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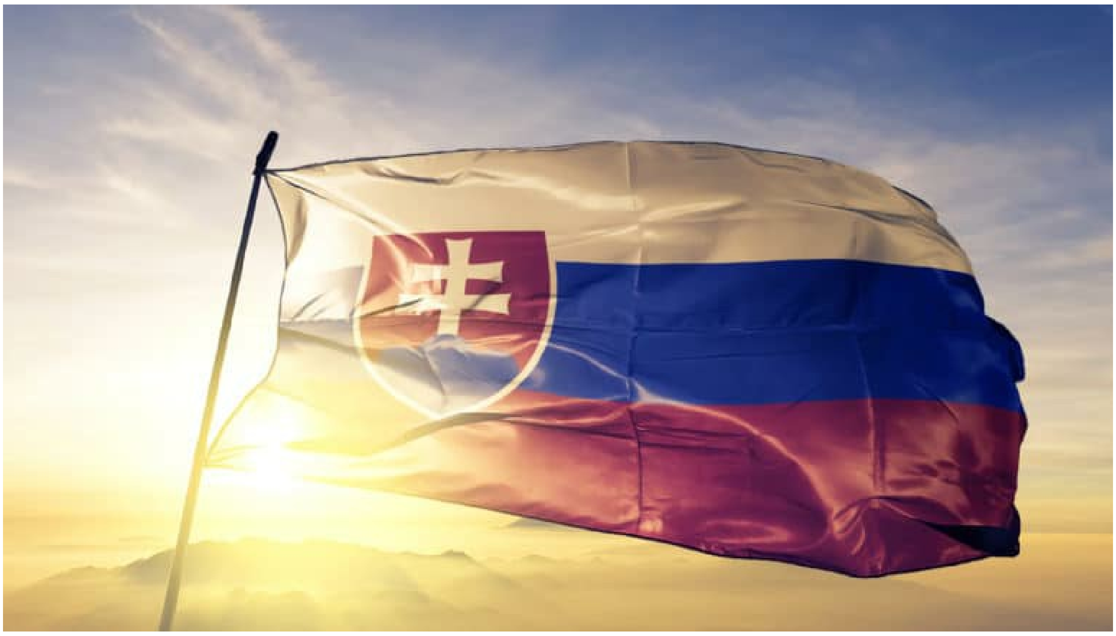
Slovakia: moving towards long-term sustainability?

Martin Brozman



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New budget 2019-2021

The engine of economy in Slovakia is running on a good momentum. In recent years it has been going through a cyclical upswing. Let us take a look at the drivers, but also consider potential threats going forward.

On 10th October, the ruling political party SMER, approved the draft state budget for the subsequent three years, i.e. until 2021. It is projected that the fiscal deficit will reach 0.6% this year and narrow to 0.1% in 2019. In 2020 the country should have a balanced budget, in 2021 even a slight surplus of 0.2%. This is complemented by favourable debt levels relative to GDP which is expected to reach 49% this year (51% in 2017), and should gradually trend towards 45% by 2021 due to an expected consolidation of public finances. This is well below the 60% Maastricht threshold, but more importantly significantly less than the Eurozone average of 86.8%.

Missing structural reforms

On the other hand, the budget does not mention crucial structural reforms which Slovakia needs to remain competitive – education, infrastructure development or road construction are the key topics. The overall unemployment rate stands at historic lows of 6.5%, which is close to full employment. Despite being the highest from the Visegrad 4 (V4) countries, high demand for skilled labour continues. This is, however, causing a slight divergence between the supply and demand for the labour force – shortage of skilled labour, putting constraints onto a further growth potential. As a natural step, it would seem that more resources should have been allocated towards education and research and development in order to meet the needs of the labour market, and thus help to improve value-added growth of Slovakia.

Slovakia

Source: Ministry of Finance of the Slovak Republic; Slovenská sporiteľna, a.s.

Jaguar Land Rover

On 25th October Jaguar Land Rover opened its production plant in Nitra, which is expected to strongly contribute to GDP growth, reaching 4.5% next year as per the budget proposal. This marks the arrival of the 4th car manufacturer to Slovakia. The notion of over-reliance of auto exports definitely comes to the forefront given that car production should rise by some 40% in the next half-decade. It currently represents 35% of Slovakia's industrial production and 40% of all industrial exports. Slovakia is the world leader in the coefficient of the number of cars produced per 1000 citizens which currently stands at 0.192 cars per person per annum. The leading export markets for locally produced vehicles are Germany, Austria and other CEE markets. This may be considered as an advantage as the world is currently stuck in the U.S. and China trade dispute which is adding unnecessary uncertainties. On the other hand the country could feel the knock-on secondary effects of trade tariffs through subcontractors.

Growth driven by…

It the light of the positive economic sentiment and the GDP growth driven primarily by domestic demand, household consumption and investments, growth of both domestic and corporate credit has simultaneously accelerated. Retail and corporate loans advanced in 2017, by roughly 12% and almost 10%, respectively. To prevent a situation when things would spiral out of control the Slovak National Bank implemented a regulation on debt-to-income (overall indebtedness should not exceed 8x the annual net income of a household), and loan-to-value (maximum of 90% of the real estate value) ceiling. Moody's estimates domestic credit growth at roughly 6% through 2021, whilst loan-to-deposit ratio of the commercial banks should rise from a current 90% to exceed 100%, indicating further expansion, though at a more moderate pace.

In Q2 Slovak Republic issued its first 50-year bond, with an issue size of 500m EUR and a coupon of 2.25%. Investors shower big interest and oversubscribed the issue was by 3x. It is the longest bond issued in the CEE region in the past 10 years, and the longest Slovakia has ever issued. This placement on the capital markets can be viewed as measured and successful, utilising historic low cost of debt.

To sum up, Slovakia is expected to enjoy a prolonged period of growth at least through 2021, the main drivers of which should be industrial production – primarily thanks to auto industry, household consumption, growth of credit, and investments. This can however be curtailed by inappropriate placement of the government budget at the expense of structural reforms, such as that of the educational system which has a lot of room to be tailored for the needs of the market. This would arguably enable Slovakia to close the gap to its V4 counterparts in such indicators as the unemployment rate and GDP growth.

Slovakia

Source: Bloomberg

Disclaimer: Past Performance ist not a reliable indicator for future developments.

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Martin Brozman

Portfolio Manager, Erste Asset Management Slovakia