Medium-Term Forecast

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Contents

The Slovak economy is heading for a recession followed by a strong recovery

Overview

Slovakia entered this year amid favourable expectations for its economic performance. The fourth quarter of 2019 brought a number of upside surprises in the composition and volume of production. Furthermore, several partial indicators of economic developments also improved moderately in the early part of the year.

From January, however, reports were coming through about a coronavirus epidemic in China, and within a short time this epidemic became a pandemic. In the meantime, the epicentre of the coronavirus (COVID-19) outbreak shifted to Europe.

Since February, Slovakia has taken several administrative measures to slow the spread of the virus, and these have had a major impact on the economy. The declaration of a two-week state of emergency resulted in almost the entire service sector being shut down. Apart from that, the impact of similar measures by Slovakia's trading partners has disrupted global supply chains, with major consequences for foreign trade.

These and other events have significantly altered the economic outlook, not only for Slovakia, but for the whole world. Given that the situation is changing day by day, that uncertainty is rising and that the behaviour of individuals, firms and commodity markets is being, and will be, severely constrained by this exceptional situation, it is currently impossible to produce a meaningful, detailed forecast using standard approaches and procedures.

Consequently, in this Medium-Term Forecast (MTF-2020Q1), Národná banka Slovenska has decided to produce three scenarios of what may happen in 2020, instead of standard projections of economic developments.

These scenarios indicate that, compared with 2019, the Slovak economy could contract by between 1.4% and 9.4% in 2020, depending on developments in Slovakia's trading partners. Despite monetary and fiscal stimulus measures, the impression gleaned from financial markets and the ongoing uncertainty is that the economic contraction could be between 4.5% and 9.4%, i.e. in the higher half of the estimated range of severity.

Three scenarios for developments in 2020

Our three scenarios differ mainly in their assessment of the extent of the ongoing crisis in the external environment. The **first scenario** is based on the "domino" scenario presented by the OECD in early March.[1] It assumes that the coronavirus outbreak has a relatively short (from today's perspective) duration and does not affect the global economy in a major way.

The second and third scenarios envisage greater disruption of global value chains. In the **second scenario**, which assumes that the exceptional situation in Slovakia's euro-area trading partners lasts around a month, euro area GDP contracts by 2-3% and economies and trade begin recovering from autumn 2020. In the **third scenario**, which assumes that the exceptional situation continues into the summer of this year, euro area production falls more sharply.

The second scenario assumes that the decline in Slovakia's foreign demand in 2020 will be half as large as the decline in the financial crisis year of 2009, while the third scenario assumes that it will be about the same as in 2009, causing overall exports to drop by around one-fifth.

All three scenarios also include a deterioration in the domestic side of the economy, predicated on a two-month state of emergency that weighs heavily on consumer demand. The sector hardest hit is services, in which many small and medium-sized enterprises operate. The probability is very high that these firms will be laying off workers and that the labour market situation will therefore worsen. In second and third scenarios, moreover, the labour market and consumer demand are adversely affected by a decline in foreign demand, which has an additional negative impact on the domestic side of the economy. These two scenarios assume significant decreases in investment demand and private consumption, with the result that **between around 75,000 to 130,000 jobs could be under threat** this year.[2]

The impact of the current situation on inflation is difficult to estimate. On the one hand, the slump in demand and the current low level of energy commodity prices will have a dampening effect on headline inflation; on the other hand, higher domestic cost factors could exert upward pres-

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[1] OECD Interim Economic Assessment, March 2020.

[2] Referring to the difference between the number of employed people in the fourth quarter of 2020 and in the fourth quarter of 2019.

sure. It is envisaged that the negative household income effect could cause a slight slowdown in inflation.

Table 1 Outlook for 2020 (annual percentage changes)

	Scenario 1	Scenario 2	Scenario 3
GDP	-1.4	-4.5	-9.4
Employment	-0.3	-1.7	-3.1
Inflation	2.3	2.1	2.0

Source: NBS calculations.

The scenarios do not incorporate coronavirus-related measures announced by the Slovak Government, or those announced by the European Commission, since these had not been sufficiently elaborated by the cut-off date for the data used in the scenarios. After being approved, these measures will be factored into future updates of the economic outlook. The scenarios do, however, imply significant changes in Slovakia's tax and social contribution revenues in 2020. Depending on the scenario, the negative impact on these revenues is estimated at between 1.5% of GDP and 3.4% of GDP. If that lost revenue were to be replaced by debt financing, at a time of declining GDP, the implication is that public debt would increase to a sanction-triggering level under the debt brake regime.[3] The Government's measures may cause a further deterioration in fiscal performance and public debt; at the same time, they may slightly ease the contraction, though that will be affected more by the speed and eventual extent of the economy's recovery.

Outlook for 2021

All three scenarios envisage the economy returning to recovery in the second half of 2020 and gaining momentum in 2021. It is probably unavoidable, however, that at least some production will be permanently lost.

The model estimates do not take into account impacts on the financial sector. This sector is better prepared than it was during the financial crisis; nevertheless, in the current climate of uncertainty about macroeconomic developments, the impacts on this sector are relatively difficult to quantify. In any case, capital requirements appear to be sufficiently high.

[3] The obligation to apply sanctions under the third to fifth sanctioning zones as defined in the Fiscal Responsibility Act does not apply for a period of 24 months beginning on the first day after the day on which the Government's policy statement was approved. The Act provides for non-enforcement of the sanctions in exceptional cases, and the envisaged scenarios may fall into that category.

Nor do the model estimates factor in the expected benefits of official measures, which in addition to those taken by the Slovak Government, must include EU-level initiatives such as the European Central Bank's decisive monetary policy measures.[4] One purpose of the ECB's measures is to support the confidence of people, firms and financial markets in the economic system, both during the crisis and going forward; another purpose is to support the flow of lending to the household, corporate and government sectors, so as to help them bridge the crisis and to expedite the economy's recovery in the second half of the year. Similar measures are being taken by central banks and governments across the world.

4 In addition, on 18 March 2020 the European Central Bank approved a new temporary asset purchase programme of private and public sector securities – the Pandemic Emergency Purchase Programme (PEPP).