Slovakia Economic Insights: So far so good

Raiffeisen RESEARCH

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Despite being one of the more vulnerable countries, the Slovak economy is manoeuvring surprisingly well through the current crisis. Although some industries feel the heat and the crisis is definitely not yet over, chances to avoid even the technical recession are increasing.

Key financial figures

	2020	2021	2022	2023	2024
Real GDP (% yoy)	-3.4	3.0	1.7	1.0	2.4
CPI Inflation (avg, % yoy)	2.0	2.8	12.1	9.8	3.9
Unemployment (avg, %)	6.7	6.9	6.2	6.2	6.0
Budget Balance (% of GDP)	-5.4	-5.5	-3.4	-6.0	-4.2
Public Debt (% of GDP)	58.9	62.2	58.3	55.5	55.8
Current Account Balance (% of GDP)	-0.4	-0.8	-1.2	0.1	0.4
Gross Wages (LCY, % yoy)	3.8	6.9	8.4	10.0	7.6
Private Consumption (% yoy)	-1.2	1.7	5.1	0.0	2.5
Gross Fixed Capital Formation (% yoy)	-10.8	0.2	6.5	8.0	-6.0
Policy Rate (% eop)	0.00	0.00	2.50	4.25	3.75
Nominal GDP (EUR bn)	93.4	98.5	107.7	117.9	125.0
GDP per Capita (EUR)	17,116.0	18,035.2	19,707.5	21,554.4	22,852.2

Source: Macrobond, Statistical office of SR, RBI/Raiffeisen Research

Economy supported by energy price cap

The Slovak economy is going through dynamic changes induced by high energy prices. A couple of companies had to reduce or fully stop their production. High global inflation is changing long-term relations among different indicators. It is especially difficult to estimate GDP growth in such an environment. Moreover, data coming from the Statistical office also provides a blurry picture in recent months due to both dynamic changes in the economy and its own procedures.

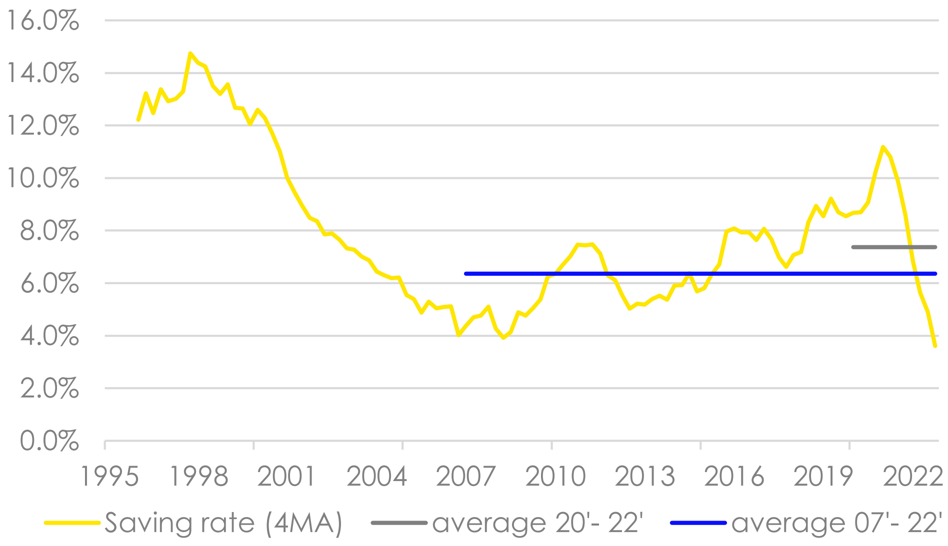
It is not surprising that in such an environment, uncertainty regarding the GDP Q4 22 results was quite high. In the end, the reading released by the Statistical Office of SR came as a positive surprise. For now, fears of GDP decrease are off the table. The Slovak economy posted growth of 0.3% qoq and 1.1% yoy. The whole **year's result of 1.7% yoy was close to our forecast of 2% yoy released only a few weeks after the conflict in Ukraine began.**

Besides the high energy prices, inflation and war, the year 2022 was also affected by the consequences of COVID restrictions. Even despite high inflation, household spending in real terms was the most important pillar of economic growth. Savings created during the

Boris FOJTIK
Analyst
+421 2 5919-2079
boris_fojtik@tatrabanka.sk

Andrej MARTISKA
Analyst
andrej_martiska@tatrabanka.sk

pandemic years enabled households to spend above their long-term average. An increase in real consumption by 5.2% yoy was the highest since the financial crisis. As a result, the saving ratio fell down to its historical minimum and deposits in banks have decreased by 1.3% yoy as of January 2023.



Source: Macrobond, Tatra Banka Research

The Slovak economy and our forecast do not rely on household consumption to keep GDP growing in 2023. January retail sales have already been at black zero and supermarkets lost 6% in yoy terms. Moreover, no support from foreign trade is expected this year as well. We forecast further deepening of negative foreign trade balance from -6.3 % to -7.2 % of GDP. Moreover, the production side of the economy should still suffer from high energy prices and the loss of some export partners.

Investments should be the key factor of current year GDP growth even though the expectations of the utilization of structural funds and NGEU funds bear a question mark. We assume 8% yoy growth of investments mainly driven by the public sector.

A very important pillar of economic performance are compensations for high energy prices. Prices of electricity and gas are capped for households as well as for companies. Thanks to the cap, households should be able to keep real consumption at least at an unchanged level in yoy terms. At the same time, companies should be able to survive the period with extremely high energy bills. The probability of technical recession has thus decreased thanks to generous government intervention. The compensation mechanism will be as high as 3.5 % of GDP and part of it should be repaid by EU funds. After sluggish or no growth in H1 2023, a slight acceleration in the GDP dynamic is expected in H2 2023. **Overall, we forecast GDP growth of 1% yoy in 2023.**

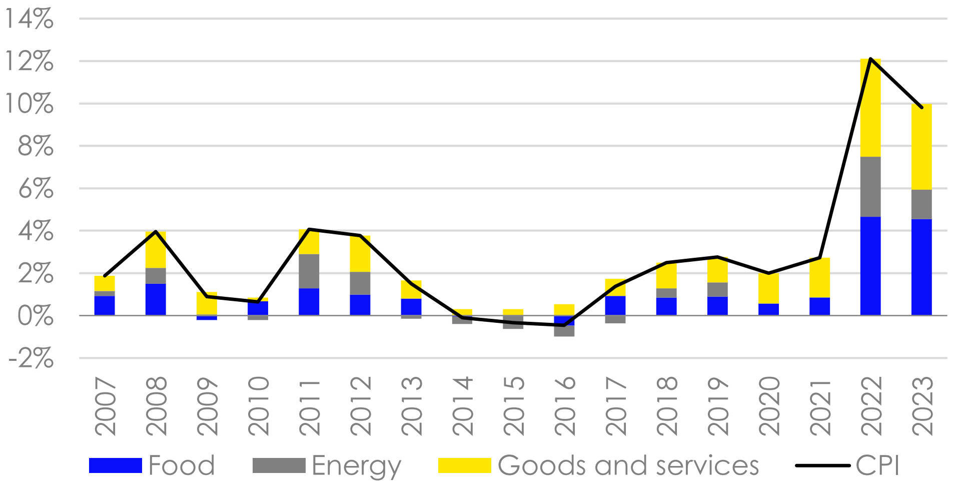
In the year 2024, household consumption, NGEU funds and recovery of foreign demand should play a key role. We expect that the Slovak economy will benefit from the eurozone's revived growth next year (we forecast the euro area economy to grow by 2% yoy).

Inflation in 2023 dampened by government measures

Consumer prices increased by 12.1% yoy in 2022. Such an inflation dynamic was last seen 20 years ago when the economy was undergoing significant structural changes. **Due to a cap on energy prices and a decrease in demand, the Slovak economy could avoid repeating double-digit inflation in 2023. However, the risk is tilted upwards.**

Thanks to the low increase in energy prices (6.2% yoy), inflation measured by European harmonized methodology recorded only a 15.1% yoy increase n January, the same result as the maximum in November 2022. However, food inflation can set a new record high also in Q1 2023. According to flash estimate, headline inflation jumped to 15.5 % yoy in February 2023. We do expect a cooling down of inflation dynamics in the course of coming quarters as the restrictive monetary policy will "bring its fruit". Decreasing demand and lower retail sales should be the best cure for inflation disease. The second round effects of energy prices will, though, keep the inflation dynamic still in high single-digit territory.

Cap on energy prices has reshuffled inflation



All in all, we expect average inflation to be slightly under 10% in 2023. However, the significant cap on energy prices poses a risk of another increase in the following year. As costs to cap energy prices are quite high considering the public budget, we expect another increase in prices in the housing category. It should alleviate inflation development to 3.9% yoy in 2024.

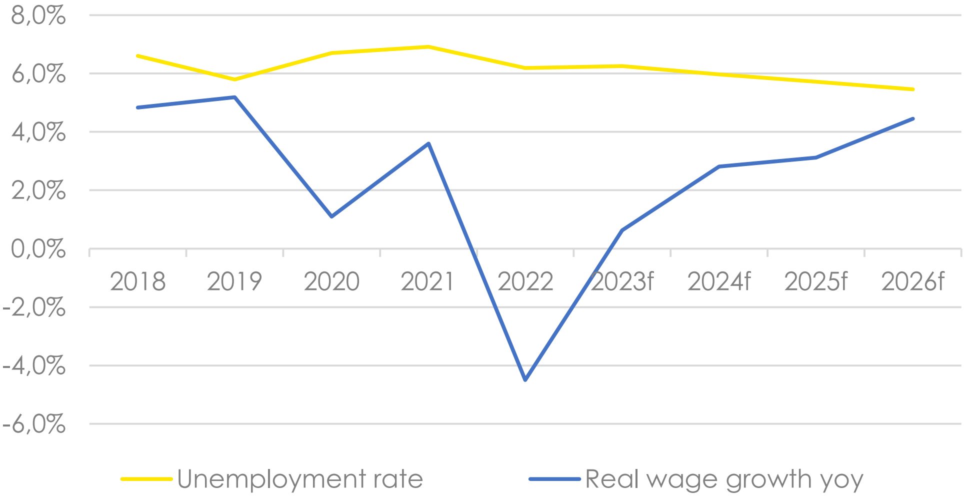
Wages do not keep up with inflation

The Slovak labour market continues to be strong despite the economic slowdown. The unemployment rate has been decreasing for six quarters in a row. In the final quarter of 2022, it fell to 6%. For the entire year 2022, the unemployment rate reached 6.1% which is significantly less than 6.8% a year ago. At the same time, the total number of employees in Slovakia for the year 2022 increased by 1.7% to almost 2 604 000 people with the strongest contribution in services. Industry, hit by the energy crisis, saw a notable decrease in employees. The large regional disparities and a significant share of long-term unemployment have remained the main obstacles to further improvements in the labour market.

Despite the recent positive trends and general strength of the Slovak labour market, wages did not keep up the pace with rapidly surging inflation in the past year. The average monthly wage has decreased in real terms for the fourth consecutive quarter. The drop in real wage was particularly sharp in the 4th quarter of 2022 when the average nominal monthly wage increased by 6.5% year-on-year while the real wage declined by 7.6% year-on-year due to the rapid pace of consumer price growth. This was the sharpest drop in real wages in 22 years and is mostly the result of poor wage growth in the public sector. For the whole year of 2022, the nominal wage increased by 7.7% which wasn't enough to keep pace with almost 13% inflation, so the real wage declined by 4.5%.

We forecast that the labour market in Slovakia will remain tight with the unemployment rate reaching 6.2% this year and 6.0% next year. The environment of a tight labour market and wage pressures boosted by sharp real wage decline in the previous year should be conducive to strong nominal wage growth that will reach 10% according to our forecast. Given the expected deceleration in consumer price growth, the real wage growth should be around 0% for the entire year of 2023. For the next year, the real wage is expected to grow by 2.8%.

Labor market remains tight but real wages decline



Source: Macrobond, Tatra Banka Research

Long waiting for the snap elections

Following the no-confidence vote in the Parliament in late December, the administration of PM Heger now remains in office in a caretaking capacity with limited powers. In such a situation, snap elections should take place as soon as possible to avoid an extended period without a fully functional and legitimate government as more than a year remains until regular elections. However, this is not the case in Slovakia. **Former coalition parties agreed to schedule snap elections no earlier than the end of September, so Heger's administration will function in a caretaking capacity for more than nine months. This non-standard situation brings about many peculiarities.**

Most importantly, **the centre of power has effectively moved from government to parliament**, where MPs have been given free hand to introduce any legislative proposals they want. Given the timing of snap elections, this means MPs now have 7 months to campaign in parliament. Such a setting is, of course, hardly conducive to sound and fiscally responsible bills. Instead, some MPs are trying to outcompete each other in populist and balderdash proposals with no regard for the health of public finance. For instance, the former minister of Finance proposed to pay €500 to every eligible voter who casts his or her vote in the September snap elections. Of course, the majority of these proposals will not find enough support in parliament (hopefully including the aforementioned example) but some of them might do. The current **political setting thus poses a significant risk to the health of public finance.**

Results of elections in Slovakia are generally hard to predict a few months in advance due to large electoral volatility and this is particularly true for September snap elections given the current highly fragmented political environment. However, there is a non-negligible risk that populist and anti-EU/NATO succeeds in elections.

Public finance back in focus

The current energy crisis and political situation in Slovakia are not in favour of sound public finance. The probability **that the deficit will turn out to be higher than expected due to the activity of MPs is not negligible.**

The Council for budget responsibility has worsened its expectations of deficit in 2023. Due to the higher cost of energy price compensation, the negative balance between revenues and expenditures could be as high as 6% of GDP. The budget approved by parliament includes a deficit estimate of 6.4% of GDP. In 2024 it assumes a deficit of 4.3% of GDP and in 2025 at the level of 4.1% of GDP. Due to a lack of credible consolidation measures, Council for budget responsibility considers the budget plan unrealistic.

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Slovakia

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Thomas SternbachLegal and ComplianceRaiffeisen Bank International AGAm Stadtpark 9, 1030 WienTel: +43-1-71707-1541Fax: +43-1-71707-761541thomas.sternbach@rbinternational.com

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Slovakia ,
boris_fojtik@tatrabanka.sk

TIBOR LORINCZ
Slovakia ,
tibor_lorincz@tatrabanka.sk

ANDREJ MARTISKA
Slovakia ,
andrej_martiska@tatrabanka.sk

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