Slovak industry amid the crisis

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Recently, the Slovak Statistical Office revised downwards its 3Q08 GDP growth figure to 6.6% YoY from an original estimate of 7.0%. In addition, GDP growth decelerated to 2.5% YoY in 4Q08, which resulted in growth of 6.4% YoY for 2008 as a whole – well below 2007's 10.4%. The easing in 4Q08's GDP growth reflects lower growth in private consumption, a sharp deceleration in investment growth and a drop in export activity.

Industrial value added, which decreased by 20% YoY in 4Q08, particularly explained the sharp deceleration in economic activity. The strong base effect from 4Q07 (owing to the forward-buying of tobacco products in 4Q07) also partly explained the drop in GDP growth.

In 1Q09 we expect GDP growth to remain weak, as many factories ceased production in January, after gas supplies were cut off due to the disagreement between Russia and Ukraine. As result, the industrial production dropped by 27% YoY in January 2009. However, we do not expect economic activity to have recovered after January's stoppage for the following reasons:

i) Although March´s composite confidence indicator improved somewhat, it is still closet to all-time lows. Moreover, the industrial confidence indicator worsened to -25 in March from February´s 22 reflecting lower demand and higher stock of finished products. The marked slowdown from 4Q08 was (with the Czech Republic) one of the sharpest in the region. In our view, the drop in the industrial confidence indicator points to a gloomy outlook for 1Q09 GDP.
ii) In our view, the drop in industrial activity has so far occurred at the earlier stage of production. Value added in the chemicals sector dropped by 36% YoY in 4Q08, while decreasing by almost 40% YoY in the metals industry. By contrast, Slovakia's key industry – transport, electrical machinery and equipment – decreased by only 6% YoY in 4Q08.

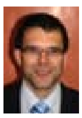
> **Owing to our expectations of a significant deceleration in Slovak GDP growth to 0.8% YoY in 2009, budget shortfalls are likely to be larger than the government's deficit targets, as these consolidation measures are based on solid revenue growth and not on a sharper reduction in expenditure.**

iii) Based on Citi's expectations of a deeper recession in the eurozone (Citi expects the eurozone's GDP to contract by 4.3% YoY in 2009), we think Slovak exporters are likely to suffer from weak foreign demand. Moreover, Citi expects private consumption in the euro area to fall by 1% YoY in 2009 and mild recovery in 2010, suggesting there is significant downside risk to export performance as consumer goods account for 40% of Slovak exports (with a large share of durable consumer goods, which are in our view more sensitive to the economic cycle).
iv) The components of February's composite indicator changed from previous months, reflecting declines in consumer confidence. In 2009, we expect growth of household consumption to fall sharply (retail sales recently eased well below average growth of 7.3% in 2008), owing to a higher unemployment rate and a drop in nominal wage growth (which is likely to be only partly offset by consumer price disinflation). We expect these effects to be only partly offset by the income effect of the koruna's strong revaluation against the euro in May 2008 (before euro adoption). However, the strong income effect could in our view distort the statistics on household consumption in 2009 as Slovak consumers could increase their expenditure abroad (particularly on durables goods), owing to the koruna's strong depreciation against some of its neighboring countries' currencies (the Hungarian forint, Polish zloty and Czech koruna), which have weakened against the euro.

On balance, Slovak exporters are likely to miss the flexibility of their own currency, which could have at least cushioned the negative impact of a global recession, as in other CEE countries. Although the revaluations of the koruna's parity against the euro have been largely explained by the substantial increase in productivity (which has been considerably higher in comparison with productivity in the eurozone), we argue that only three industries (transport equipment, electrical and optical equipment and electricity, gas and water) have been driving productivity growth and explain 70% of all labor productivity growth in industry. However, their share of employment is less than 30% of total employment in industry. By contrast, if Slovakia had not adopted the euro in January 2009, we feel exporters may have been hit by hedging losses in FX.

Mix of economic policy is likely to be counter-cyclical

Monetary policy is likely to be counter-cyclical, which is based on Citi's baseline scenario that envisages the ECB's policy rate being reduced to 0.5% in mid-2009. Owing to our expectations of a significant deceleration of Slovak GDP growth to 0.8% YoY in 2009, budget shortfalls are likely to be larger than the government's deficit targets, as these consolidation measures were based on solid revenue growth and not on a sharper reduction in expenditure. Therefore, we expect a general government deficit of 3.6% of GDP in 2009. We are skeptical about any strong pro-growth impact of a fiscal stimulus, as we believe: i) the economic slowdown reflects the drop in external demand, which is unlikely to be offset by domestic demand; and ii) interest rate expenditure on public debt is likely to increase owing to the large supply of sovereign bonds across Europe in 2009-10, which is likely to decrease the pro-growth effects of the previous fiscal consolidation.



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