Slovakia | Macro Outlook

Domestic demand and net exports are driving growth
First ECB rate hike only at the end of 2020
Slovak yields to remain affected by the ECB's policy for longer
Dollar to firm slightly in the months ahead

Economy (%)	2018	2019e	2020e
GDP (real, y/y)	4.1	3.4	3.3
Unempl. Rate	6.5	5.8	5.7
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	48.9	47.7	46.2

Source: Erste Group Research

Market	Spot	19Q3	19Q4	20Q1
ECB Target R.	0.00	0.00	0.00	0.00
3M Euribor	-0.32	-0.30	-0.30	-0.30
EUR/USD	1.13	1.10	1.13	1.15
10Y Bond (%)*	0.31	0.55	0.65	0.80

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	17,368

Source: Erste Group Research

Spot Rates as of:
06th Jun. 2019

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Note:
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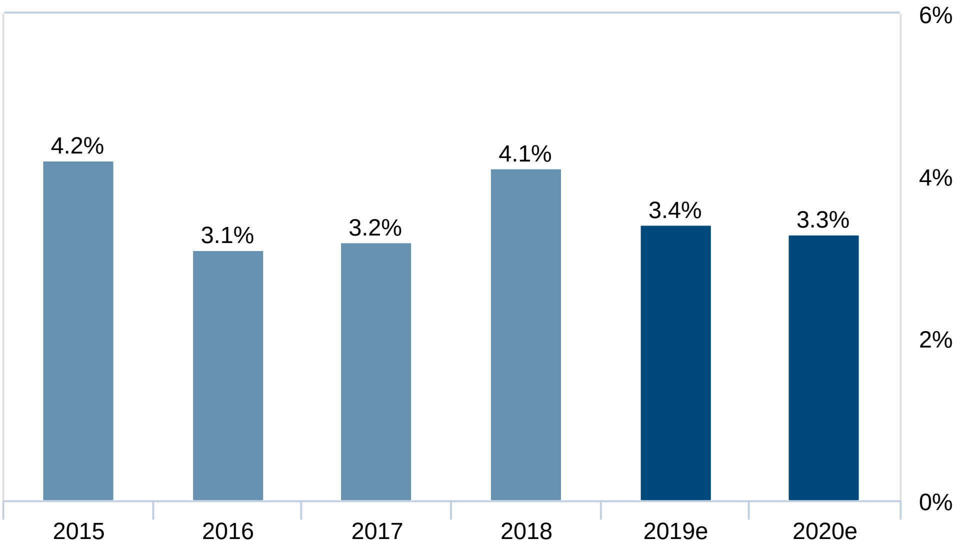
Real GDP growth reached 3.7% y/y in 1Q19, mildly above 4Q18 but below the cyclical peak of 2018 (4.1%). Both domestic demand and net exports drove growth. Even though the start of the year brought some welcome news about net exports, the clouds over the external environment have not dissipated - some of them (esp. Brexit) have even become more prominent. This year, we expect economic growth to average 3.4%, driven largely by domestic demand as the external environment is likely to remain cloudy (Germany and China slowing down, uncertainty stemming from Brexit, unresolved protectionism in foreign trade). Given this outlook, we have revised our 2020 growth forecast down to 3.3%.

Labour market invigoration continues as the unemployment rate fell to a new low of 5.8% (-1.3pp y/y) in 1Q19. Employment growth (LFS) rose by 1.8% y/y in 1Q19, easing only marginally. Nominal wage growth exceeded our expectations as it shifted up a gear to 7.1% y/y, reflecting the tighter labour market (real wages were up by 4.6% y/y in 1Q19). Better 1Q19 figures led us to revise our forecasts - we now expect the unemployment rate to average 5.8% this year and 5.7% in 2020. Nominal wage growth is likely to average 6.6% and 6.1% in 2019-20, respectively. Inflation is expected to reach 2.5% both this year and the next, driven by food, service and energy prices.

GDP (real,y/y)



Source: Erste Group Research

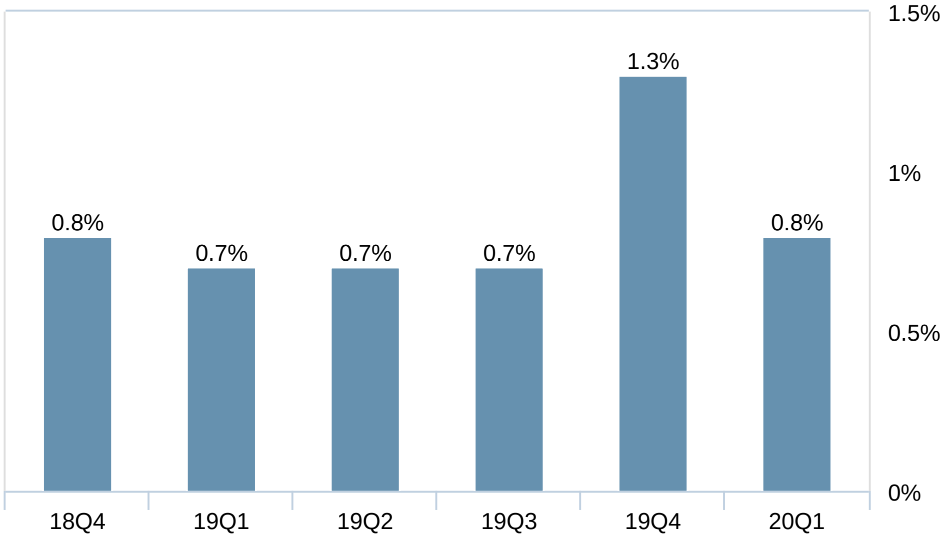
GDP

Domestic demand and net exports are driving growth

Driven by both domestic and external demand, real GDP growth reached 3.7% y/y in 1Q19 (0.9% q/q) - accelerating mildly from 4Q18. Gross investment rose by 6.6% y/y (gross fixed investment was up by 2.1 % y/y), contributing 1.3pp to GDP growth. Yet, household consumption was underwhelming (up by 1% y/y) as it only brought 0.6pp to the growth print, despite the favourable labour market and gross disposable income development. A sizeable increase in savings occurred in 1Q19. Exports rose by 7.2% y/y as import growth reached 6.4% y/y, thus net foreign trade brought 1pp towards the GDP growth rate. Similar to the previous quarters, statistical discrepancy accounted for 0.4pp in 1Q19.

Even though the start of the year brought some welcome news about net exports, the clouds over the external environment have not dissipated - some of them (esp. Brexit) have even become more prominent. This year, we expect economic growth to average 3.4%, driven largely by domestic demand as the external environment is likely to remain cloudy (Germany and China slowing down, Brexit uncertainty, unresolved protectionism in foreign trade - possible impact on local car makers, which the newly started production of Jaguar Land Rover will not make up for). Given this outlook, we have revised our 2020 growth forecast down to 3.3%.

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%	3.3%
CPI (y/y)	-0.5%	1.3%	2.5%	2.5%	2.5%
Private Consumption	2.9%	3.5%	3.0%	2.4%	2.8%

Source: Erste Group Research

ECB Monetary Policy

First ECB rate hike only at the end of 2020

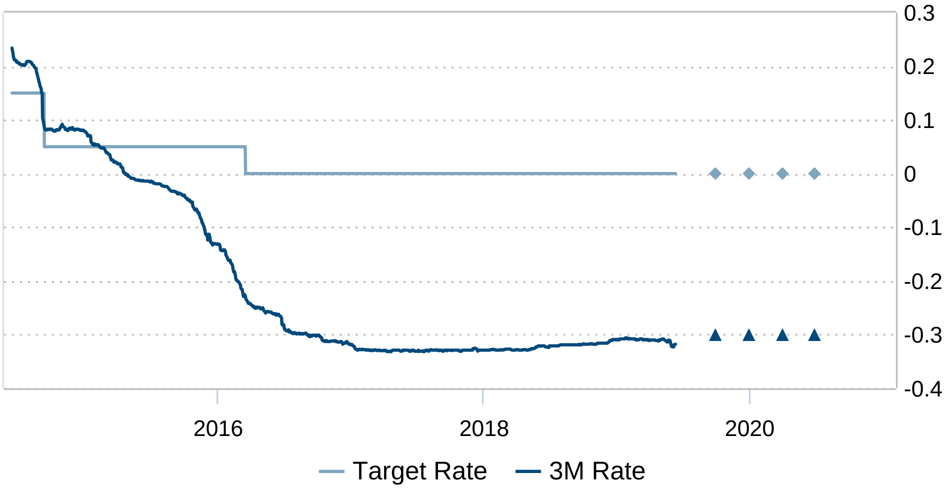
Recent political developments in the United Kingdom suggest that there will be a hard Brexit after October 31. A new British prime minister will probably not be appointed until the end of July. That leaves three months for the new prime minister to find a majority in the British Parliament, which Theresa May failed to achieve for seven months. A hard Brexit will weigh on the Eurozone economy for at least two quarters. The ECB will therefore have to wait even longer for progress towards its inflation target to emerge. This will postpone the ECB's first interest rate hike, which we do not expect until December 2020.

Slovakia Inflation

Inflationary pressures to remain fairly contained

Inflation gathered speed, averaging 2.5% in 2018. Core inflation marked a 2.8% increase in 2018 and is expected to ease somewhat to 2.2% 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 and will likely play some role also next year, given the development in commodity and oil prices. Overall, we expect inflation to average 2.5% in both 2019 and 2020.

Eurozone Short Term Yields



Source: FactSet, Erste Group Research

Market (%)	Spot	19Q3	19Q4	20Q1	20Q2
Target Rate	0.00	0.00	0.00	0.00	0.00
3M Rate	-0.32	-0.30	-0.30	-0.30	-0.30

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 noticeably lower than at the start of the year, reflecting more dovish ECB stance, cautious Fed and higher uncertainty (Brexit, trade). 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 mid-2020 constitute more easing on the part of ECB. Domestically, macroeconomic conditions and tax collection help to trim the budget deficit, which fell to 0.7% of GDP in 2018. The Ministry of Finance expects a balanced budget in 2019.

We see a bumpier pace of consolidation with deficit at 0.7% of GDP in 2019, due to risks regarding among others the municipalities' performance. Government debt, comfortably under the Maastricht's 60% of GDP, fell below 50% of GDP already in 2018. Overall, yields on government bonds could increase somewhat reflecting Slovak inflation and stable stock of QE. However, more uncertain path of monetary policy in the US and the first ECB hike being postponed towards the end of 2020 (together with further easing in the Euro Area via TLTRO3) have led us to revise our forecast downward. We expect the 10-year Slovak government bond yield at 0.42% at the end of 2Q19 before rising to 0.65% towards the end of the year.

10Y Generic Govt. Bond Yield (%)

Source: Datastream, Erste Group Research

Market	Spot	19Q3	19Q4	20Q1	20Q2
10Y Bond*	0.31	0.55	0.65	0.80	n.a.

Source: Datastream, Erste Group Research

Note:
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Euro

Dollar to firm slightly in the months ahead

With the expectation of a hard Brexit as of October 31, we expect a stronger dollar, at least for the coming months.

In an environment characterized by high uncertainty, we expect the dollar to strengthen for the time being, but this should be relatively moderate, as the dollar is already highly valued. Starting from these lows, the euro should strengthen towards the end of the year. The movement should, however, be slow, as it will take time for the markets and the Eurozone economy to come to terms with the effects of the hard Brexit.

EUR/USD

Source: FactSet, Erste Group Research

	Spot	19Q3	19Q4	20Q1	20Q2
EUR/USD	1.13	1.10	1.13	1.15	1.18
vs. Spot		*-2.7%*	*0%*	*1.8%*	*4.4%*

Source: FactSet, Erste Group Research

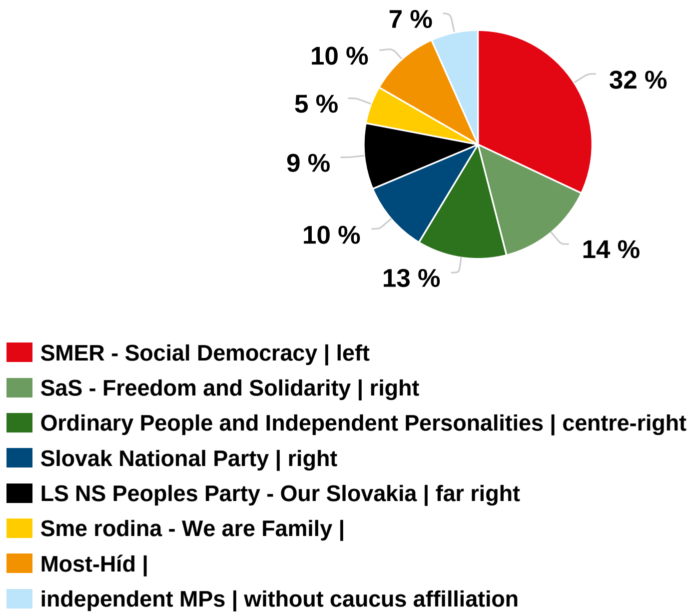
Politics

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 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). Slovakia has a new female president Zuzana Caputová (pro-European, left of centre), who overwhelmingly won the presidential elections in March.

The ruling coalition is discussing various measures it would like to enact next year, possibly amounting to EUR 500-700 mn (0.5-0.7% of GDP). Among the key measures is the introduction of a 15% income tax for small companies and a 20% rate for the rest (currently a flat 21% rate), lower VAT on all foodstuffs at 10% (except sweets and soft drinks) as well as increasing the basic tax deductible for employees. The government wants to increase the minimum wage to EUR 620 (currently at EUR 520), introduce a flexible parental benefit and extend maternity benefits from 34 to 52 weeks and/or introduce a regular 13th pension. It is unclear, how many of these proposals and in what form will make it into the budget proposal. Nevertheless, they are likely to put a strain on the planned fiscal stance.

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	3.3
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	5.8	5.7
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	2.4	2.8
Fixed capital formation growth	-0.9	3.0	21.9	-9.4	3.4	6.8	2.4	2.9
Percent of GDP								
Trade balance	3.9	3.6	1.3	2.0	0.8	0.1	0.2	0.8
Current account balance	1.9	1.1	-1.7	-2.2	-2.0	-2.5	-2.4	-1.2
Foreign direct investment	0.9	0.2	-0.5	1.0	0.6	1.5	0.7	0.6
Budget balance	-2.7	-2.7	-2.6	-2.2	-0.8	-0.7	-0.7	-0.4
Public debt	54.7	53.5	52.2	51.8	50.9	48.9	47.7	46.2
External debt, gross	82.1	90.0	85.2	92.2	111.0	113.3	105.7	98.0
(percent)								
CB policy rate (avg.)	0.55	0.16	0.05	0.01	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	-0.32	n.a.
2Y Yield (average)*	0.51	n.a.	n.a.	n.a.	-0.27	-0.29	0.05	0.30
5Y Yield (average)*	1.08	n.a.	n.a.	n.a.	-0.08	0.13	0.29	0.55
10Y Yield (average)*	2.72	1.75	0.90	0.66	0.94	0.86	0.55	0.85

Source: Erste Group Research

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