

Slovakia: January 2009

Changes over previous version

Bad figures from the Euro area released before the Christmas break along with the weak sentiment and stagnating Slovak industrial production made us to revise our growth expectations for the next two years downwards. However, we still expect domestic demand to remain supportive to the growth over this year. Monetary policy accommodation of the ECB should support credit and consumption in our view. The ECB cut its key interest rates by larger than expected 75bp before the year-end and further cuts worth 75-100bp might be expected in 1Q09.

Long-term outlook – Fixed Income Research – Jänner 8, 2009

		2004	2005	2006	2007	2008f	2009f	2010f	2011f
Real economy									
Real GDP	% y/y	5.2	6.6	8.5	10.4	7.0	4.2	4.5	5.5
Nominal GDP	fixed EUR m*	45.2	49.3	55.1	61.5	68.4	73.4	79.2	86.3
GDP per capita	EUR	6315	7140	8261	10149	12174	13565	14630	15914
Household consumption (real)	% y/y	4.2	6.5	5.9	7.1	5.9	5.3	5.5	5.0
Gross investments (real)	% y/y	13.6	16.5	6.6	7.1	7.4	3.7	6.8	6.5
Industrial output	% y/y	4.0	3.8	9.9	12.8	5.0	3.0	5.0	4.0
Retail sales (real)	% y/y	6.2	9.7	8.3	4.8	7.0	6.0	5.5	5.0
External balance									
Import	% y/y	13.8	13.1	22.9	10.2	8.9	5.0	8.2	12.3
Export	% y/y	10.9	11.1	24.5	15.2	9.5	5.3	8.2	13.0
Merchandise foreign trade balance	EUR m	-1.6	-2.5	-2.5	-0.7	-0.5	-0.3	-0.4	0.0
	% of GDP	-3.6	-5.0	-4.5	-1.2	-0.7	-0.5	-0.5	0.0
C/A (since 2005 incl. reinv. earnings)	% of GDP	-3.6	-8.4	-7.2	-5.3	-5.4	-4.9	-4.6	-3.9
Net FDI inflow (equity capital)	USD bn	1.1	0.7	2.1	1.1	1.2	1.4	1.5	1.8
	% of GDP	2.5	1.5	3.7	1.5	1.2	1.4	1.5	1.7
Prices									
CPI inflation	% y/y, Dec	5.9	3.7	4.2	3.4	5.0	3.9	3.9	3.9
	% y/y, avg	7.5	2.7	4.5	2.8	4.6	4.0	3.9	3.9
Core inflation (CPI ex-reg. prices and taxes)	% y/y, Dec	1.5	1.7	2.7	4.2	4.6	4.0	3.9	3.9
Harmonized inflation	% y/y, Dec	5.8	3.9	3.7	2.5	3.9	3.4	3.7	3.8
	% y/y, avg	7.5	2.8	4.3	1.9	4.0	3.3	3.7	3.8
Producer prices	% y/y, Dec	4.3	7.0	5.4	2.8	6.1	3.8	2.5	2.0
Labour market									
Unemployment rate (ILO methodology)	%	18.1	16.2	13.3	11.0	9.7	10.0	9.7	9.3
Employment (domestic concept)	thousands	2170	2216	2301	2357	2432	2453	2477	2498
	% y/y	0.3	2.1	3.8	2.4	3.2	0.9	1.0	0.8
Average wage	fixed EUR*	525	573	623	669	729	785	849	921
Average real wage	% y/y	2.5	6.3	3.3	4.3	4.2	3.6	4.0	4.4
Public sector									
Fiscal balance (ESA-95, ex pension reform)	% of GDP	-2.3	-2.2	-2.4	-0.7	-0.7	-1.0	-1.1	-0.6
Fiscal balance (ESA-95, with pension reform)	% of GDP	-2.3	-2.8	-3.5	-2.0	-2.2	-2.4	-2.5	-2.0
Public debt	% of GDP	41.4	34.2	30.4	29.4	28.6	29.0	29.4	29.0
Interest rates									
Central bank's policy rate	Dec	4.0	3.0	4.8	4.3	2.50	1.75	2.75	4.00
3M BRIBOR	Dec	3.7	3.2	4.7	4.3	2.98	2.20	3.05	4.30
	avg	4.7	2.9	4.3	4.3	4.15	2.65	2.65	3.70
1Y BRIBOR	Dec	3.5	3.4	4.6	4.4	3.28	2.40	3.50	4.35
	avg	4.4	2.9	4.6	4.4	4.61	2.90	2.95	3.90
5Y yield (zero curve)	Dec	4.0	3.6	4.3	4.6	3.20	4.00	4.50	4.50
	avg	4.6	3.3	4.5	4.5	4.30	3.50	4.25	4.50
10Y yield (zero curve)	Dec	4.5	3.7	4.3	4.8	3.75	4.70	5.00	5.00
	avg	5.1	3.9	4.5	4.6	4.52	4.10	4.85	5.00
Exchange rates									
USDEUR	Dec	1.36	1.18	1.32	1.47	1.41	1.30	1.25	1.25
	avg	1.24	1.24	1.25	1.37	1.47	1.32	1.28	1.25
EURSKK	Dec	38.8	37.8	34.6	33.6	30.1	30.1	30.1	30.1
	avg	40.0	38.6	37.2	33.8	31.3	30.1	30.1	30.1

Note:* euro-fixed time series is a series in SKK multiplied by the conversion rate of 30.1260 SKK/EUR.

Source: Štatistický úrad, Eurostat, NBS, SLSP, Erste Research

Real economy

After reaching the peak at the record 10.4% in 2007, the Slovak economy started to slow down; in 2008 we expect the growth rate to reach 7.0% and in 2009 we expect further slow-down to around 4.2%. In past few years economy benefited from established foreign direct investments, placed mainly in the automotive and electronic industries. The pace of potential output growth slowed down in 2008 as the car factories did not deliver such one-off boost as was seen in 2007. In addition, this-year growth will be negatively affected by worsened growth outlook in the Euro zone, which will likely dampen Slovak exports especially in the cyclically sensitive industries (although cheap labour force should give the country competitive advantage). The second negative factor will be liquidity constraints and cautiousness of financial institutions in their loans provisions, hitting corporate business and investment growth. Private consumption will likely be effected in lesser extent than the corporate sphere and should continue provide a support to the economy.

External balance

The foreign trade deficit narrowed significantly in 2007 to 1.2% of GDP, due to sustained growth of car exports, slowdown of investment-related imports and smaller increase in oil prices than in 2006. Along with the trade balance, the current account deficit narrowed as well to 5.3% of GDP last year. We expect the trade balance to end 2008 with a deficit of 0.7% of GDP and similar deficit of 0.5% of GDP can be expected also in 2009. While slowdown in the Europe has already brought lower demand for Slovak products in late 2008, imports slowed down as well due to lower material imports of key Slovak exporters and decline of oil prices since mid-2008. We expect sluggish trade dynamics at least in the first half of 2009, while gradual recovery in Euro area in the second half of 2009 can be expected.

Prices

Inflation was gradually increasing since the second half of 2007 until September 2008, particularly on the back of high food and oil price growth (harmonised inflation reached its peak in September at 4.5% y/y and headline CPI peaked at 5.3%). Despite higher inflation, Slovakia was meeting Maastricht inflation criterion since the second half of 2007. Harmonized consumer inflation has gradually declined since September to below 4% by year-end and we expect it to stay below 4% in 2009. Deceleration of annual price growth was due to the higher base (last year's food prices increase has not repeated). At the same time, oil price decline in second half of 2008 eased the pressure on energy prices (the government also exerted significant pressure to prevent a gas price hike), which were previously regarded as the biggest inflation risk by us. On the other hand, higher prices of cigarettes should still fuel inflation in the last quarter of 2008. In 2009, average inflation should stay around 3.3%.

Labour market

The labour market continued to experience favorable tendencies. In recent years, improved possibilities to work abroad after the EU entry contributed to the employment growth in Slovakia. However, the number of people working abroad has stabilized in 2007. At the same time, employment rises on the back of strong domestic job creation. We expect the continual employment growth even though the financial crisis poses a risk for Slovak labour market. Due to growing labour force, the unemployment rate will likely increase in 2009 despite employment growth. Also, in the medium term, Slovakia could face a problem that almost 60% of unemployed people did not work for more than two years. This could later serve as a barrier to a more significant improvement. Employment growth is accompanied by the real wage growth, which we expect to stay at around 4% in the years ahead thanks to productivity gains resulting from implementation of foreign technology and know-how.

Public sector

The 2008 general government deficit will likely come in close to the budgeted ceiling at 2.3% of GDP, which is a level similar to the 2007 fiscal deficit, which stood at 2.2% of GDP. The public debt stands at around 30 % of GDP. The Parliament passed the public finance deficit for 2009 with a deficit at 2.1% of GDP, which was revised from previously planned 1.7% of GDP, due to lower projected tax incomes, as the economy is likely to slowdown visibly due to financial crises and global economic slowdown. The tendency seen in public finances confirms our view that once euro goal has been fulfilled and the 2010 elections are looming, the government will not stick to its original medium term fiscal plan and indeed we will see deterioration of public finances in 2009 and 2010.

Interest rates

Slovakia entered the Euro area on January 1, 2009 and along with the single currency Slovakia adopted also Eurozone interest rates. Effectively, the NBS followed the steps of the ECB already since mid-2008. The ECB cut its interest rates in December by larger-than-expected 75bp, putting its key interest rate to 2.50%. Due to financial crisis and recession in the countries of Euro area, more monetary policy easing on the side of ECB is expected (further cuts of 75-100bp might follow). Money market rates declined along with the lower official rates; 3M Euribor ended the year 2008 slightly below 3% and is expected to decline further this year to 2.2% by December. The financial crisis also widened spreads on Slovak government bonds. In normal conditions, we see a 20-30bp yield differential over the Eurozone as reasonable after EMU entry due to differences in liquidity and the credit risk. But due to financial crisis, the convergence to these levels might be rather a medium-term story.

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