

# Slovakia Business Forecast Report Q2 2014

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## Abstracts

### Core Views

Prime Minister Robert Fico will continue to benefit from his party's outright majority in parliament, which has eased the policy formation and implementation process. While this is positive for political stability in the short term, it does not provide much space for consensus politics, with Fico's tax and welfare reforms likely to keep investors cautious.

The short-term economic picture has brightened as export growth remained solid amid a slowdown in regional growth, and household spending showed the first signs of a recovery. The government will continue with its fiscal consolidation plan, with a shrinking deficit likely to buoy market sentiment. Creeping public debt will remain a concern for the authorities, however.

### Major Forecast Changes

We have revised up our real GDP growth forecast for 2014 and 2015 to 2.2% and 2.8% respectively, from 2.0% and 2.6% previously. This is based on strong industrial production and retail sales readings in H213 that point to a more broad based economic recovery taking hold.

Our forecast for Slovakia's fiscal trajectory has been revised to reflect the government's updated medium-term budget objectives, which include a slower pace of deficit consolidation. While we previously saw the budget deficit falling to 2.1% of GDP by 2015, our forecast currently stands at 2.6%.

### Key Risks To Outlook

The risks to our short-term growth forecast are well balanced, and largely based on

ongoing uncertainty over the regional economy. With exports in 2013 representing approximately 100.1% of GDP, Slovakia's economy is vulnerable to any shifts in external demand. The emphasis on revenue-boosting measures to achieve significant fiscal consolidation leaves the deficit reduction programme vulnerable to weaker-than-expected growth while also threatening investment inflows.

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### CHAPTER 1: POLITICAL OUTLOOK

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BMI Political Risk Ratings  
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Fico Presidency Puts Majority At Risk

Slovakian Prime Minister Robert Fico's decision to run for president in 2014 could have negative long-run implications for the Direction- Social Democracy party's dominant political position, as Fico's popularity has largely driven its strong electoral showings in recent years. However, we expect a high degree of policy continuity until general elections in 2016, with fiscal consolidation remaining a top priority.

Table: Political Table

Long-Term Political Outlook  
Convergence With West Remains Core View

We expect Slovakia to continue to converge with Western European policies and standards of living over the next ten years as the small economy has benefitted greatly from inclusion in the bloc. However, we stress that the country will face a number of challenges to political stability including corruption, relations with the eurozone, ethnic tensions and population decline.

### CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis  
BMI Economic Risk Ratings  
Economic Activity  
Rising Exports To Spur Domestic Demand Recovery

We forecast real GDP growth in Slovakia to reach 2.2% and 2.8% in 2014 and 2015, respectively, on the back of improving external demand and a recovery in industrial production and exports. However, in contrast to previous years, the shape of growth will be come more weighted towards domestic demand, implying a diminishing contribution of net exports as imports rise.

Table: GDP BY EXPENDITURE

## Balance Of Payments

### Rebalancing Has Further To Run

Slovakia's current account surplus will peak at 3.2 % of GDP in 2015 before narrowing gradually over the long term, as domestic demand growth drives a narrowing of the trade surplus. Although the external account surplus precludes a reliance on foreign capital, foreign direct investment will remain key to future export growth.

Table: BALANCE OF PAYMENTS (Euro)

## Fiscal Policy

### Falling Deficit Masks Fiscal Risks

Although we forecast Slovakia's fiscal deficit to fall to 2.8% of GDP in 2014 and 2.6% of GDP in 2015, we see important risks to the country's medium-to long-term consolidation path stemming from an overreliance on temporary and one-off revenue raising measures.

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## Regional Exchange Rate Policy

### Euro Strength Unsettling The ECB

Passive monetary tightening and improved investor sentiment will compound policy inertia from the ECB has keep the euro strong heading into 2014. However, weak economic growth, high unemployment, euro strength, deflation risks, a potential LTRO-cliff and anaemic structural reform are becoming increasingly unpalatable for policymakers. As such, we expect substantial monetary intervention in 2014. If this comes in the form of an LTRO top-up, then the euro will initially hold firm before sliding by end-year as growth will remain weak. If, however, the ECB opts for negative deposit rates (a far more extreme option), expect a sharp and disorderly euro correction.

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## Regional Monetary Policy

### ECB Cut: Pushing On A String

A cut in the ECB's refinancing rate will do little to ease monetary policy in the eurozone, given the fractured credit transmission channel and passive tightening resulting from banks repaying LTRO funds. While there are few easy options to ease policy in the near term, we warn that if the long running disinflationary trend evolves into full blown deflation, the ECB may have to look at more aggressive forms of policy stimulus.

## Operational Risk

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### The Slovak Economy To 2023

#### Lower Trend Growth Ahead

Macroeconomic stability and institutional convergence with Western norms will be

bolstered in the long term by Slovakia's eurozone membership. However, we believe the drawbacks of having the euro will outweigh the benefits, limiting potential growth in the next decade. Nevertheless, we expect real GDP to average 2.6% over our 10-year forecast period to 2023, well above eurozone averages.

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