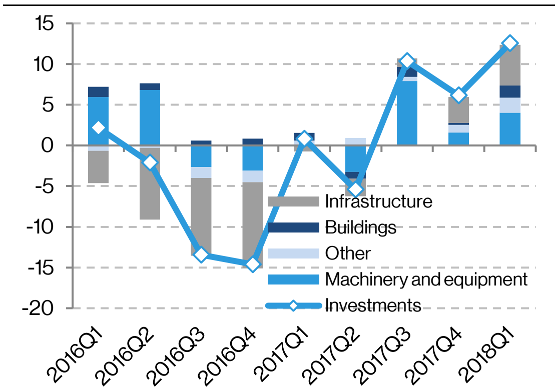
In 2020 and 2021 the economic growth will slow down to 3.9 and 3.3 per cent, respectively. Effects of the new car production will gradually fade out. Foreign demand (imports of main trading partners) shall decelerate to its long-run potential. A more modest growth in domestic consumption and investment is expected as well. Output gap is projected to reach the peak and start to narrow down at the end of the forecasting horizon.

Figure 1: Contributions to GDP growth (p.p.)



Source: IFP

Figure 2: Investments accelerate in line with the economic cycle (yoy growth, per cent)



Source: IFP

MF SR FORECAST - MAIN ECONOMIC INDICATORS (June 2018)

indicator (growth in % unless otherwise noted)	actual 2016	forecast 2018	2019	2020	2021	diff. from Jan 2018 2018	2019	2020	2021
Gross domestic product									
GDP, real	3.4	4.1	4.5	3.9	3.3	-0.1	0.0	0.0	-0.1
GDP, nominal (bn €)	85.0	90.5	96.7	102.9	108.9	0.3	0.6	0.8	0.9
Private consumption, real	3.7	3.4	3.2	2.8	2.5	-0.1	0.0	0.0	0.0
Private consumption, nominal	5.1	6.0	5.6	5.3	5.0	0.3	0.3	0.2	0.1
Public consumption	0.2	1.5	1.3	1.2	1.1	0.9	0.0	0.0	-0.1
Fixed investments	3.2	6.5	4.0	3.3	3.0	1.3	0.7	0.0	0.0
Export of goods and services	4.3	7.3	8.5	7.1	5.9	-0.6	0.0	0.0	0.0
Import of goods and services	3.9	7.1	7.4	6.2	5.3	0.0	0.2	0.0	0.1
Labour market									
Employment (registered)	1.8	1.7	1.0	1.0	0.7	0.0	-0.1	0.0	0.0
Wages, nominal	4.6	5.8	5.7	5.4	5.3	0.6	0.3	0.2	0.1
Wages, real	3.3	3.2	3.4	3.0	2.7	0.0	0.1	0.1	-0.1
Unemployment rate	8.1	6.9	6.4	5.8	5.6	-0.4	-0.3	-0.3	-0.3
Inflation									
CPI	1.3	2.5	2.3	2.4	2.5	0.5	0.3	0.2	0.2

Source: SO SR, IFP

Jobs will be created in industry and services, followed by construction

Slovak economy will add more than 40 thousand jobs, increasing employment in 2018 by 1.7 per cent. In terms of structure, the employment growth will be dominated by industry and market services, jointly creating almost 30 thousand new jobs. The recovery in construction will increase employment in this sector by more than 3 per cent, which is the highest growth since the crisis. Nevertheless, a gradual deceleration of the overall employment growth below 1 per cent is projected at the end of forecasting period. The participation of foreign workers in the domestic labour market will increase, and help to ease off the increasing overheating in the labour demand.

Unemployment rate below 7 per cent already this year

Unemployment rate should decline to 6.9 per cent. The number of jobless persons decreased in the first quarter of this year by the highest pace since mid-2015. The unemployment rate is expected to fall further in the rest of the year. It should decline to 5.6 per cent at the end of the forecasting period.

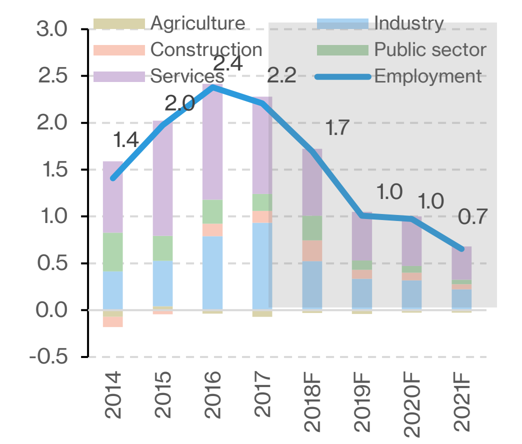
Wage growth will rise up to 6 per cent to

The average nominal wage growth is projected to accelerate to 5.8 per cent. Wages will prop up in all sectors, but most rapidly in industry and public sector. Vigorous wage acceleration reflects current labour market tightness as well as the rising inflation. In the following year, the nominal wage growth should be similar. **Real wages' dynamics will float above 3 per cent by 2020.**

Inflation on the rise

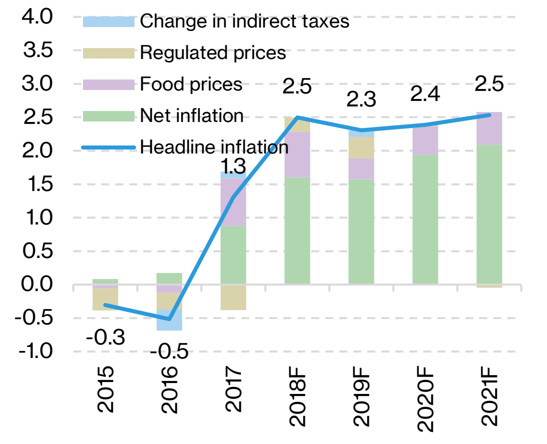
In 2018 prices will rise by 2.5 per cent. The acceleration of the demand-pulled inflation driven by wage growth will be accompanied by higher growth of food prices, which should persist throughout the rest of the year. Regulated prices will increase slightly following the decision by the regulatory authority from the beginning of the year. Higher oil price will push the prices of fuel up. Yet, prices of tradeable goods will increase only moderately as no foreign inflation pressures are expected.

Figure 3: Contributions to the employment growth (in ppt.)



Source SO SR, IFP

Figure 4: Headline inflation and contributions of individual components (p.p.)



Source: SO SR, IFP

Impulse to food prices dissipates next year

In the following year the inflation will ease off to 2.3 per cent, as the food prices' impulse vanishes. However, prices of tradeable goods and, especially, services will accelerate. The reason is the surge in wages due to the tight labour market. Based on the development of prices of energy-commodities and future contracts on the world market only a moderate increase in regulated energy-prices is projected. In the medium-term the rising prices of services will pull the headline inflation towards 2.5 %.

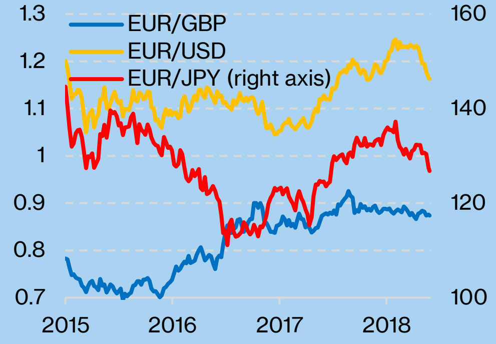
BOX 1: External Environment Assumptions

Monetary policy in the USA continues to normalize, whereas the euro area is still waiting for the inflation pressures. After increase in the benchmark interest rate to 1.75 per cent in March, the majority of the FOMC (Federal Open Market Committee) expects two more hikes this year, followed by three hikes in 2019. Expectations of rising interest rates make the US government bond yield curve extremely flat, thus discouraging long-tern investors. FED will continue in reducing the volume of its balance sheet. Conversely, **the ECB announced its intention to continue in quantitative easing with pace of 30 billion euro on monthly basis until September 2018**. Unfavorable developments in inflation indicate the hike in key ECB rates earliest at the end of 2019.

The euro has weakened slightly against the US dollar, following a rather poor performance in the euro area in the first quarter (Figure 5). However, the fundamentals of the European economy remain strong so far, suggesting that the euro will strengthen against other currencies over the forecast horizon. The position of the euro may be, nonetheless, negatively affected by the escalation of political risk in Italy. The exchange rate against the British Pound will be affected in particular by the Brexit negotiations. Clarification ot terms of the final agreement may affect the pound positively.

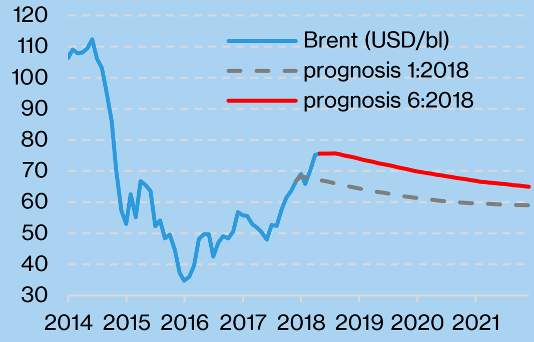
The oil price was close to USD 80 per barrel and is projected to decline slightly. Geopolitical uncertainty and low production in Venezuela increased prices in the first quarter of 2018. The expected extension of the oil production agreement in OPEC countries should push the commodity price up. Yet, attracted investors and subsequent increases in the oil production should stabilize the oil price below USD 70 per barrel (Figure 6) at the end of the forecast horizon.

Figure 5: Euro weakened against US dollar



Source: Bloomberg

Figure 6: Brent oil prices in USD per barrel



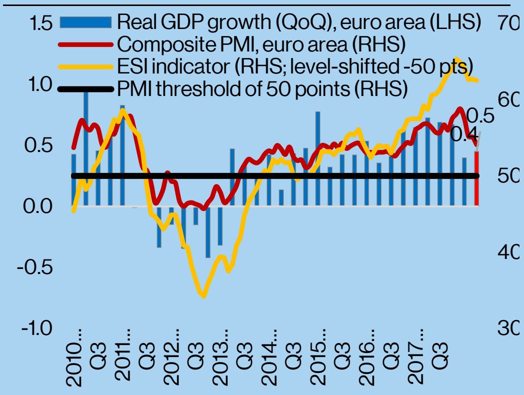
Source: Bloomberg

The cyclical peak experienced in the euro area at the close of last year faded in the first quarter of 2018 (Chart 3). The euro area economy slowed to 0.4 per cent QoQ[1], on the back on decelerated external trade. The latter, alongside the robust investment dynamics have constituted vital engines of euro area expansion in the 2H 2017. The cyclical momentum was further buttressed by supportive factors, including easy monetary policy conditions, robust labour markets, as well as intensification of global trade. The euro area growth eased up thanks to a pronounced slowdown in Germany and to a lesser extent in France and Italy, while growth in Spain remained resilient.

The US economy lost some steam in the first quarter against the backdrop of weaker private consumption. Meanwhile, the UK economy recorded the slowest growth rate since 2012 at 0.1 QoQ. The Chinese economy expanded at a stable rate of 6.8 per cent.

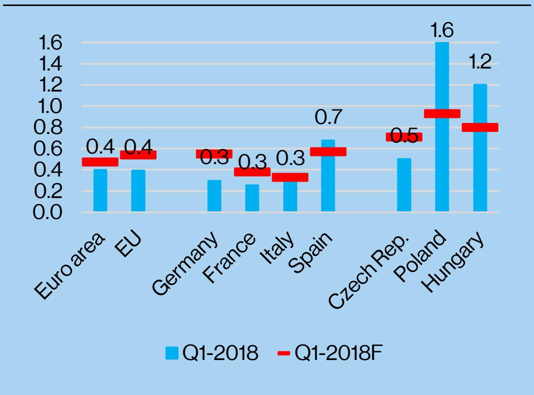
Contrasting with the slowdown in the euro area and some major markets, the Visegrad 3 region posted another dynamic quarter (Chart 4). Poland and Hungary led the way powered by vigorous private consumption and strong contribution of public investment. Imports grew rapidly to satiate demand of households, and cater to the import intensity of public investment under the 2014-2020 EU programming period. The Czech Rep. pace of expansion weakened, correcting for the better-than-expected performance at the close of last year (Chart 4). Dynamic wage growth, historically low levels of unemployment, upbeat consumer and business sentiment and selected policy measures are set to uphold private consumption in the V3 region over the medium-term forecast horizon. That, alongside a significant rebound in investment activity projected, will make domestic demand the principal driver of V3 growth going forward.

Figure 7: Euro area survey readings signal soft landing from cyclical peak (LHS %, RHS pts)



Source: Markit, EK, Eurostat

Figure 8: The V3 regional performance exceeded expectations (GDP growth %)



Source: IFP, Eurostat

[1] Down from 0.7 per cent QoQ posted in the last three months of 2017

The latest survey information on euro area conjuncture signal soft landing from the cyclical peak posted at the close of last year. In line with that, we expect euro area growth to stabilize at 0.4 to 0.5 per cent QoQ over the short-term. The euro area economy is set to gradually slow down over the medium term, as supportive factors wear out and the economy hits its supply-side limits (e.g. labour shortages) which will weigh down its productive capacity.

The cyclical peak recorded in the euro area at the close of last year together with stronger-than-expected performance of our V3 trading partners led to upward revisions of both, the weighted GDP indicator (+0.2 pp, +0.1 pp) and the foreign demand indicator (+0.5 pp, +0.1 pp) over 2018-2019 (Table 1). The outlook for Germany has been revised down for this year due to the bleak performance recorded in the first quarter. The noticeable upward revision of the foreign demand indicator this year owes, for the most part, to household consumption of imported goods and public investment intensity in V3. The cut-off date for selected external environment assumptions, including interest rates and commodity prices is May 30, 2018.

Table 1: The External Environment Assumptions 2018 – 2021

	GDP (% growth)					Difference vs. last					Import (% growth)					Difference vs. last				
	2017	2018	2019	2020	2021	2017	2018	2019	2020	2021	2017	2018	2019	2020	2021	2017	2018	2019	2020	2021
Most important trade partners	3.4	2.8	2.4	1.9	1.8	0.1	0.2	0.1	0.0	0.0	6.5	5.9	5.0	4.7	4.5	0.3	0.5	0.1	0.0	0.0
Euro area*	2.6	2.2	2.0			0.0	0.0	0.0			5.4	5.0	4.2			0.3	0.4	-0.2		
Germany	2.5	2.0	1.9			0.0	-0.2	0.0			5.6	5.7	4.4			0.4	1.1	0.3		
Czech Rep.	4.6	3.4	2.9			0.2	0.4	0.2			6.2	5.6	5.1			0.1	-0.4	0.0		
Poland	4.7	3.9	3.5			0.3	0.4	0.3			8.7	8.1	6.0			1.7	1.5	0.0		
Hungary	4.2	3.8	2.9			0.3	0.4	0.2			9.7	8.0	6.9			-0.4	1.1	0.6		

* exports-weighted euro area

Source: IFP, EK.

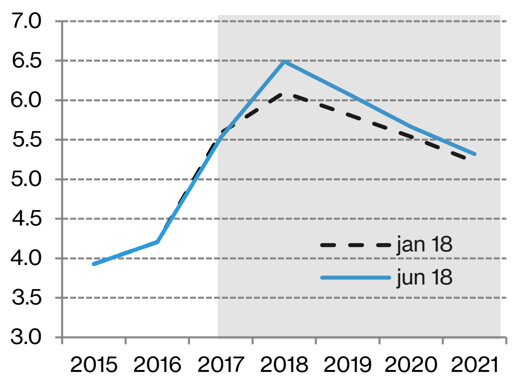
Risks tilted downwards

The balance of risks to the forecast is tilted downwards. The greatest negative risk in the external environment is the increasing protectionism in the international trade. An increase in US import duties on cars would reduce the Slovak GDP up to 0.11 p.p. (BOX 2) assuming no second-round effects. The economic situation in the euro area may be negatively affected also by political developments in Italy. On the upside, spillovers from the US tax stimulus may occur. There are two negative risks in the domestic environment. The first one stems from the labour market where the amount of available labour could reach its limit and thus reduce the growth potential of the economy. The second risk relates to the slowdown in household consumption due to the saturation of the economy by credit. On the upside the acceleration of wages in the private sector as a result of the overheating labour market represents the main concern. Public sector may also accelerate due to government social package measures. Influx of foreign workers could further improve the situation on the labour market.

Favourable impact of the forecat on tax bases

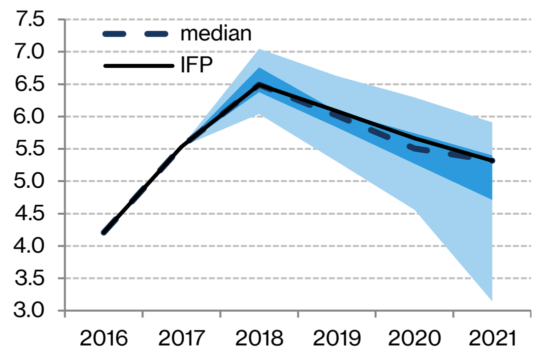
The overall impact of the macroeconomic forecast update on tax bases is positive. The main reason is the increased wage growth over the whole forecast horizon. Tax bases for withholding tax and bank levy have been affected only marginally. CIT tax bases are raised due to increased inflation. The overall impact of the present macroeconomic forecast on tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee meeting held on June 21st, 2018.

Figure 9: Macroeconomic tax bases growth compared to previous forecast



Source: IFP

Figure 10: Comparison of forecasts of macroeconomic bases[2] with the members of the Macroeconomic Forecasts Committee



Source: IFP

The medium-term forecast prepared by the Institute for Financial Policy (IFP) of the MF SR was discussed at the Macroeconomic Forecast Committee on June 13th, 2018. The medium-term forecast was **evaluated as realistic by most members** of the Committee (NBS, ČSOB, Infostat, SAV, SLSP, Unicredit), while two members assessed the forecast as optimistic (Tatrabanka, VÚB), especially at the far end of the forecast horizon. The detailed macroeconomic forecast, as well as the minutes from the meeting and all supporting documentation are available at the IFP website.

BOX 2: Potential impact of increased tariffs on car exports to US

The United States have definitely stepped into a trade war with the rest of the world on June 1st when the US President applied steel and aluminium tariffs to its closest trading partners - the EU, Canada and Mexico. Based on the announced retaliative measures of the EU and the longstanding interest of US to trigger tariffs on cars, further escalation of the trade war cannot be ruled out.

Increased[3] tariffs on European cars would hit particularly Slovakia. Although, exports to the US are less than 3 per cent of total exports and ranks 10th among the main trading partners of the Slovak economy, the dominant item is the export of cars. It accounts for two-thirds of exports to US. The ratio of car exports to US over the Slovak GDP, which is up to 1.7 per cent, is markedly the highest among all EU member states. Main exporters of cars from the European continent to US are German manufacturers (especially VW), Jaguar Land Rover and Volvo.

Should the US introduce tariffs on European cars, the static impact on Slovak GDP would be between 0.03 and 0.11 p. p. The core of the estimated effect comes from direct exports from Slovakia to US (from existing exports and new production capacity of VW and JLR). Yet, Slovak economy can be hit also indirectly through its trading partners. However, such impact is only limited as the main trading partners of Slovakia export far less cars to the US.

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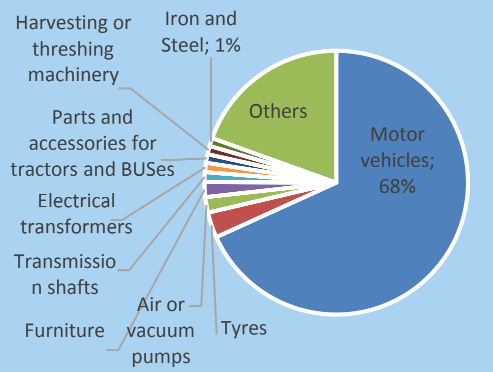
[2] Macroeconomic basis for the budget revenues (weight of indicators depends on the proportional share of the particular tax on the total tax revenues); Wage base (employment x nominal wage) – 51,1 per cent; Nominal private consumption – 25,7 per cent; Real private consumption – 6.6 per cent; Nominal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

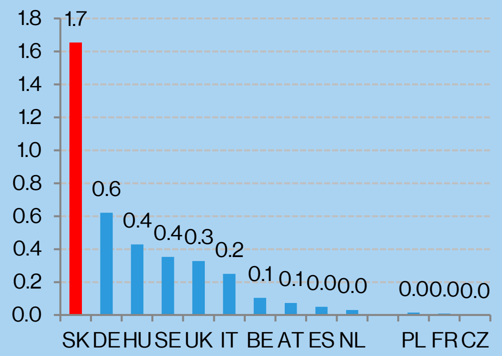
[3] Currently a 2.5 per cent tariff is applied to EU exports into US and a 10 per cent rate vice versa

Figure A: Commodity shares on exports to US



Source: Eurostat

Figure B: Ratio of car exports to US on GDP (in per cent)



Source: UN Comtrade, Eurostat

Two scenarios assume the introduction of protective tariffs in the range of 10 to 25 per cent from 2019 onwards, based on the USA's previous practice. We estimate the price elasticity of car tariff to be 0.5. The elasticity is rather low, as the vast majority of cars exported to US are luxury cars with non-elastic demand. Moreover, a likely euro depreciation will soften the effect and provide some support to euro area exporters. Part of the negative effect may also be diminished and absorbed by the high margins of the producers. Last but not least, exports can be redirected to other countries, but the scope for such reallocation is considerably smaller due to saturated markets compared to 2014 (Ukraine-Russian conflict) and 2015 (Dieselgate affair). In case of higher elasticity the impacts would increase proportionally.

Table: Static impact of increased tariffs on cars (in per cent of GDP)

	10 per cent scenario	25 per cent scenario
Direct exports to US	0.02	0.06
New production capacities at VW and JLR	0.01	0.04
Main trading partners	0.00	0.01
Total static effect	0.03	0.11

Source: IFP

Note 1: Assumed import intensity of car production in Slovakia reaches 70 per cent

Note 2: 20 per cent of new VW a JLR capacity is assumed to be meant for the US market