inštitút finančnej politiky

Policy brief 2024/02

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As inflation eases, households will take a breather this year

Macroeconomic forecast for years 2024 – 2028

IFP Analysts

The Slovak economy strengthened in 2023 thanks to the use of EU funds. GDP grew by 1.1 per cent, while other V3 economies lagged behind. GDP growth will reach 2 per cent in 2024, supported by receding inflation and a recovery in domestic demand. Strong real wage growth will lead to an increase in household consumption, which will drive the recovery. The absorption of EU funds will be partly offset by stronger implementation of Recovery and Resilience Plan projects. Foreign trade will rebound and the sentiment in the global economy will slowly improve, boosting domestic exports. A stable labour market will be hampered by labour shortages. However, the risks to the forecast are mainly on the downside, as persisting geopolitical tensions may destabilise energy and food prices.

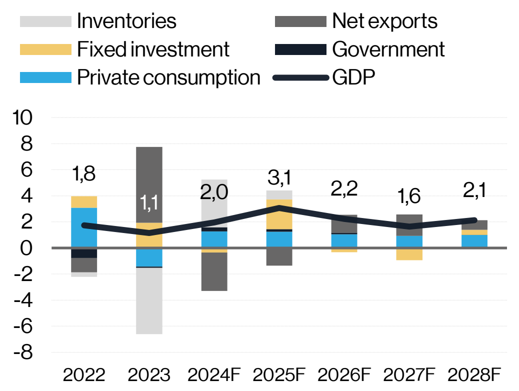
GDP in 2023 pushed up by EU funds

The Slovak economy strengthened in 2023 thanks to EU funds, GDP grew by 1.1 per cent. The absorption of EU funds stabilised the Slovak economy, while other V3 economies lagged behind. Households' consumption fell more sharply than expected, with consumers redirecting more income in the second half of the year to rebuild their savings, which they lost to the inflation shock. Exports lagged behind due to weaker demand from our trading partners, especially in Germany. The trade balance finished the year in strongly positive territory due to lower imports of energy and goods, which were drawn mainly from inventories.

Recovery of household consumption and another injection of EU funds will accelerate GDP growth in 2024

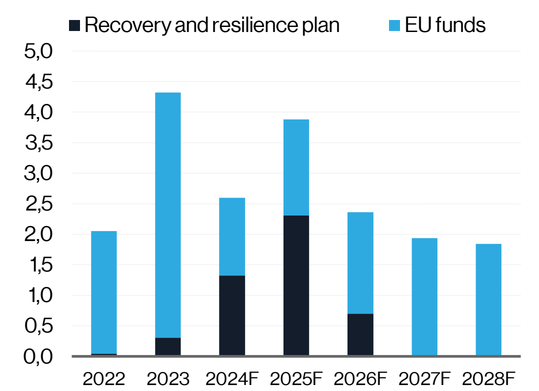
GDP will grow by 2 per cent in 2024, driven by receding inflation and a recovery in domestic demand. The recovery will be driven by household consumption, which will be supported by strong real wage growth above 3 per cent. The 2023 peak in EU fund absorption will be partly replaced in 2024 by a stronger implementation of Recovery and Resilience Plan (RRP) projects as well as the purchase of military equipment. Improving global sentiment will boost foreign trade and support domestic exports during the year The labour market will remain stable despite the labour force shortages hampering job creation.

Figure 1: Contributions to GDP growth (constant prices, p.p.)



Source: SO SR, IFP

Figure 2: Planned volume of EU funds (per cent of GDP)

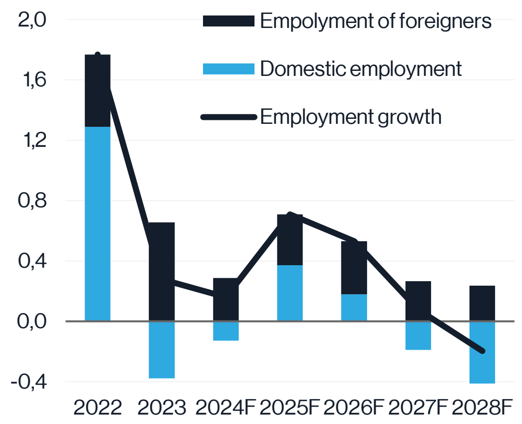


Source: IFP

The business cycle will likely peak in 2025

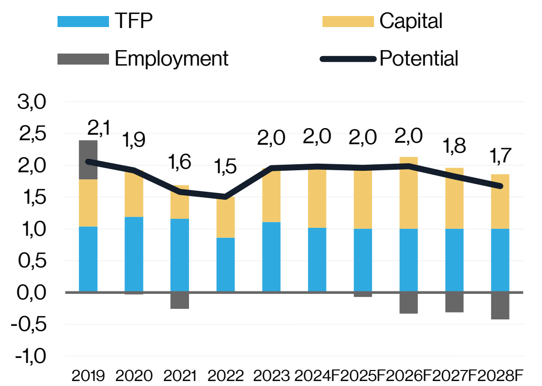
In 2025, the economy's performance will peak at 3.1 per cent. Half of GDP growth is to be provided by the roll-out of the Recovery and Resilience Plan. We assume that electricity and gas prices for households will return to market levels, which may lead to a modest increase in inflation dynamics. However, the savings rate will have stabilised and real income growth will continue. Household consumption will thus maintain its momentum. Investment absorption from the RRP will peak, giving a boost to the economy. The external environment will take a recovery path and monetary easing will become more pronounced, with domestic exports slowly picking up pace. On the other hand, the necessary adjustment of government spending will dampen activity.

Figure 3: Employment of domestic and foreign workers (in ppt.)



Source: SO SR, IFP

Figure 4: Shift in the dynamics of potential due to demography (per cent of GDP)



** TFP – Total Factor Productivity of Labour*
Source: IFP

Growth between 2026 and 2028 on fair grounds

We expect economic growth of around 2 per cent between 2026 and 2028. The impacts of the drawdown from the Recovery and Resilience Plan will fade over time. Instead, higher export capacity in the automotive industry will drive the economy in the years to come. With new models, domestic carmakers will gradually penetrate foreign markets and catching up on lost market shares is expected. Consolidation of public finances will dampen government consumption. However, household consumption will remain stable. The effects of the ageing population will be exhibited in the economy. The main age cohorts of the labour force will shrink and lower employment will cause a reduction in the dynamics of the economic potential.

The downside risks to the forecast prevail, as the ongoing geopolitical tensions may again destabilise energy and agricultural prices. Domestically, weaker absorption of RRP funds remains a risk, which should significantly increase the capital stock and ensure productivity gains in the face of looming demographic challenges. The outcome of the US elections may also cause a rise of protectionism in trade relations with the EU. The opportunity, on the other hand, is stronger integration of people from abroad into the domestic labour market. World energy prices have fallen more sharply, opening the way for more moderate growth in regulated (energy) prices.

Employment will stagnate

The labour market is resilient, the unemployment rate is close to the minimum, but employment dynamics remain low due to labour shortages. The economy will create about

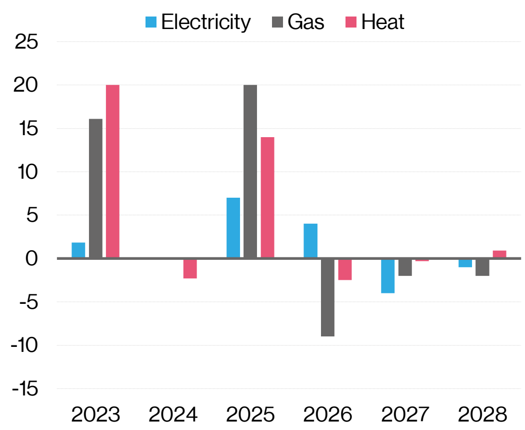
4,000 new jobs in 2024, a third fewer than last year. Industry and low-skilled services, where employment has still not reached pre-pandemic levels, will suffer most from the deterioration in domestic and foreign demand. Increased early retirements will continue to a lesser extent this year. The problem of a shrinking workforce in Slovakia continues to be cushioned by over 100,000 foreign workers. The unemployment rate will decrease to a new low of 5.5 per cent.

Employment will accelerate along with the economy to 0.7 per cent next year. Up to 14,000 new jobs will be created as a result of the RRP's spending peak. In the period ahead, growth in the labour market will moderate along with the decline in the economically active population. The unemployment rate will decrease to 5 per cent at the end of the forecast horizon.

Wage growth outpaces inflation

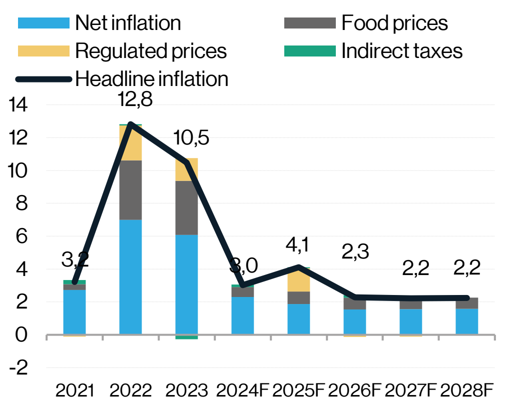
Real wages will increase after two years of declines. Nominal wage growth will slow year-on-year, along with lower productivity growth, inflation and back-indexation. Negotiations in the public sector reflect the need for consolidation. The private sector will thus outpace the public administration in terms of wage increases in 2024. In the following years, the scissors between the growth of average wages in the economy and labour productivity will gradually close. Real wages should increase at an average rate of 2 per cent per year from 2025 onwards.

Figure 5: Assumptions of energy prices



Source: IFP

Figure 6: Contributions to inflation rate (p.p.)



Source: SO SR, IFP

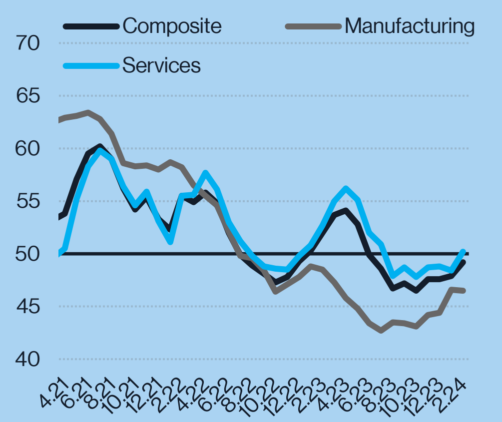
Inflation will decelerate to 3 per cent in 2024 and the price shock will subside across the EU. Slow price growth since April last year has led to a gradual decline in annual inflation, which has continued in 2024. The low price growth was also supported by the continuation of energy prices subsidies for households. Food prices, which were one of the main causes of high price increases in the recent past, have stabilised, as have prices of tradable goods and services.

Price growth in 2025 may accelerate slightly if energy prices switch to market levels. Since autumn last year, the dynamics of electricity and gas futures prices have strongly decelerated, with a price decrease of around a third since October 2023. Thus, the assumption of an end to energy price subsidies may lead to a more moderate increase in gas and heat prices. Electricity prices will still be subject to the memorandum with SE next year. The return to market-based energy prices will lead to a temporary acceleration of inflation above four per cent next year. However, markets expect energy commodity prices to decrease in the coming years, so we can expect that energy prices will dampen inflation in the medium term. Once the inflation shocks subside and the base effect wears off, we expect food and tradable goods prices to return to the growth rates seen in 2017-20. Services prices will rise faster, but overall price growth will be dampened by consolidation over the medium term.

BOX 1: External environment assumptions

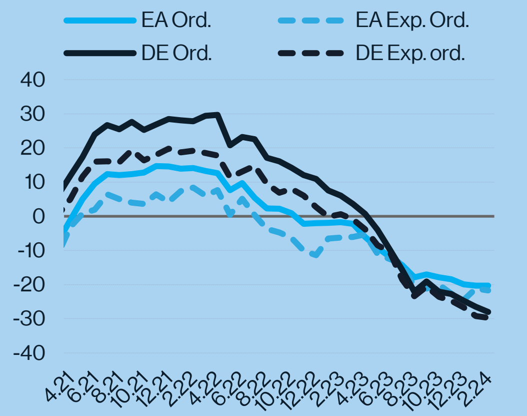
The global economy showed signs of slowing in 2023. High interest rates, receding inflation and energy shock have weighed on the performance of the world's major economies. The situation was particularly unfavourable in Germany, which was the only rich developed country to see its economy shrink. China also experienced a significant slowdown, while the US economy surprised with its resilience. Our closest trading partners in the V4 experienced negative developments as well, with the Czech and Hungarian economies contracting slightly and the Polish economy flattening.

Figure A: Services lead the recovery in the euro area (Purchasing Managers' Index, values above 50 = expansion)



Source: Bloomberg, IFP

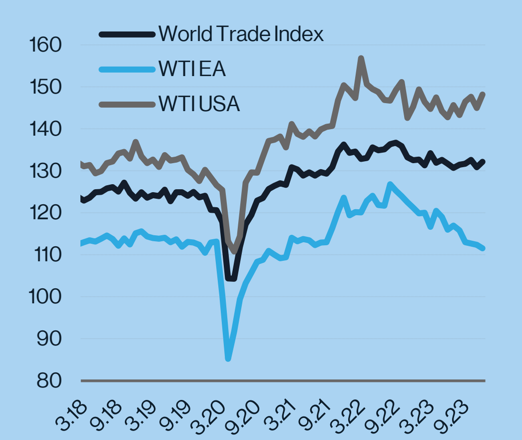
Figure B: Domestic and export orders in industry continue to decline (ESI, points)



Source: EC, IFP

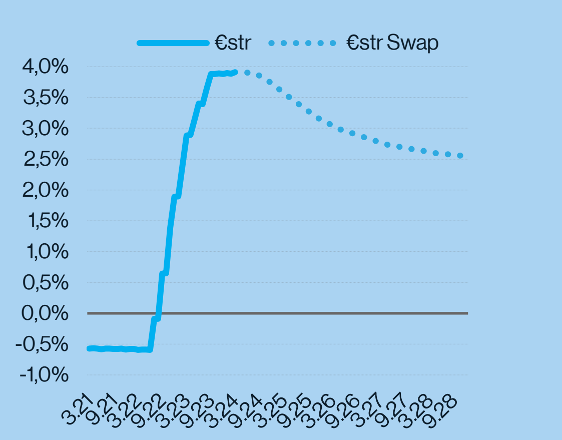
The industrial sector remains problematic, while services are supporting the recovery. European industry has not been able to get on the road to recovery throughout the year due to low external demand and high interest rates. Heavy and energy-intensive industry in particular is under pressure, with Germany, but also other heavily industrialised countries such as the Czech Republic and Hungary, paying their toll. Despite leading indicators pointing to the onset of a modest recovery in the global industry, the unfavourable developments in Germany and the euro area as a whole persisted in the first quarter of this year. In contrast, the services sector entered the new year with positive momentum and recorded the first months of growth, suggesting that this year's economic growth could outperform last year's performance.

Figure C: World trade growth at the expense if the euro area (World Trade Index)



Source: CPB, IFP

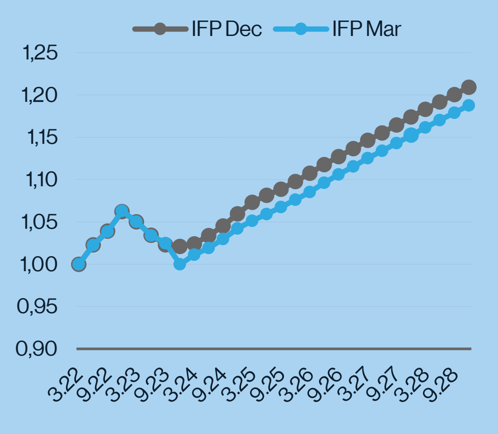
Figure D: Rate cuts expected in the second half of the yar (€str curve estimate acc. int. r. swaps, per cent)



Source: Bloomberg, IFP

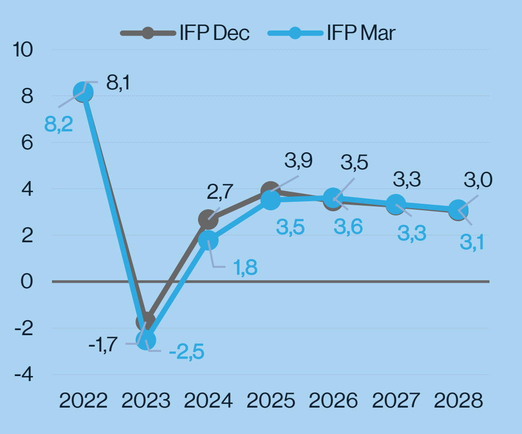
Foreign demand will grow more slowly this year than we expected in the previous forecast. Given the negative momentum from the beginning of the year and the weaker carry-over effect from last year, foreign demand will be lower this year. The acceleration of the recovery should come in the second half of the year when the ECB cuts its interest rates. Lower funding costs and a continued global recovery will support growth, especially in the suffering industrial sector. External demand will accelerate this year mainly due to solid growth in the V3 region supported by the rapid pace of monetary easing. Over the longer term, we expect a gradual accommodation of shocks in the euro area and Germany, which will ensure that external demand stabilises in the years ahead.

Figure E: External demand will grow slower (weigh. ind. of ex. dem., level, indexed)



Source: IFP

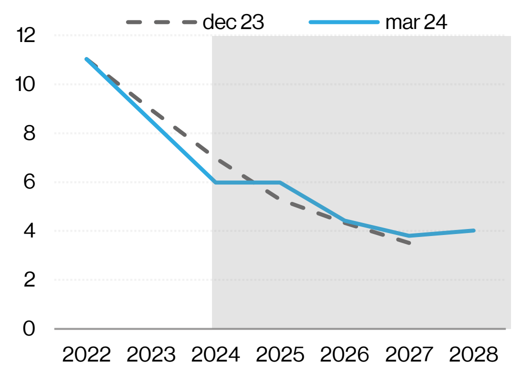
Figure F: Weaker performance of foreign partners will weigh on foreign demand (yoy, weigh. ind. of ex. dem., per cent



Source: IFP

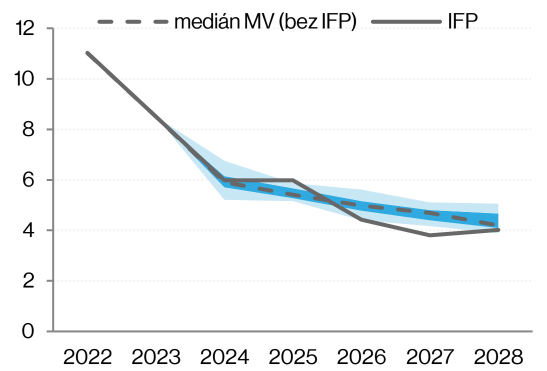
The update of the Ministry of Finance's macroeconomic forecast was the subject of a meeting of the Committee for Macroeconomic Forecast on 20 March 2024. **The forecast was assessed as realistic by all of the Comittee members** (NBS, SAV, RRZ, SLSP, Tatrabanka, Infostat, Unicredit, VÚB a ČSOB)**.** The forecast update as well as the minutes of the Macroeconomic Forecast Committee and the background materials are available on the IFP website.

Figure 7: Evolution of macroeconomic bases compared to the previous forecast (growth, per cent)



Source: IFP

Figure 8: Comparison of tax bases forecasts[1] by members of the MFC (growth, per cent)



Source: IFP

MF SR FORECAST – MAIN ECONOMIC INDICATORS (March 2024)

indicator (growth in per cent unless otherwise noted)		forecast					difference from January 2024 forecast					
	2023	2024	2025	2026	2027	2028	2023	2024	2025	2026	2027	2028
Gross Domestic Product												
GDP, real	1.1	2.0	3.1	2.2	1.6	2.1	-0.1	-0.7	0.3	0.1	0.0	0.3
GDP, nominal (bn. €)	122.2	130.7	139.6	146.2	151.9	158.4	0.3	-0.6	0.4	-0.4	-0.2	122.2
Private consumption, real	-2.5	2.3	2.2	1.9	1.7	1.8	-0.5	-1.1	0.6	0.8	0.6	0.0
Private consumption, nominal	7.5	6.1	6.3	4.1	3.9	4.1	-1.4	-1.0	1.2	-0.3	0.7	-0.1
Government spending	-0.5	1.9	1.2	0.8	-0.5	0.0	1.0	0.6	1.6	1.7	-0.9	0.3
Fixed investment	9.6	-1.6	10.8	-1.4	-3.8	1.8	1.8	-6.7	6.5	-2.3	-1.1	0.8
Export of goods and services	-1.3	2.8	3.1	4.5	4.5	3.2	-0.6	-1.2	-0.8	-0.2	0.1	0.0
Import of goods and services	-7.4	6.3	4.7	3.1	2.9	2.6	-1.0	-1.1	1.2	-0.1	0.0	-0.1
Labour market												
Registered employment	0.2	0.1	0.7	0.5	0.1	-0.2	-0.1	-0.3	0.2	0.4	0.4	0.1
Wages, nominal	9.7	6.3	5.5	4.4	4.0	4.5	-0.2	-0.8	0.2	-0.1	-0.2	0.5
Wages, real	-0.8	3.2	1.4	2.0	1.7	2.2	0.0	-0.5	-0.8	0.7	0.1	0.5
Unemployment rate	5.8	5.5	5.2	5.1	5.0	5.0	0.0	0.1	0.2	0.0	-0.4	-0.3
Inflation												
CPI	10.5	3.0	4.1	2.3	2.2	2.2	-0.2	-0.2	1.0	-0.8	-0.3	0.0

Source: SO SR, IFP

[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) – 55.9 per cent; Nominal private consumption – 24.4 per cent; Real private consumption – 4.2 per cent; Nominal GDP growth – 10.6 per cent; Real GDP growth – 4.9 per cent..

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

	2022	2023	2024	2025	2026
RRP total	**49**	**373**	**1 730**	**3 226**	**1 026**
Public investment	2	81	1 079	2 036	690
Compensations	27	38	145	159	56
Intermediate consumption	13	25	102	94	29
Soc. transfers in kind	0	2	13	5	0
Social transfers	4	9	30	30	0
GFCG firms	3	39	262	809	158
GFCG households	0	180	100	93	93

Source: IFP