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The End of a Golden Era

Macroeconomic forecast 2019 – 2022

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The Slovak economy is projected to lose steam to 2.4 per cent in 2019, owing to the cooldown taking place in the euro area. The lacklustre growth projected for the Slovak main trading partners will adversely weigh on the labour market, and will slow down household consumption. In 2020, growth will further moderate to 2.3 per cent, while the unemployment rate will remain flat and wage growth will level off. 'No-deal' Brexit, as well as a marked slowdown in the euro area and the V3 economies pose the main downside risks to the current forecast.

Pronounced slowdown in foreign demand...

The Slovak GDP growth is set to decelerate to 2.4 per cent this year, in the wake of the cyclical slowdown taking place in the euro area. Recent data corroborate that subdued foreign demand has weighed down Slovak export activity in the second quarter, while across Slovak trading partners, German growth seems to have eased most pronouncedly. In terms of structure, the weak household consumption recorded in the first quarter will adversely impact this year's performance of the Slovak economy. On the other hand, investment in the first half of the year was driven predominantly by the private sector, while in the latter half of the year public investment is expected to pick up. Government consumption has been on the rise thanks to the increased employee compensations in the public sector.

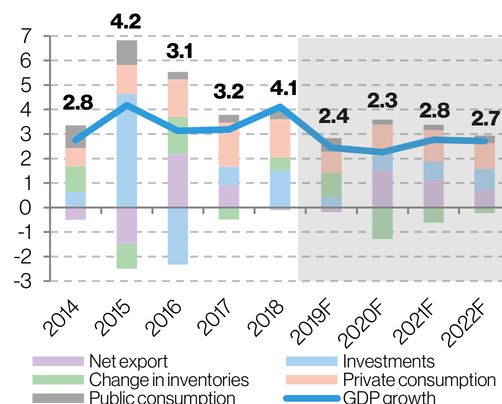
...will transpire in the domestic economic performance

In 2020 the economy is projected to continue on its downward trajectory, dropping to 2.3 per cent. Next year's growth will be, to some extent, fuelled by more dynamic export activity, thanks to the projected contribution of Jaguar Land Rover (JLR) production capacities. Lower disposable income will weigh down household consumption, whilst government consumption is expected to correct the strong performance posted in the preceding year. Following a decline in the previous period, the output gap is set to close by this point.

EU fund-fuelled investment to support growth in latter years

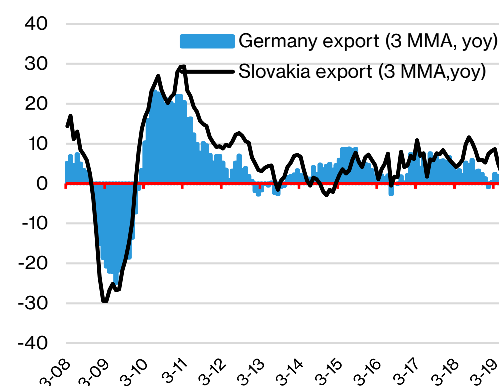
In the following years, a brisker pace of expansion will resume, with the economy projected to rise over its potential. In terms of growth structure, export will outperform foreign demand thanks to JLR, and both, investment and government consumption will pick up as the next EU funds programming period draws to a close. In addition, household consumption is set to accelerate as saving rate is projected to fall.

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



Source: IFP

Figure 2: Slovak goods exports in Q2 tumbled, following the slowdown in Germany (%)



Source: Eurostat, IFP

MF SR FORECAST - MAIN ECONOMIC INDICATORS (Sep 2019)

indicator (growth in % unless otherwise noted)	actual	forecast				diff. from Jun 2019			
	2018	2018	2019	2020	2021	2019	2020	2021	2022
Gross domestic product									
GDP. real	4.1	2.4	2.3	2.8	2.7	-1.1	-1.1	-0.4	0.0
GDP. nominal (bn €)	90.2	94.6	98.6	103.5	108.8	-1.2	-2.9	-3.7	-4.0
Private consumption. real	3.0	1.7	2.1	2.5	2.1	-0.5	-0.6	0.2	0.1
Private consumption. nominal	5.4	4.0	4.2	4.7	4.5	-0.8	-1.1	0.0	0.0
Public consumption	1.9	3.1	1.1	1.3	1.7	1.7	-0.2	-0.2	0.1
Fixed investments	6.8	1.9	3.6	3.3	3.8	-0.3	0.3	-0.1	0.2
Export of goods and services	4.8	2.8	5.3	4.6	4.2	-3.3	-0.6	-0.6	0.1
Import of goods and services	5.3	3.2	4.1	3.8	3.8	-2.3	-1.2	-0.8	0.0
Labor market									
Employment (registered)	1.9	1.1	0.2	0.3	0.2	-0.1	-0.5	-0.3	-0.3
Wages. nominal	6.2	7.4	4.7	5.1	4.8	0.7	-1.5	-0.2	0.0
Wages. real	3.6	4.8	2.5	2.9	2.4	0.7	-1.1	0.1	0.0
Unemployment rate	6.6	5.8	5.8	5.8	5.7	0.1	0.2	0.3	0.4
Inflation									
CPI	2.5	2.5	2.1	2.2	2.3	0.0	-0.4	-0.2	-0.1

Source: SO SR, IFP

Employment growth to stagnate in the remainder of 2019

Employment growth is estimated to rise by 1.2 per cent this year, corresponding with 30 thousand new jobs. The solid growth rate reflects predominantly a strong performance posted in the first half of the year, while dismal performance in the external environment, and particularly in Germany, poses a set-back to the Slovak production. The latter is expected to gradually transpire in the labour market. At the same time, the expected private sector employment has been on a decline for several consecutive months, justifying a stagnating employment profile for the rest of the year.

Most new jobs added in construction

The economy will add more than a half of new jobs in the services sector, although employment will rise across all sectors of the economy. Job creation is expected to be most rapid in construction, while industries prone to external developments will suffer, cooling job creation to beneath 0.5 per cent.

Unemployment rate to waver below 6 per cent at the forecast horizon

Next year employment is anticipated to grow by 0.2 per cent, as invigorated economic activity restores job creation at the year's onset. In the years to follow, employment growth will hover at around 0.3 per cent. **The unemployment rate is projected to hit a new record low at 5.8 per cent this year**, mostly stagnating over the medium term.

Wages will grow at a slower pace next year

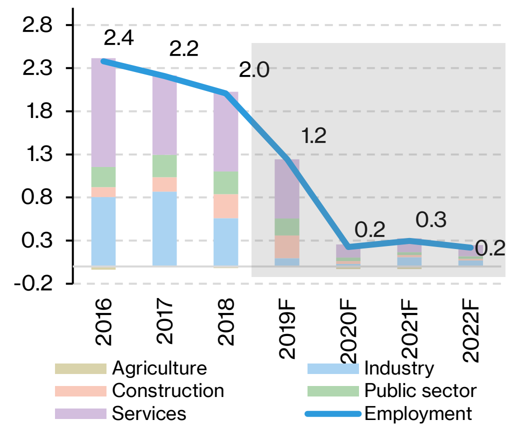
Turning to nominal developments, **the average nominal wage growth will pick up to 7.4 per cent this year, which constitutes most pronounced acceleration since the crisis.** Across sectors, the public sector will benefit from this acceleration most prominently, at above 12 per cent, partly owing to the greatest public sector wage valorisation in the country's history. Meanwhile, private sector wage growth is expected to waver at about 6 per cent in line with last year. The one-off effect of the bonus remuneration pay-outs, with a

portion that is tax- and levy- free, contributed an estimated 1.9 percentage points to a particularly strong second quarter. However, year-round dynamics will not be affected, as the one-off bonus effect is expected to be offset by other factors at the close of the year (see Box 2). **Wage growth will level off to below 5 per cent in the upcoming years**, while the slowdown will be palpable across all sectors. Real wage growth will linger below 3 per cent over the forecast horizon.

Price growth to remain stable

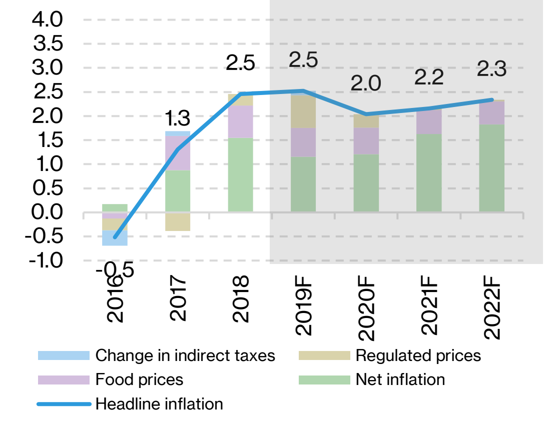
Consumer price growth is projected to reach 2.5 per cent this year, similarly to the year before, driven primarily by the services sector in response to labour market over-heating. In the meantime, food price inflation is expected to pick up pace in the second half of the year due to a base effect. The contribution of regulated prices is driven by rising energy prices (especially at the beginning of the year), and is partly offset by introduction of a lunch subsidy in kindergartens and elementary schools in September. In the meantime, prices of fuel have been on a declining trajectory this year, in tandem with falling oil prices, while the prices of tradable goods echo price developments abroad.

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

Economic slowdown will limit inflation

The cyclical slowdown will reduce inflation over the medium-term. On the one hand, weaker domestic demand will soften price growth in the services sector, on the other, the slowdown abroad will limit inflation in the tradables sector. Meanwhile, regulated prices will be fuelled by the expected significant rise in the prices of electricity in 2020, and to small extent offset by cheaper elementary school lunches. With a gradual pick-up in the pace of growth, inflation will converge to about 2.3 per cent over the medium term.

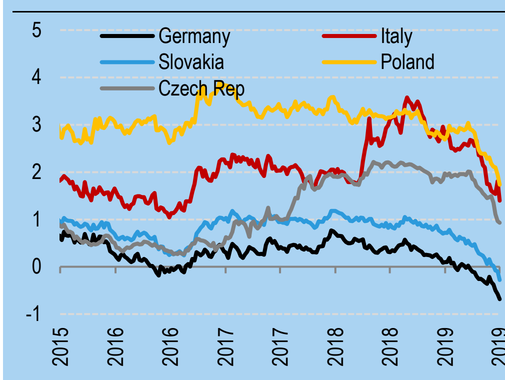
BOX 1: External Environment Assumptions

The global financial markets are under pressure, while the EU government bond yields have wavered around their historical lows. Concerns about weakening global demand, coupled with the disappointing performance of the real economy have pushed equity prices down. However, the single most important event moving the markets has been the trade conflict between the US and China. The accumulation of several negative signals led to increased investors´ risk aversion, which translated into a redistribution of resources into safer instruments. Markedly, government bonds yields in the USA and Germany have dropped to their historical lows (Figure 5).

Central banks are considering supportive measures in response to the weakening economic outlook. The US Fed has sent a signal of gradual reduction in the key interest rates should the US economy lose its pace. Currently, two to three interest rate cuts appear to be most likely by the end of 2019, bringing the reference rate to around 1.75 per cent at the end of the year. The pace at which the European economy has decelerated is more pronounced, which is reflected in a looser stance of the ECB policy. Policy-makers at the Old continent declared readiness to deploy a relatively wide arsenal of instruments, including a reinstatement of its quantitative easing programme and further policy rate cuts on the deposit rate. At the same time, the ECB has expressed its intention to support commercial banks whose interest margins have been squeezed for a long period of time.[1] **The economic slowdown is also reflected in the yield curves of both economies.** The US yield curve has inverted, which is empirically considered as a reliable indicator of recession. The European yield curve not only flattened but also shifted to negative territory.

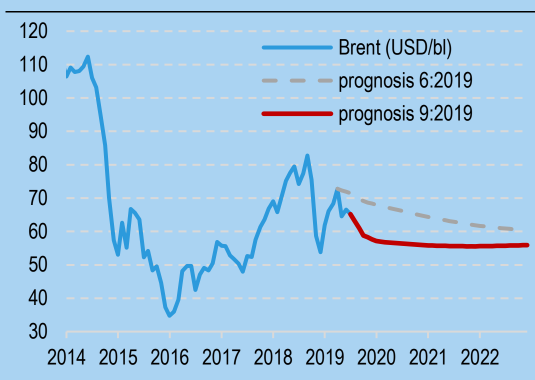
The more pronounced slowdown in economic performance in the euro area, along with the rising risk of 'no-deal' Brexit, led to a depreciation of the euro against the US dollar to 1.1 EUR / USD. The threat of a decline in global trade activity has fed into a decline in oil demand, whose price has fallen to USD 65 per barrel (Figure 6).

Figure 5: Decline in bond yields



Source: Bloomberg

Figure 6: Brent crude oil prices (USD per barrel)

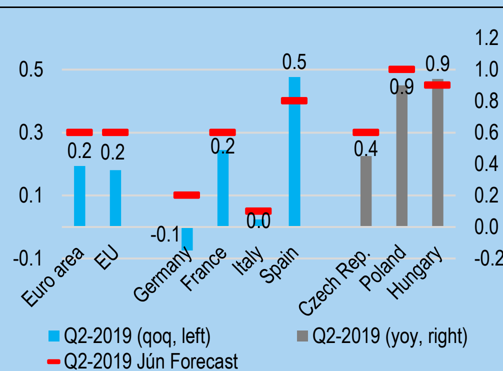


Source: Bloomberg

Global trade and the world economy are easing, to a large extent on the back of the ongoing trade conflict between the US and China. The euro area growth, in particular, has deteriorated to 0.2 per cent qoq in the second quarter, against the backdrop of the poor performance in Germany, at 0.1 per cent qoq, over the same period. The cooling off in Germany owes on the one hand to subdued foreign demand, on the other, to domestic factors. Domestic concerns stem primarily from the automotive industry, which is, without a doubt, Germany's growth engine, and one significant for the euro area as a whole. **By contrast, the V3 countries have benefited from strong domestic factors.** Dynamic household consumption and investment activity of firms, coupled with government stimuli in Poland and Hungary, reinforced the regional economy despite the weak external sector (Figure 7).

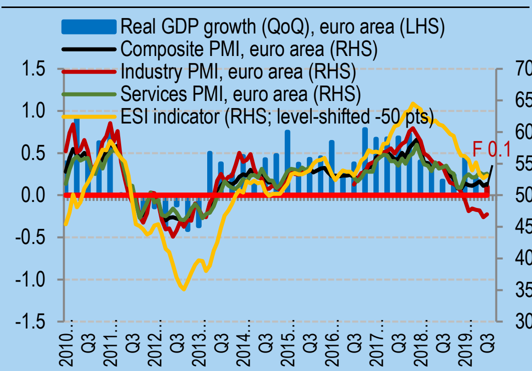
[1] On 12 September, after the cut-off date, the ECB cut its deposit interest rate by 0.1 pp and launched a quantitative easing of 20 billion EUR per month. It also adopted supportive measures for the banking sector to compensate low interest margins.

Figure 7: The V3 countries have posted robust growth



Source: IFP, Eurostat

Figure 8: Leading indicators in the euro area point to a slowdown



Source: IFP, Markit, EC, Eurostat

Conjunctural survey readings for the euro area point to a plunge in industry, fueled by weak industrial production in Germany (Figure 8). The service sector remains resilient, but its growth potential is likely to reach its limits. The euro area economy is therefore expected to rise by 0.1 per cent qoq in the third quarter of 2019. We have revised GDP and import projections down for 2019 for almost all key trade partners, except for Poland and Hungary (Table 1). The cut-off date for external environment assumptions, including interest rates, commodity prices, and exchange rates is August 27, 2019.

Table 1: The External Environment Assumptions 2018 – 2022

	GDP (per cent growth)					Difference vs. last					Import (per cent growth)					Difference vs. last				
	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022	2018	2019	2020	2021	2022
Most important trade partners	2.7	2.0	1.9	1.7	1.7	-0.1	-0.1	-0.2	-0.1	0.0	4.4	3.5	3.6	3.6	3.7	-0.5	-0.6	-0.4	-0.3	-0.2
Euro area *	1.9	0.9	1.2			0.0	-0.2	-0.2			3.2	2.5	2.8			0.1	-0.4	-0.8		
Germany	1.5	0.5	1.1			0.0	-0.2	-0.2			3.4	2.4	2.4			0.0	-0.5	-0.9		
Czech Rep.	2.9	2.5	2.3			0.0	-0.1	0.0			5.9	3.3	3.5			-0.1	-0.9	0.0		
Poland	5.2	4.5	3.7			0.0	0.1	0.0			7.1	5.6	5.3			-0.1	-0.1	0.0		
Hungary	5.0	4.7	3.1			0.0	0.1	0.0			7.1	6.8	5.1			0.0	0.0	0.0		

* exports-weighted euro area

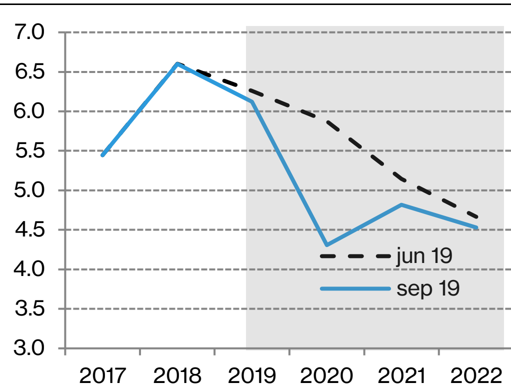
Source: IFP, EC.

Risks to the baseline forecast are tilted to the downside

The balance of risks to the current forecast is tilted to the downside. Most downside risks emanate from the external environment, including a pronounced slowdown in the euro area, the closing of the output gaps in the V3 region, enduring trade wars, and a 'no-deal' Brexit. Domestically, a stronger labour market reaction to the ongoing cyclical slowdown through the channel of private consumption poses the main downside risk.

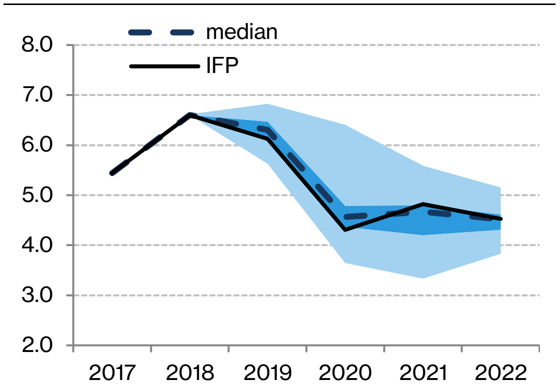
The overall impact of the macroeconomic forecast update on tax bases is negative. The slower tax base growth hinges on a slower pace of GDP growth, private consumption, as well as labour market developments. The overall impact of the present macroeconomic forecast on tax and social contributions will be subjected to further scrutiny at the Tax Forecast Committee meeting held on September 19, 2019.

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 has been discussed at the Macroeconomic Forecast Committee on September 11, 2019. **The medium-term forecast was evaluated as realistic by most members of the Committee** (ČSOB, Infostat, NBS, SLSP, VÚB, Tatrabanka, Unicredit), while a single member assessed the forecast as conservative (SAV). The detailed macroeconomic forecast, as well as the minutes from the meeting and all supporting documentation are available at the IFP website.

[2] Macroeconomic base 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.

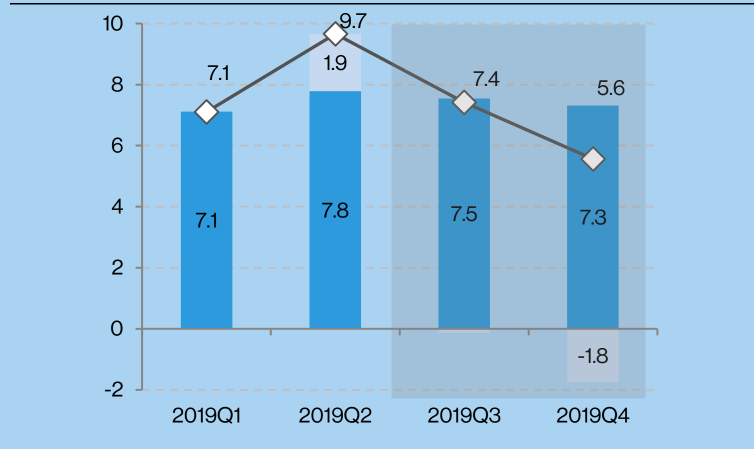
BOX 2: The one-off effect of the bonus remuneration package on the wage growth in the second quarter

The extraordinarily powerful nominal wage growth recorded in Q2 was to a significant extent fuelled by the one-off outcome of the bonus remuneration package coming into effect. We estimate this impact in Q2 to be 1.9 percentage points, though we do not expect it to affect a year-round dynamics.

The average nominal wage rose by close to 10 per cent in the second quarter of this year, which constitutes the largest upsurge since the beginning of 2008. Wage growth accelerated in both, public and private sectors but about one fifth of the reported growth can be credited to the aforementioned bonus one-off effect.

The tax- and levy- breaks associated with the introduced bonus scheme led employers to move their pay-outs from last year when they were due to May 2019. In this way, the number recipients of this bonus among employee ranks increased 15-fold on an annual basis. At the same time, the average pay-out markedly exceeded the amount of EUR 500 freed from taxes in May. We estimate the overall impact of the paid out bonuses to amount to the contribution of 1.9 percentage points, however this one-off effect should not affect the annual wage growth figure. The latter is a result of delaying the pay-outs from last year, and this positive effect will be offset by a weaker performance at the end of the year.

Figure 11: Contribution of the one-off effect of the bonus remuneration package on the year-on-year wage growth in 2019



Source: IFP