Slovakia | Macro Outlook

Domestic demand remains behind the GDP steering wheel
ECB floods markets with additional liquidity
Slovak yields to remain affected by the ECB's policy for longer
Dollar has further upside potential

Economy (%)	2018	2019e	2020e
GDP (real, y/y)	4.1	3.4	3.6
Unempl. Rate	6.5	6.3	5.8
CPI (y/y)	2.5	2.5	2.5
Retail Sales (y/y)	3.6	2.8	2.5
Ind. Prod. (y/y)	4.4	7.0	3.0
Public Debt/GDP	49.1	48.3	46.6

Source: Erste Group Research

Market	Spot	19Q2	19Q3	19Q4
ECB Target R.	0.00	0.00	0.00	0.00
3M Euribor	-0.31	-0.30	-0.30	-0.30
EUR/USD	1.13	1.12	1.14	1.16
10Y Bond (%)*	0.76	0.90	1.00	1.00

Source: FactSet, Erste Group Research

Rating	Current	Outlook
Moodys	A2	pos
S&P	A+	stable
Fitch	A+	stable

Source: Erste Group Research

General	2018
Population mn	5.5
GDP/Capita EUR	17,335

Source: Erste Group Research

Spot Rates as of:
07th Mar. 2019

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(Eurozone)

Note:
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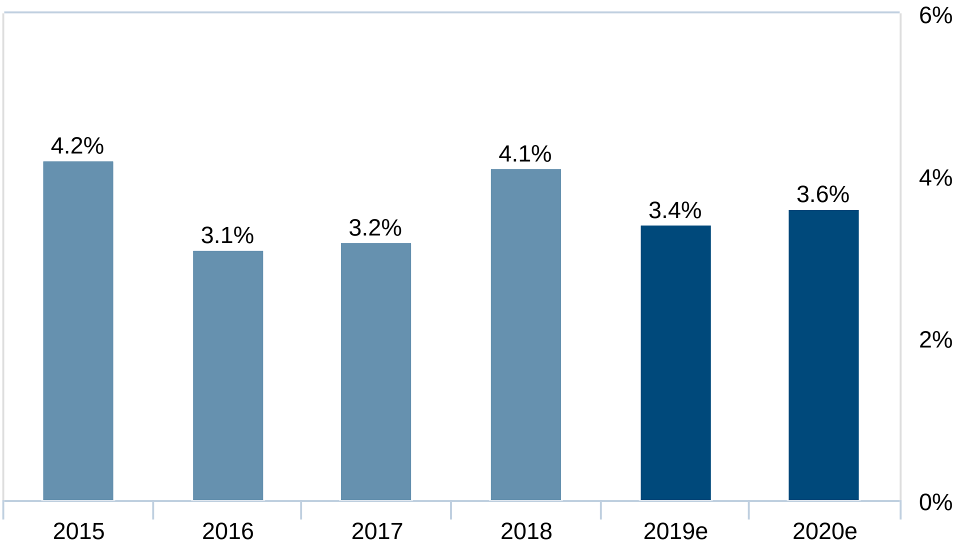
Real GDP growth eased to 3.6% y/y in 4Q18, driven solely by domestic demand as net exports' contribution was negative. The economy ended the year on a weaker footing; yet overall, 2018 represents a cyclical peak of 4.1%. This year, we expect economic growth to average 3.4%, driven predominantly by domestic demand as the external environment is likely to remain cloudy (Euro Area and China are slowing down, protectionism has not been resolved, uncertainty stemming from Brexit remains and all of these may have an impact on local car makers). The slowdown should prove to be temporary. We stick to our 2020 GDP growth forecast of 3.6%.

Labour market invigoration is under way as the unemployment rate fell to 6.1% (-1.6pp y/y) in 4Q18 and reached 6.6% on average last year. Employment growth (LFS) sped up to 1.9% y/y at the end of the year, bringing the FY2018 average to 1.4%. Despite some easing in 4Q18 (5.8% y/y), nominal wage growth averaged 6.2% last year, reflecting tighter labour market conditions. We expect the unemployment rate to drop to 6.3% in 2019, before falling to 5.8% in 2020. Nominal wage growth is likely to average 6.4% this year and could remain close to 6% also in 2020. Inflation is expected to average 2.5% both this year and the next, driven by food, service and energy prices.

GDP (real,y/y)



Source: Erste Group Research

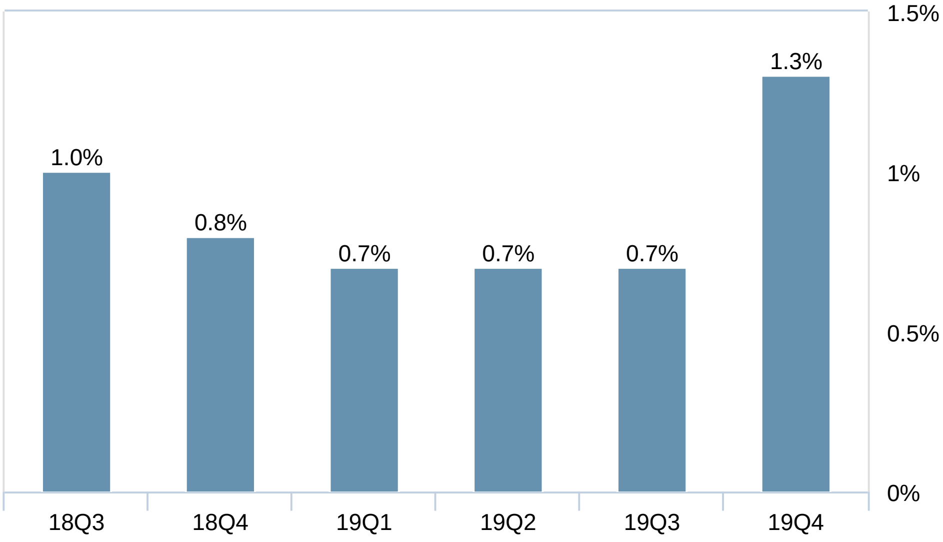
GDP

Domestic demand remains behind the GDP steering wheel

Real GDP growth was confirmed at 3.6% y/y in 4Q18 (0.8% q/q), with domestic demand as its sole driver. Investment was the largest contributor to growth in 4Q18, as gross capital formation rose by 13.9% y/y, contributing 2.9pp to the GDP growth rate. Household consumption sped up to 3.4% y/y in 4Q18, contributing 1.8pp to GDP growth. Due to the much higher growth pace of imports than exports, net exports were a drag on economic growth in 4Q18 (-2.7pp), thus bringing the full-year contribution also into the negative territory. Similar to the previous quarter, statistical discrepancy accounted for a sizeable amount of 0.8pp in 4Q18.

GDP growth ended last year on a weaker footing; yet overall, 2018 represents a cyclical peak of 4.1% for the Slovak economy. This year, we expect economic growth to average 3.4%, driven predominantly by domestic demand that continues to benefit from a supportive labour market development. The external environment is likely to remain cloudy (Germany, Euro Area and China slowing down, protectionism, uncertainty stemming from Brexit, and possible impact on local car makers - which the newly started production of Jaguar Land Rover will not make up for). Yet the slowdown in growth should prove to be temporary. We stick to our 2020 GDP growth forecast of 3.6%.

GDP (real, s.a., q/q)



Source: Erste Group Research

Annual	**2016**	**2017**	**2018**	**2019e**	**2020e**
GDP real	3.1%	3.2%	4.1%	3.4%	3.6%
CPI (y/y)	-0.5%	1.3%	2.5%	2.5%	2.5%
Private Consumption	2.9%	3.5%	3.0%	3.3%	3.0%

Source: Erste Group Research

ECB Monetary Policy

ECB floods markets with additional liquidity

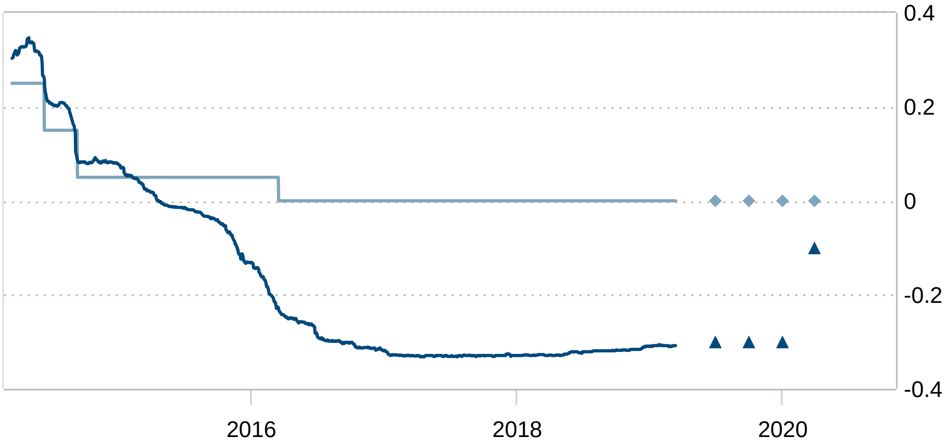
At its March meeting, the ECB Governing Council reacted surprisingly strongly to the economic slowdown. The earliest time for a first interest rate hike was postponed by four months, from September 2019 to January 2020. We continue to expect the first interest rate hike to take place in March 2020. Further, the Governing Council adopted an additional liquidity program, which provides liquidity at the ECB's main refinancing rate on a quarterly basis from September 2019 to March 2021. The term is two years. With this measure, the ECB is providing banks with long-term liquidity at very favorable conditions and flooding the market with additional liquidity.

Slovakia Inflation

Inflationary pressures to remain fairly constant

Inflation gathered speed, averaging 2.5% in 2018. Core inflation marked a 2.8% increase in 2018 and is expected to ease somewhat to 2.1% and 2.3% in 2019-20, respectively. Consumer price increases are mainly driven by food, services and energy prices. Higher service prices reflect growing disposable income of households amidst labour market improvement. Higher regulated prices affected inflation at the start of the year. Food prices rose in early 2019 also on the back of the newly introduced levy on retailers; however, it is likely the EU will strike the levy down. Overall, we expect inflation to average 2.5% in both 2019 and 2020.

Eurozone Short Term Yields



Source: FactSet, Erste Group Research

Market (%)	Spot	19Q2	19Q3	19Q4	20Q1
Target Rate	0.00	0.00	0.00	0.00	0.00
3M Rate	-0.31	-0.30	-0.30	-0.30	-0.10

Source: FactSet, Erste Group Research

Bond Yields

Slovak yields to remain affected by the ECB's policy for longer

Slovak 10Y government bond yields recently moved lower than at the start of the year, reflecting more dovish ECB stance. Net inflows of QE stopped in December 2018 but reinvestment of maturing amounts will continue for a substantial amount of time beyond the first rate hike. The recently announced TLTRO3 and changed forward guidance that sees rates at their current level at least until the end of 2019 constitute more easing on the part of ECB. Domestically, macroeconomic conditions and tax collection help to trim the budget deficit, which fell to 0.8% of GDP in 2017. The Ministry of Finance expects the 2018 deficit at 0.6% of GDP, before balancing the budget in 2019.

We see a bumpier pace of consolidation, with deficits at 0.8% and 0.7% of GDP in 2018-19, respectively, due to risks regarding the municipalities' performance. Government debt, comfortably under the Maastricht's 60% of GDP, should fall below 50% of GDP already in 2018. Overall, yields on government bonds could increase somewhat, reflecting inflationary developments and stable stock of QE. However, more uncertain pace of monetary policy tightening in the US and the first ECB hike being postponed to 2020 have led us to revise our forecast downward. We expect the 10-year Slovak government bond yield at 0.9% at the end of 2Q19 before rising to 1% in the second half of 2019.

10Y Generic Govt. Bond Yield (%)

Source: Datastream, Erste Group Research

Market	Spot	19Q2	19Q3	19Q4	20Q1
10Y Bond*	0.76	0.90	1.00	1.00	1.10

Source: Datastream, Erste Group Research

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Euro

Dollar has further upside potential

Most recently, the EURUSD has remained at the lower end of the range that has existed for months. It is still too early to deduce an imminent outbreak from this. The possibility exists, however, as from our point of view the fundamentals speak for the dollar.

Eurozone economic data is likely to take a few more months to show a significant improvement. US data, on the other hand, is already showing a solid economy. This means that interest rate expectations for the US will remain better than those for the Eurozone, at least for the time being. We therefore still see potential for a strengthening of the dollar. Later in the year the trend should reverse and the euro is set to gain.

EUR/USD

Source: FactSet, Erste Group Research

	Spot	19Q2	19Q3	19Q4	20Q1
EUR/USD	1.13	1.12	1.14	1.16	1.18
vs. Spot		*-0.9%*	*0.9%*	*2.7%*	*4.4%*

Source: FactSet, Erste Group Research

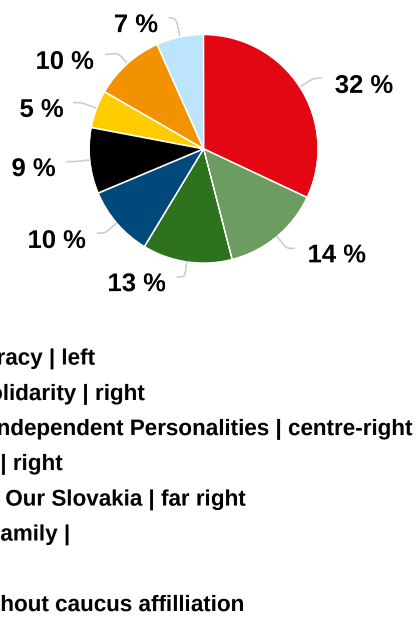
Politics

Parliamentary democracy

There are 3 coalition parties in the government: nationalistic SNS and centre-right Most led by SMER-Social Democracy which previously ruled alone. The government largely continues in the policy-making of the previous government. The Slovak political scene was shaken in March 2018 as the murder of investigative journalist J.Kuciak and his fiancée sparked nation-wide protests and led to the resignation of the Prime Minister. The situation calmed down after the government reshuffle (new PM is still from SMER: Peter Pellegrini). Presidential elections are scheduled later in March but we do not expect them to affect economic development.

This year, public sector wages went up by 10% and new public sector wage tables came into force. VAT on tourism was cut to 10% and EUR 500 travel vouchers for employees were introduced (55% paid for by employers),exempt from taxes and payroll levies. Minimum wage rose to EUR 520 (+8.3%). A new special levy on retailers, amounting to 2.5% of net sales of large retailers in developed regions, came into force; yet it is likely the EU will strike the levy down. Employing foreigners has become easier as the time required for non-EU citizens to get a work permit was shortened. The government is considering some changes to the tax set-up, but more details are yet to be released.

Parliament Seats



Source: Erste Group Research

Last Election:
2016, March

Next Election:
2020, March

Forecasts

Annual	2013	2014	2015	2016	2017	2018	2019e	2020e
Real GDP growth	1.5	2.8	4.2	3.1	3.2	4.1	3.4	3.6
Inflation (CPI, avg)	1.4	-0.1	-0.3	-0.5	1.3	2.5	2.5	2.5
Unemployment rate (avg)	14.2	13.2	11.5	9.6	8.1	6.5	6.3	5.8
Retail sales growth	0.1	3.6	1.7	2.2	6.0	3.6	2.8	2.5
Industrial output growth	1.5	3.2	6.6	4.6	3.3	4.4	7.0	3.0
Private consumption growth	-0.8	1.4	2.3	2.9	3.5	3.0	3.3	3.0
Fixed capital formation growth	-0.9	3.0	21.9	-9.4	3.4	6.8	2.0	3.0
Percent of GDP								
Trade balance	3.9	3.6	1.3	2.0	0.8	0.9	1.7	2.2
Current account balance	1.9	1.1	-1.7	-2.2	-2.0	-1.5	-0.9	0.2
Foreign direct investment	0.9	0.2	-0.5	0.9	1.8	1.3	0.8	0.7
Budget balance	-2.7	-2.7	-2.6	-2.2	-0.8	-0.8	-0.7	-0.4
Public debt	54.7	53.5	52.2	51.8	50.9	49.1	48.3	46.6
External debt, gross	82.1	90.0	84.9	90.8	111.0	104.2	96.5	89.0
(percent)								
CB policy rate (avg.)	0.25	0.05	0.05	0.00	0.00	0.00	0.00	n.a.
3m interbank offer rate (avg.)	0.22	0.20	-0.02	-0.26	-0.33	-0.32	-0.20	n.a.
2Y Yield (average)*	0.51	n.a.	n.a.	n.a.	-0.27	-0.29	0.09	0.38
5Y Yield (average)*	1.08	n.a.	n.a.	n.a.	-0.08	0.13	0.43	0.75
10Y Yield (average)*	2.72	1.75	0.90	0.66	0.94	0.86	0.92	1.20

Source: Erste Group Research

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