| **Quarterly report** |

Slovak Economic Outlook

Investments take break after last year's sprint

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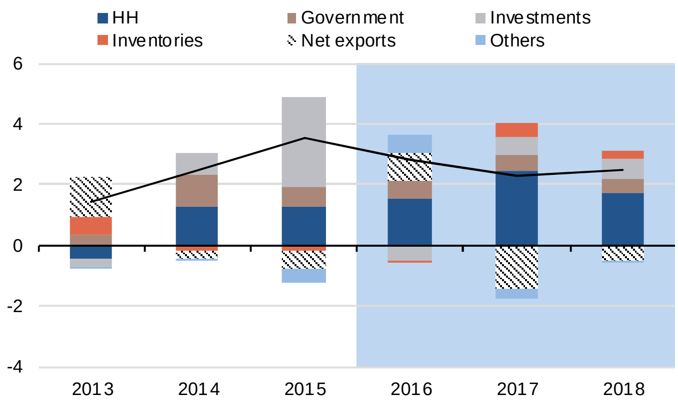
Surprising GDP growth in the first half of the year, the pro-Brexit result of the British referendum and further strengthening of the labour market have changed the initial conditions of our forecast. The changed outlook for the external environment poses another challenge for the Slovak economy. All in all, it means economic growth is set to reach 2.8% this year. A deceleration to 2.3% is ahead in 2017 as net exports are expected to turn negative due to enhanced investment activity.

- The increasing participation rate is pressing wages up. Hours worked and rising salaries are pushing up the wage bill. Hence, gross disposable income growth depends on the labour market income, but it allows consumers to save. Higher savings do not undermine the propensity to consume. Private consumption will remain the key growth driver.

- Investments are losing ground since the EU funds channel has dried up and political uncertainties do not favour any courageous investment activity. However, investments should turn positive again next year.

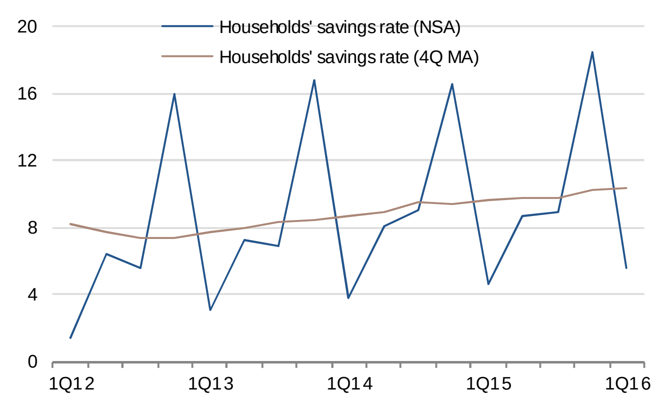
- Solid export growth and low import dynamics as a result of muted investment activity bring the net export contribution to GDP into positive territory for this year. As soon as investment activity revives, will send the net export contribution to GDP growth into the negative again.

Private consumption and next export will drive the growth



Source: Eurostat, Economy & Strategy Research, Komerční banka

Savings rate is continuously adding up



Source: SSO, Eurostat, Economy & Strategy Research, Komerční banka

- Deflation recorded a historical high in July (-0.9% yoy), thus just a little change that the average for this year will be positive. Our forecast indicates to record the change in the consumer price level at -0.3%. With the fading out of the high statistical base on crude oil prices, inflation should pick up next year. The higher pace will be supported by rising food prices, as well.

Mid-term macroeconomic forecasts for the Slovak Republic

Oil prices rescue inflation

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A new phenomenon, Brexit, has entered the scene since we published our last outlook. Given the uncertainty surrounding Brexit, SG economists have lowered their growth outlook for the euro area and Germany. They also no longer expect the Fed to hike rates this year, while they see the ECB's policy as likely to be even looser. On the other hand, thanks to the rise in oil prices, the inflationary outlook should be virtually unchanged with prices expected to increase gradually in the United States, the euro area and in the CEE region, as well.

External factor assumptions (average values)

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17
Brent crude oil prices (USD/brl)	54.9	62.9	51.3	44.7	35.2	46.8	48.0	50.0	52.5	53.0	57.5
GDP yoy - euro area	1.3	1.6	1.6	1.7	1.6	1.6	1.6	1.5	1.3	1.3	1.3
CPI yoy - euro area	0.2	-0.3	0.2	0.1	0.2	0.0	-0.1	0.5	1.2	1.7	1.6
EUR/USD	1.13	1.11	1.11	1.10	1.10	1.13	1.10	1.08	1.05	1.05	1.05

Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics, Bloomberg

United States: no rate hike this year

Inflation in the United States is likely to rise to 2% in December.

Inflation in the United States decelerated to 0.8% yoy. **Given the base effect and the prospect of oil price growth, SG analysts expect CPI inflation to rise to 2% yoy by December 2016**, and for the same reasons it could even accelerate to 2.5% yoy in 1Q17. The development of core prices will probably be more muted, and we see them hovering around the current level of 2.2-2.3% yoy. More worrying for the FED than inflation are GDP growth (just 1.2% qoq in 2Q16), the risks stemming from the global outlook and volatility on the labour market.

GDP growth is driven by domestic demand.

May's labour market statistics disappointed. Although the June data surprised on the upside, from the beginning of the year just 160,000 new jobs on average have been created in the private sector, substantially less than the full-year 2015 average of 220,000. Still, the current pace of job creation should be enough to push the unemployment rate down further (currently 4.9%). This should put pressure on wages and support household consumption, which is currently the key driver of the economy. GDP growth should reach 1.9% in 2016. Business investment, which was negatively affected by investment cuts in the energy sector (due to the drop in oil prices), is still exerting a drag but, with oil prices rising, this negative effect should gradually diminish and investments should start to grow. **This should be reflected in a faster pace of GDP growth in 2017 (+2.2%).**

Next year the FED is expected to hike rates twice.

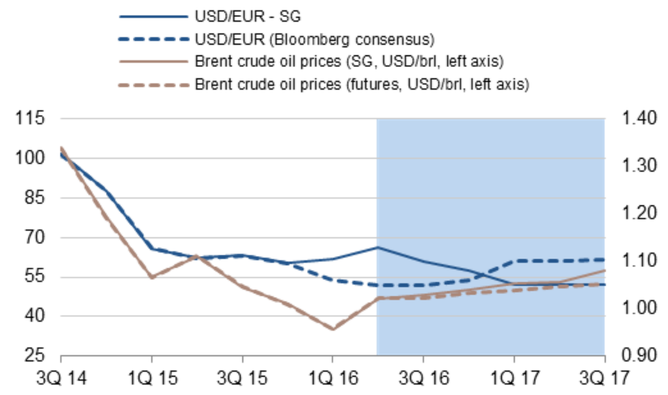
The combination of Brexit and the volatile data from the U.S. labour market have led to a revision of the outlook for interest rates. SG economists now believe the FED will leave rates unchanged this year and that there will be just two rate hikes in 2017 (before Brexit, they expected one hike in 2016 and three hikes in 2017). For 2019, they are already anticipating a rate cut as they believe the U.S. economy will fall into a recession in late 2018 or early 2019. The widening gap between FED and ECB monetary policy is likely to lead to EUR/USD weakening. EUR/USD is likely to weaken slightly to 1.08 by end-2016 and an average 1.06 in 2017.

Euro area: Brexit hit the GDP forecast

Inflation will go up, but slowly.

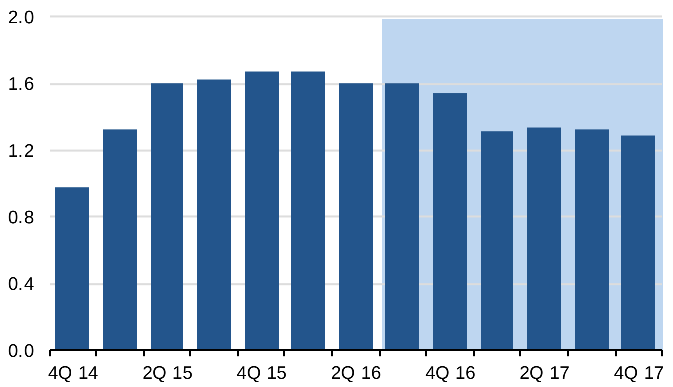
Inflation in the euro area returned to positive territory in July (+0.2% yoy) as a result of the base effects from energy prices. In the coming months, it will be mostly oil prices and a higher comparison base that will push euro area inflation higher. Headline inflation is likely to reach 0.4% on average in 2016, but for the period of 2017-2020 it stands at 1.5%. Core prices are likely to rise slowly. Unit labour costs are expected to remain subdued while the output gap should close very slowly (estimated at -0.7% of GDP in 2016). For these reasons, SG economists expect core prices to increase only marginally this year (+1.0% yoy), while on the mid-term horizon they should rise 1.2% on average, below the long-term average of 1.4% yoy.

Oil prices and EUR/USD



Source: SG Cross Asset Research/Economics, Bloomberg, Economic & Strategy Research, Komerční banka

Euro area GDP (%)



Source: SG Cross Asset Research/Economics, Datastream, Economic & Strategy Research, Komerční banka

The ECB is likely to extend the QE programme.

At its July meeting, the ECB took no action. Nevertheless, given the Brexit vote, the problems facing Italian banks and inflation coming in considerably below the ECB's target, the ECB is likely to take some steps at its September meeting, when the new ECB inflationary prognosis will be available. The **ECB is likely to extend the QE programme until September 2017** (versus March 2017, currently). **At the same time, it will probably have to change the conditions for bond purchases**. Brexit has led to a fall in the yields of many bonds to below the ECB's deposit rate (-0.4%), the rate at which the banks place excess liquidity at the ECB. The ECB cannot buy the bonds below this rate. With the 33% issuer limit and the current rate of purchasing, the ECB is expected to run into issue share limits within two to four months for Germany, the Netherlands and Finland. As a result, it will probably have to raise the issue share limit (to 50% for bonds where there is no risk of gaining a blocking minority).

GDP outlook for the euro area was revised slightly lower.

The Brexit vote impacts the GDP forecast for the euro area. **According to SG economists, Brexit will cost 0.1pp on average of euro area GDP per annum by 2020 (0.7pp of GDP on a cumulative basis)**. This year, GDP growth is expected to come in at 1.6%; in 2017, however, it is likely to decelerate to 1.3%. The hit to GDP will likely come from higher uncertainty created by Brexit, leading to a drop in business investment and exports to the United Kingdom (because of weaker British domestic demand). GDP growth is likely to remain driven mainly by household consumption, which is being underpinned by a pickup on the labour market, easy fiscal policy, low inflation and low interest rates.

BOX 1: Oil – the market is looking for a new equilibrium

Our inflationary prognosis for individual countries is based on the assumption that oil prices will gradually move higher. Although world inventories still remain relatively high, oil supply from non-OPEC countries (especially from the United States) has started to decline. This year, non-OPEC production should decline 0.8 Mb/d while in 2017 it should increase slightly (0.1 Mb/d). On the other hand, SG economists expected global demand to grow (+1.3 Mb/d in 2016, +1.4 Mb/d in 2017). Demand is rising mainly in China but also in other countries in Asia, including India. This should gradually create pressure on price growth. SG economists expect Brent oil prices to rise to $48/b in 3Q16, $50/b in 2016 and $56/b in 2017. In the longer term, low-cost production in the Middle East and medium-cost U.S. shale oil will not be sufficient to meet rising demand. As a result, high-cost deepwater offshore and Canadian oil sands will be needed to fill the gap. As a result, Brent oil prices are likely to jump to $70-80/b (2018-2020).

Mb/d	3Q16f	4Q16f	2016f	1Q17f	2Q17f	3Q17f	4Q17f	2017f
OECD demand	46.5	46.3	**46.2**	46.3	45.3	46.5	46.3	**46.1**
Non-OECD demand	50.2	50.5	**49.9**	50.0	51.5	51.7	52.0	**51.3**
World demand	**96.7**	**96.9**	**96.0**	**96.3**	**96.8**	**98.2**	**98.4**	**97.4**
World supply	**96.5**	**96.7**	**96.4**	**96.4**	**96.7**	**97.2**	**97.5**	**96.9**
Stock change	**-0.2**	**-0.1**	**0.3**	**0.1**	**-0.1**	**-1.0**	**-0.9**	**-0.5**
NYMEX WTI ($/bbl)	46.00	48.00	**42.94**	50.50	53.00	55.50	58.00	**54.25**
ICE Brent ($/bbl)	48.00	50.00	**44.78**	52.50	55.00	57.50	60.00	**56.25**

Source: Bloomberg, SG Cross Asset Research/Commodities

Domestic demand drives German GDP growth.

The Brexit vote will impact the biggest Czech trading partner, Germany, as well. The uncertainty sparked by the British referendum is expected to cost the German economy 0.2pp of GDP growth this year (1.6% forecast for 2016). The effects of Brexit will mostly be seen in the worsening of the trade balance. However, investments are forecast to decelerate, as well. Net exports will therefore contribute negatively to growth. Fortunately, GDP growth is driven mostly by domestic demand, which is being supported by the strength of the labour market. Public finances are also in good shape, so there is a space to use them if necessary. As in other countries, rising oil prices will play a key role in inflation development. Inflation is expected to rise on average 0.5% yoy in 2016 and 1.6% in 2017.

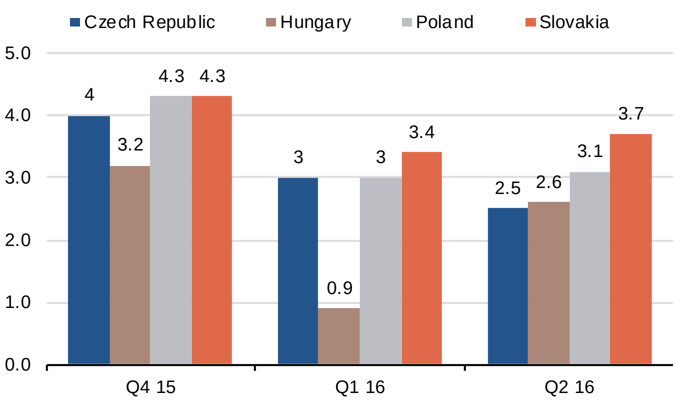
CEE: Investments are the region's Achilles heel

Investments dragged on GDP growth.

Brexit is likely to hit the CEE's Achilles heel at present – investments. Investments already substantially disappointed in 1Q16, pushing GDP growth to surprisingly low levels. In Poland, investments posted the sharpest drop since 2013 (-1.4% yoy) and for the first time since 2012, the Polish economy declined in qoq terms (-0.1% qoq). In 2Q16, CEE economies, however, improved their picture. The Czech, Polish and Slovak economies grew identically 0.9% qoq, while the Hungarian economy added 1.1% qoq. In a yoy comparison, GDP grew 2.5% in the Czech Republic, 3.1% in Poland, 2.6% in Hungary and 3.7% in Slovakia.

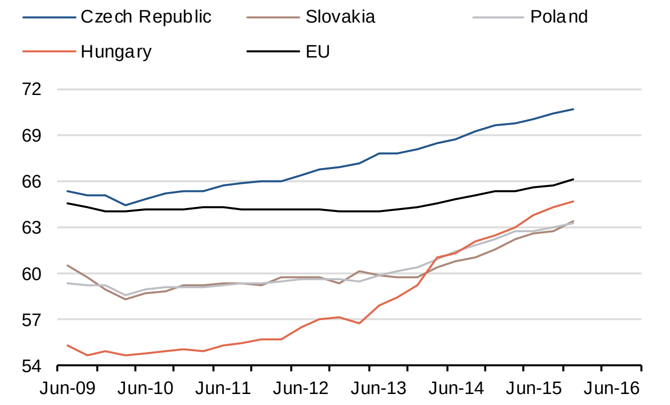
Investments were hit by a weak inflow of money from EU funds and the uncertainty linked to Brexit. According to SG economists, Brexit will cost Poland 0.2-0.3pp of GDP growth in 2017-2019. As for other countries, Brexit will have a negative impact on investments and the trade balance. Poland should be the largest net recipient of EU funds (it should receive EUR 82.5bn in the new programming period of 2014 2020). As a result of Brexit, the amount of money received from EU funds is likely to be lower. Investments are likely to remain a drag over the rest of the year. In 2016, we estimate GDP growth for the Czech Republic to be 2.1%, while GDP growth should be 3.4% in Poland, 2.8% in Hungary (according to the central bank's prognosis) and 2.6% in Slovakia.

CEE region: GDP growth (% yoy)



Source: Economic & Strategy Research, Komerční banka, Eurostat

CEE region: employment rate (%)



Source: Economic & Strategy Research, Komerční banka, Eurostat

Central banks in the region are likely to maintain loose monetary policy.

The key driver of GDP growth in the CEE region remains consumption. The unemployment rate is falling, putting pressure on wage growth. Real household disposable income is being further enhanced by inflation, which, except for the Czech Republic, is negative (in July: Poland -0.9% yoy, Hungary -0.3% yoy, Slovakia -0.9% yoy). As a result, the region's central banks are likely to maintain a loose monetary policy stance. **The Polish central bank should stay on hold this year (1.5%) but, according to SG economists, it might consider lowering the required reserve ratio** (currently 3.5% in Poland and 2% in the Czech Republic) to support investment activity.

The Hungarian central bank supports investment activity.

The Hungarian central bank already adopted a similar measure in July when it modified the terms of the three-month deposit instrument. The tender on three-month deposits will be held just once a month from August (versus once a week up to now), while from October it will also limit the amount of bids by commercial banks accepted at the tender. This should prompt the banks to lend more or to buy government bonds, which could exert downward pressure on interest rates. The Hungarian central bank is likely to keep its key interest rate unchanged at 0.9% for longer but could take similar measures to support domestic investment activity in the coming months.

The Polish zloty is expected to strengthen in the longer term.

Regarding the development of CEE currencies, rating agency decisions affected the Polish zloty this year. The downgrade of Poland's rating in January 2016 from A- with a positive outlook to BBB+ with a negative outlook by the Standard & Poor's ratings agency sent the polish zloty to its weakest level since 2012 (EUR/PLN4.5). On the other hand, the July decision by Fitch to leave the rating unchanged at A- with a stable outlook helped the currency. Ratings agencies are concerned mostly by the country's public deficit. Nevertheless, according to SG economists, Poland should be able to keep its public deficits close to 3% in the coming years. At the end of this year, EUR/PLN is expected to be traded at 4.32EUR/PLN, in June 2017 at 319EUR/PLN. The Hungarian forint, according to SG economists, should slightly weaken from its current levels of EUR/HUF310 to EUR/HUF315 at the end of this year, and toward EUR/HUF319 in June 2017.

Macroeconomic outlook: Gross disposable income shows resilience

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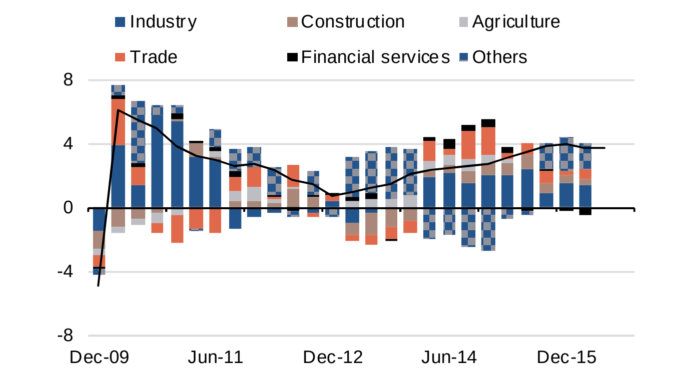
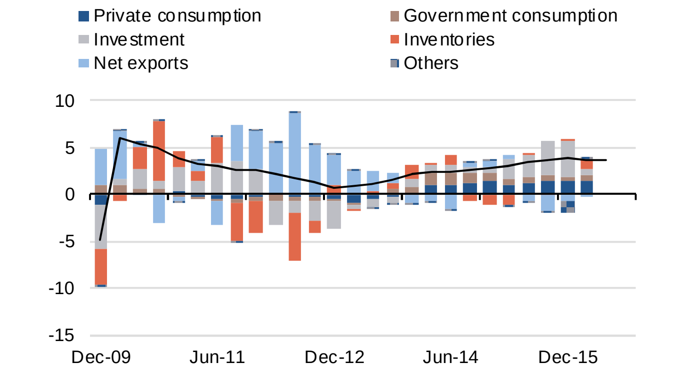
The fallout of investment in the first quarter proved our story that the economy has to run without any support of EU funds. On top of that, investment activity has to deal with the Brexit-related uncertainty. However, Slovakia's labour market is in good shape. Labour income provides support for households, which transmit it into the economy to an increasing extent. Nevertheless, it seems that even net exports are set to contribute positively this year. Exports, particularly of motor vehicles to the EU, prove their strength. Muted imports due low investment activity allow for bigger trade surpluses. Inflation pressures remain negative this year and prices will accelerate in 2017.

Sources of GDP growth (in %, yoy)



Source: Eurostat, Economic & Strategy Research, Komerční banka

Components of GDP demand (in %, yoy)

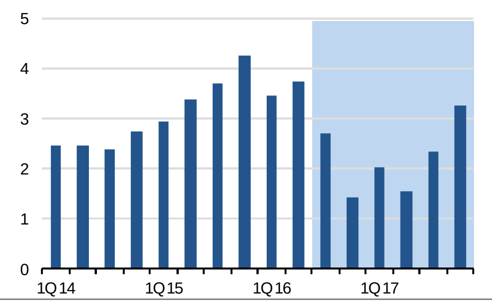


Source: Eurostat, Economic & Strategy Research, Komerční banka

Economy is slowing down as investment fade away.

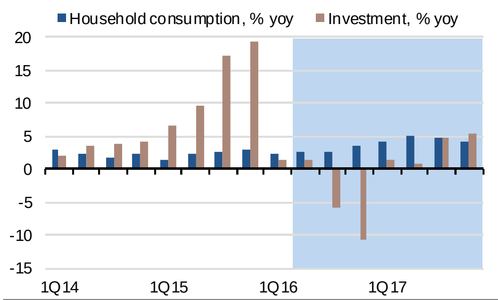
The Slovak economy added 0.9% qoq (SA) in 2Q16, which is an increase of 3.3% (SWDA) in yoy terms, yet again another positive surprise. Investment activity has further slowed down, according to our forecast. However, private consumption has again sped up a bit, since the labour market is still running on all cylinders. The government has made a positive contribution as well. On top of all that, it is expected that growth in the second quarter was supported by net exports, as well. Low investment activity suppressed imports and successful exports mainly of motor vehicles into the EU added to the positive net export contribution.

Statistical base effect is well pronounced in 2H16 (in % yoy)



Source: Eurostat, Economic & Strategy Research, Komerční banka

Private consumption to outperform investment until 1H2017 (in % yoy)



Source: Eurostat, Economic & Strategy Research, Komerční banka

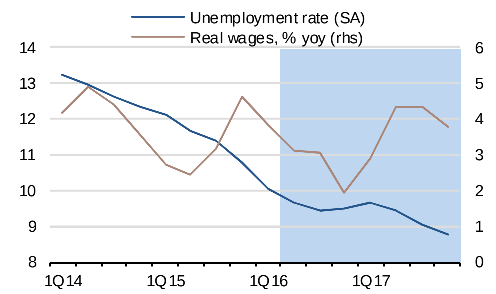
The major contribution to GDP growth this year will be due to private consumption. Investments' decline is part of this story, but most importantly household consumption is supported by the sound situation on the labour market.

Employment is supported by an increasing participation rate.

The unemployment rate is steadily decreasing, and it is set to continue along this trend since the number of vacancies is continuously rising, as well. The participation rate is increasing, and thus conditions on the labour market are more amenable for underrepresented groups (e.g. women, senior citizens). Even the long-term unemployment rate is decreasing.

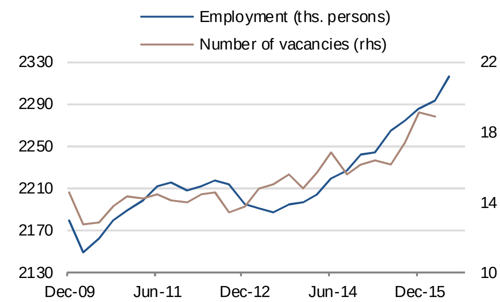
Nevertheless, private consumption is not supported only by increasing participation on the labour market, but benefits from wage-setting conditions, as well. Wages will increase 3% in 2016, and further decreasing unemployment will push wages 3.8% next year. Unemployment itself will fall to 9.7% and further decline to 9.2% next year.

Unemployment declines and wages eases a bit (in % yoy)



Source: SSO, MLSA, Economic & Strategy Research, Komerční banka

Employment as well as vacancies are rising

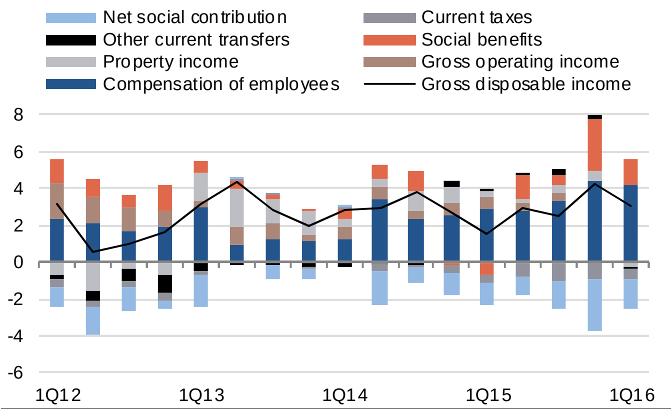


Source: SSO, MLSA, Economic & Strategy Research, Komerční banka

Deflation pushes real wage dynamics over the nominal.

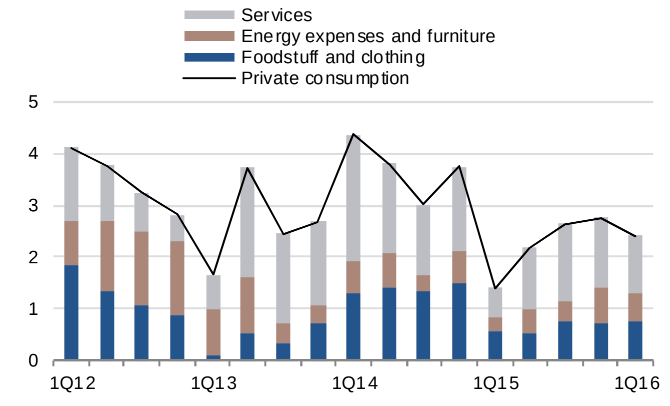
The ever-harder stimulation of the participation rate is mirrored by increasing wages in spite of the fact that dynamics slowed down in 1Q16 compared with the last quarter of 2015. Due to persisting deflation in the economy, real wage dynamics are outperforming those of nominal wages. The total wage bill in the economy is not supported just by increasing wages, but by elevating the numbers of hours worked. (More detailed information about the labour market, including a regional comparison, can be found in our special report "CEE: Labour market is hitting the limits" available at:
http://trading.kb.cz/CommentsAnalysis/Detail/dd1_cee_labour_market_is_hitting_the_limits.

Disposable income is reaching again a solid growth (in % yoy, pp)



Source: SSO, Economic & Strategy Research, Komerční banka

Still all consumption items takes part on the growth (in % yoy, pp)



Source: SSO, Economic & Strategy Research, Komerční banka

Labour income plays an important role in the decomposition of growth of disposable income.

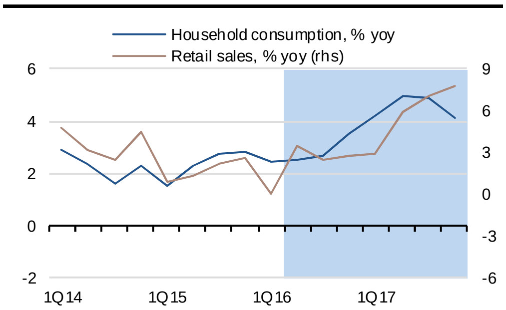
Moreover, disposable income again reaches the dynamics of 4% yoy. The decomposition shows the importance of a labour reward for growth in household income and the surprisingly increasing contribution of social benefits. On top of that, we see that disposable income is spent on all three main segments of household consumption.

Low prices of foodstuffs and fuel are mirrored in retail sales in the respective segment.

The slowdown in disposable income followed by a slowdown of consumption was mirrored in the development of retail sales. In 2Q16, retail sales accelerated again, which shows a positively stimulation of private consumption, which is in line of our forecast. Remarkable growth was recorded in 2Q in the segment of foodstuffs as well as automotive fuels. Both benefit from low consumer prices. However, double-digit growth reaching almost 30% yoy is still recorded by automotive sales. This astonishing growth trend has lasted for more than a year. Automotive sales are accompanied by sales of vehicle parts, as well. Only the repairs and maintenance of motor vehicles is still losing steam in yoy terms in spite of qoq growth of 1% in the second quarter**. In general, we expect retail sales will grow 2.2% this year and will accelerate the dynamics to 5.9% as wages and private consumption is set to revive their dynamics.**

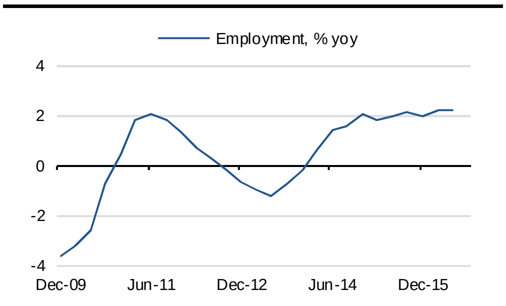
In total, we expect this development will be reflected by private consumption, which will add 2.8% this year and with bursting wage increases will rise 4.5% in 2017.

Both retail sales and consumption will accelerate (in %, yoy)



Source: SSO, Economic & Strategy Research, Komerční banka

Employment keeps solid growth pace (in %, yoy)



Source: SSO, MLSA, Economic & Strategy Research, Komerční banka

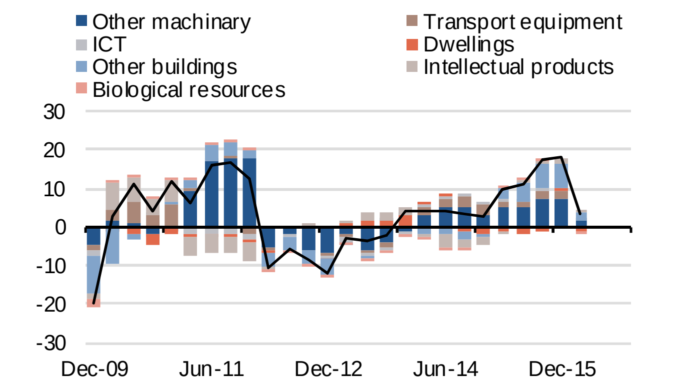
The government as the main investment driver lost its speed at the beginning of the year, and it is not expected that activity will be supported by the private sector. Investment appetite was the most hit by the uncertainty connected to the Brexit

referendum in the United Kingdom. Thus, we see a decline of investment by -3.4% this year and an expansion of 3.1% in the following year.

A lack of EU funds, Brexit-related uncertainty and government outsourcing all influence investment activity.

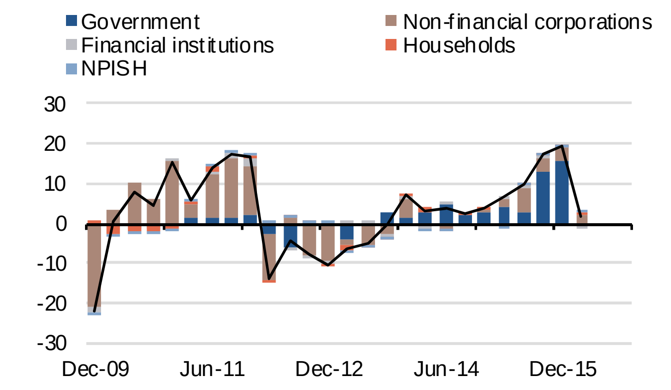
In addition to Brexit-related uncertainty, public-private partnership projects, which are quite popular in Slovakia, e.g. compared with the Czech Republic, further deteriorates government investment activity. On the contrary, Jaguar Land Rover has confirmed its interest in building a factory in Slovakia despite the negative result of the Brexit referendum. Even the sharp depreciation of the British pound as a reaction to the result supposedly won't change the plan. Hence, it supports our hypothesis that the factory would serve as an entry point to the European market regardless of the future relationship between the EU and the UK.

Fixed investment growth by type of capital (in %, pp, yoy)



Source: SSO, Economic & Strategy Research, Komerční banka

Sectoral decomposition of fixed investment growth (in %, pp, yoy)



Source: SSO, Economic & Strategy Research, Komerční banka

Engineering construction will drag the sector down, and not even the start of the Jaguar Land Rover site will be able to compensate.

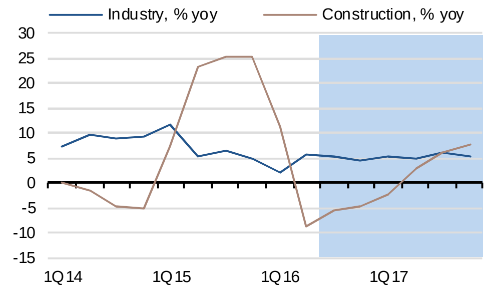
The construction work on the new factory are supposed to start in the mid of September **Despite the sound beginning of this year and the start of the Jaguar Land Rover site, the fading effect of EU funds will bring the yoy rate to 2.2% from 20.2% last year. In the following year, construction activity will normalise and add 3.6%.**

Like construction, industrial activity will slow down as well this year but with a lower amplitude. The yoy rate is expected to reach 4.4% and subsequently revive to 5.4% in 2017.

Industry benefits from car registrations in the EU.

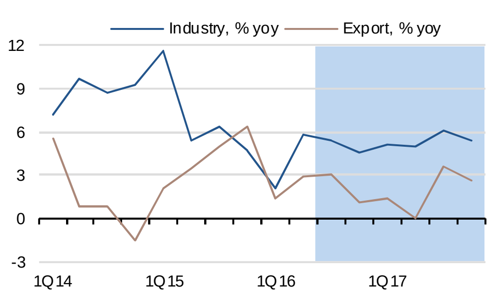
The domestic resources of industrial growth might be limited due the lack of EU funds transmitted into industry via subcontracts for construction projects. However, the second quarter of the current year shows that support for industrial production comes predominantly from abroad. The sectors of manufacturing and transport equipment show a good performance as a result of export activity. This is motivated by increasing car registrations in the EU. The metal industry as a preceding eye in the supply chain reaps its fruits, as well. On top of all that, the textile industry was able to swing again to yoy growth since the first quarter last year. Moreover, the food industry is stimulated by the solid growth of foodstuff retail sales and low consumer prices in this sector. Nevertheless, industrial production remains erratic, at least at the level of monthly data.

Dynamics of industry will stay, but construction will be influenced by the statistical base (in %, yoy)



Source: SSO, Economic & Strategy Research, Komerční banka

Growth rate of export is set to stay in positive territory (in %, yoy)



Source: SSO, Economic & Strategy Research, Komerční banka

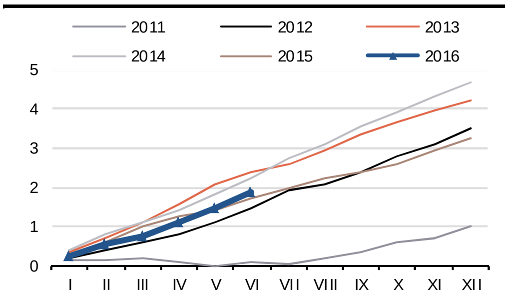
Net exports contribute positively, but will turn negative again.

The positive contribution of net exports to economic growth is due to surprisingly high dynamics of exports, mainly motor vehicles. Imports are lagging behind thanks to muted investment activity, which has higher import intensity than private consumption. The trade balance stays consistently positive and around the same level as last year. The level of exports is being dragged down by exports of mineral products. On the contrary, motor vehicle exports is the segment that stimulates export growth, which is more evenly distributed among the commodity segments. The only exception is mineral products, whose yoy decline is related to the development of prices that are still around 20% lower than last year.

A decline of exports to the Czech Republic was recorded in the first quarter.

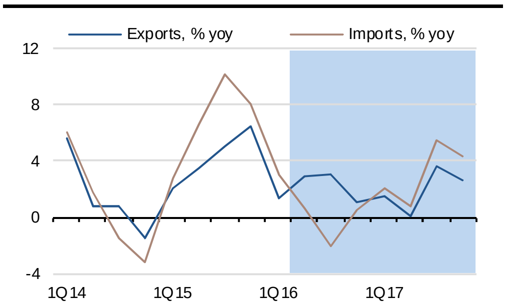
The geographical orientation of exports is supported by sound dynamics of exports to the EU and Germany, specifically. Exports to Russia continue to decline at a double-digit rate. In the first quarter, there was even a decline in exports to the Czech Republic. Imports maintain solid growth dynamics fromor the main trading partners e.g. the EU, Germany and China. On the other hand, they decelerate from the Czech Republic, Ukraine and, naturally, Russia.

Trade balance developments (EURbn)



Source: SSO, Economic & Strategy Research, Komerční banka

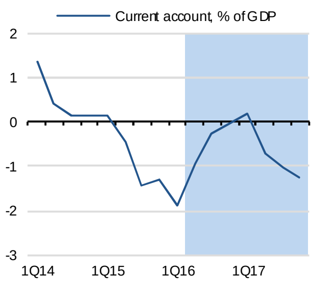
Export and import dynamics outlook (in %, yoy)



Source: SSO, Economic & Strategy Research, Komerční banka

Growth rates on a year-on-year basis for both exports and imports are expected to slow down this year. Import deceleration is more pronounced, which is caused by the low dynamics of investment activity. Hence, we expect an increase of the trade surplus this year and subsequently a positive contribution of net exports to economic growth. Nevertheless, this will again turn to negative as the investment will stimulate higher imports next year.

Current account deficit is set to turn back to zero



Source: NBS, Economic & Strategy Research, Komerční banka

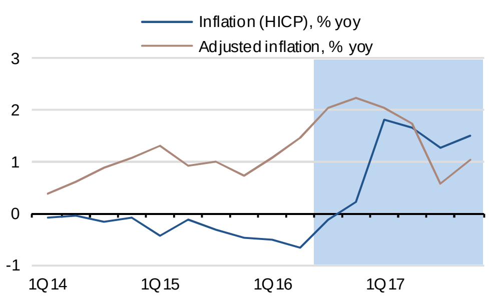
Deflation is reaching historical "highs".

The current account deficit again deepened to -2% of GDP at the beginning the year. The balance of goods was again lower mainly due to the higher increase of debit of goods, which has not been compensated by other sub-balances on the current account. However, the negative current account balance is set to shift back to zero at the end of the year since the balance of goods is set to achieve a more positive balance. The balance of services is expected to improve, as well.

Deflation not only prevails in the Slovak economy but is becoming stronger. The number for July printed -0.9% yoy. The average for the second quarter was -0.6% yoy. The drag came mainly from food prices, whereas fuel and administered prices kept their negative contribution. A positive development is still due to adjusted inflation, which reflects increasing private consumption. Adjusted inflation will further mirror the accelerating growth of private consumption. Negative contributions are expected from the remaining inflation items. Food price development will even cause more negative pressures compared with the previous forecast. As soon as the yoy dynamics of crude oil prices ease, fuel prices will reflect that. Similarly, administered prices will add positive dynamics, and food prices will revive next year.

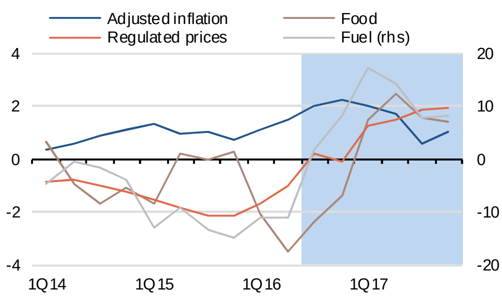
In general, the average yoy rate is expected to reach -0.3% this year. It will speed up to 1.6% next year despite the fact that adjusted inflation will ease slightly. However, other inflation items will compensate for that.

Inflation forecast (in %, yoy)



Source: SSO, Economic & Strategy Research, Komerční banka

Inflation components (in %, yoy)

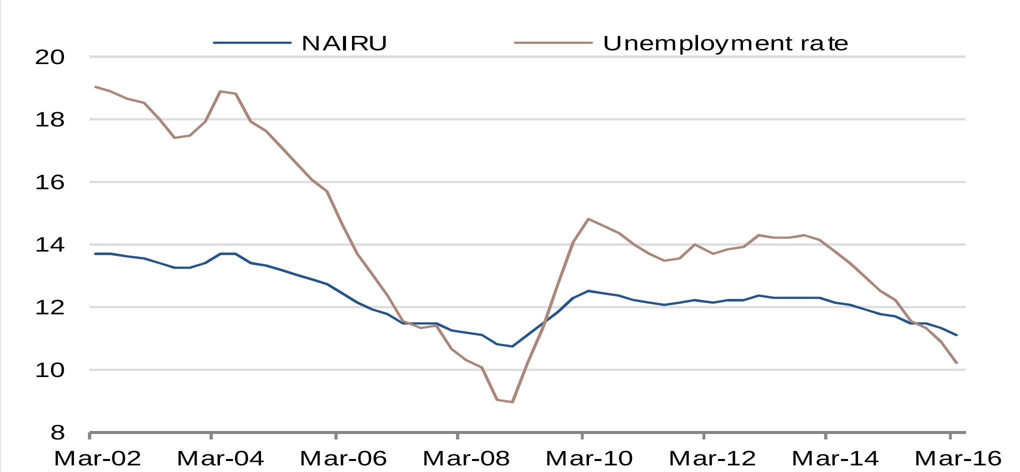


Source: SSO, Economic & Strategy Research, Komerční banka

BOX 2: NAIRU, unemployment rate and core inflation

The concept of NAIRU (non-accelerating inflation rate unemployment) is an unobservable level of unemployment at which the inflation rate is not accelerated. This acceleration happens if observed unemployment rate is below NAIRU. Our new Kalman method estimation of NAIRU shows that the theoretically expected result was obtained in the years before the crises 2008-2009, when the unemployment rate was below NAIRU and yoy growth peaked at a local maximum. However, that has not recently been the case. Our forecast shows a steady acceleration of core inflation but at a somewhat slower pace than the model would expect based solely on NAIRU estimation. This analysis might suggest the inflationary environment is different and more labour market tightening is necessary in order to stimulate core inflation to accelerate. Total inflation might then benefit from an acceleration of core inflation, which would be accompanied by the release of negative price pressures in other inflation items. However, this relationship has been loosened in other CEE countries, as well.

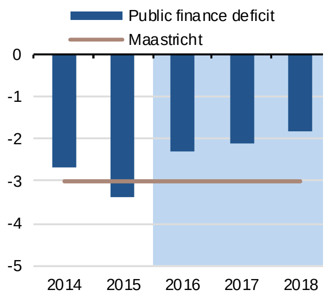
New time-varying NAIRU estimate



Source: SSO, Economic & Strategy Research, Komerční banka

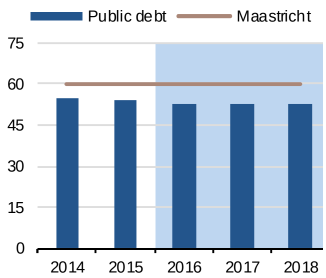
Public sector

Public finance deficit (% of GDP)



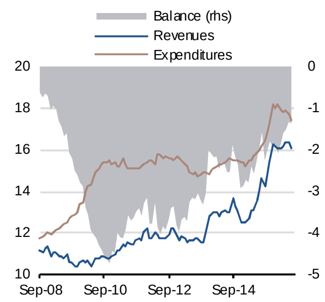
Source: Eurostat, Economic & Strategy Research, Komerční banka

Public sector debt (% of GDP)



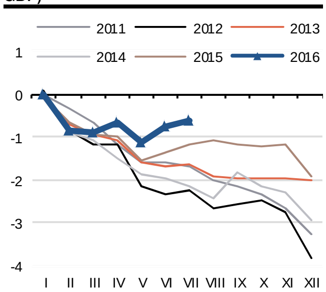
Source: Eurostat, Economic & Strategy Research, Komerční banka

State budget (12m cumulative, bn EUR, % of GDP (rhs))



Source: MFSR, Economic & Strategy Research, Komerční banka

State budget (cumulative deficit, % of GDP)



Source: MFSR, Economic & Strategy Research, Komerční banka

This year's deficit-to-GDP ratio lags far behind the plan

The government has already introduced the first proposal of the budget for 2017-2019 and updated its targets for this year. The outlook is in line with the Stability and Growth Pact submitted in April to the European Commission. Hence, there is no surprise in the ambitious plans for the future. However, the risks for the more distant future are related to downward revisions, as was previously the case. In addition, this proposition is at the beginning of the political process.

The proposal contains the current year assessment as well. Government expects that the final deficit to GDP ratio will achieve -2.1%. This still less than our forecast (-2.3%), but we have revised up our estimation up based on the current development. The budget is not boosted by the inflow of EU funds. The deficit in July has reached EUR624m which is 47% lower than YTD last year and draws the plan only from 32%. While budget revenues are 2.1% lower than previous year, but expenditures are down by 8%.

Budget revenues are boosted by tax revenues (5.2% yoy) and income taxes specifically (20.3% yoy). However, indirect taxes on goods and services do not lag behind significantly (-0.9% yoy). The drag comes from non-tax revenues (-34.8% yoy) and revenues from the EU budget. Budget expenditures are muted by the current expenditures, which are 2.8% lower yoy, but more importantly due to capital expenditures, which are 32.5% lower. The government is enjoying the low interest rate environment and saved 8% yoy on interest costs. Hence, the government is not using the opportunity to invest in future growth but is rather supporting the current consumption.

As mentioned in the previous edition of the *Slovak Economic Outlook*, we consider the long-term fiscal plans as overly ambitious and risks are related to the downside in terms of the deficit-to-GDP ratio. This is based on overly optimistic GDP assumptions and compared with our assumptions, it does not take into account the global business cycle hitting the Slovak economy as part of the international supply chain in 2019. The Council for Budget Responsibility has identified this risk in their publications, as well. Therefore, we forecast the deficit-to-GDP ratio as improving, but our estimation stays more conservative than the government.

Public sector debt is expected to print 52.7% of GDP at the end of this year after last year's 52.9%. The stabilisation effort is set to lead to debt reduction in terms of GDP percentage from next year onward to the level of 52%.

2016 borrowing needs and financing, EURm

	ARDAL	KB (August)
Borrowing needs		
Budget deficit	1940.9	1824.9
Buybacks	500.0	500.0
Redemption of T-bills	0.0	0.0
Redemption of bonds		3819.3
JPY bonds		199.7
Redemption of loans		0.0
Total		**6343.9**
Financing		
Gross T-bill issuance (ex revolving)		
Gross bond issuance (in auctions)		3800.0
Gross bond issuance (syndicated)		2000.0
Loans		225.0
Tap of liquidity reserve		318.9
Total financing		**6343.9**
Change in debt		*6025.0*

Source: Economic & Strategy Research, Komerční banka, ARDAL

2017 borrowing needs and financing, EURm

	ARDAL	KB (August)
Borrowing needs		
Budget deficit		1753.3
Buybacks		500.0
Redemption of T-bills		0.0
Redemption of bonds		3727.8
Redemption of Eurobonds		1000.0
Redemption of loans		0.0
Total		**6981.1**
Financing		
Gross T-bill issuance (ex revolving)		0.0
Gross bond issuance (in auctions)		2800.0
Gross bond issuance (syndicated)		4000.0
Loans		0.0
Tap of liquidity reserve		181.1
Total financing		**6981.1**
Change in debt		*6800.0*

Source: Economic & Strategy Research, Komerční banka, ARDAL

Risks

Rather external than internal risks are identified.

- Heightened political uncertainty is the main important risk related to the forecast. The risk assessment is biased to the downside. The main risks identified are the following:
- **Even after the Brexit referendum in the UK, political issues are present in major European countries.** Political uncertainty on the European continent is linked to activation of Article 50 of the EU Treaty and successive negotiations between the UK and the EU about future relations. The Spanish election (26 June) did not solve the political gridlock. The Italian constitutional referendum about transforming the Senate of the Republic into the Senate of Regions is going to be held this autumn. Heading into 2017 will see a year of presidential elections in France and parliamentary elections in Germany.
- **The risk that the Chinese renminbi will come under undue pressure as a result due to any of the imbalances** (equity bubble, new FX policy setup, rising property bubble and non-performing loans) **bubbling under the surface is still high.**
- **A greater fiscal boost due to the electoral cycle in many European countries is still in place.** The support might come from enhanced security measures due to increased terrorist threats.
- **A positive risk to investment might come with the behaviour of cash-rich companies, which have low rates for financing available.**

We are able to identify risks that stem purely from the domestic economy:

- **Low interest rates and a favourable situation for the Slovak motor vehicles industry export are a positive risk for investment.**

Key economic indicators

	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	2015	2016	2017
GDP (real, yoy, %)	3.5	3.7	2.7	1.4	2.0	1.6	2.4	3.3	3.6	2.8	2.3
Household consumption (real, yoy, %)	2.5	2.6	2.6	3.5	4.2	5.0	4.9	4.1	2.4	2.8	4.5
Fixed investments (real, yoy, %)	1.5	1.5	-5.8	-10.7	1.4	0.9	4.7	5.5	13.2	-3.4	3.1
Foreign trade (EUR bn)	0.8	1.1	1.0	0.8	0.7	0.6	0.7	0.5	3.3	3.6	2.5
Industrial production (real, yoy, %)	2.1	5.8	5.3	4.5	5.2	5.0	6.1	5.4	7.0	4.4	5.4
Construction (real, yoy, %)	11.1	-8.9	-5.4	-4.8	-2.2	2.8	5.9	7.7	20.2	-2.0	3.6
Retail sales (real, yoy, %)	0.1	3.4	2.5	2.7	2.9	5.9	7.1	7.8	1.8	2.2	5.9
Wages (real, yoy, %)	3.8	3.1	3.0	2.0	2.9	4.3	4.4	3.8	3.2	3.0	3.8
Unemployment (COLSAF, %)	10.1	9.5	10.5	10.5	10.7	10.5	10.0	9.8	11.5	10.1	10.2
Inflation (HICP, yoy, %)	-0.5	-0.7	-0.1	0.2	1.8	1.6	1.3	1.5	-0.3	-0.3	1.6
Adjusted inflation (yoy, %)	1.1	1.5	2.0	2.2	2.0	1.7	0.6	1.0	1.0	1.7	1.3
Food prices (yoy, %)	-2.0	-3.5	-2.4	-1.4	1.5	2.5	1.6	1.4	-0.3	-2.3	1.8
Fuel prices (yoy, %)	-11.2	-11.2	1.6	8.4	17.3	14.4	7.8	8.1	-12.6	-3.1	11.9
Regulated prices (yoy, %)	-1.6	-1.0	0.2	-0.1	1.3	1.5	1.9	1.9	-1.9	-0.6	1.6

Source: Eurostat, SSO, NBS, MF, COLSAF, Economic & Strategy Research, Komerční banka
Note: KB forecasts are in blue

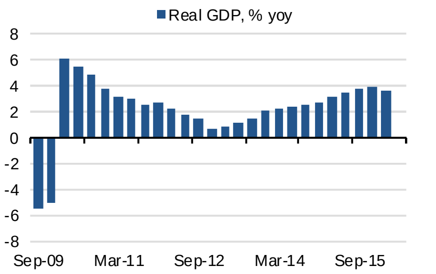
Slovak long-term macroeconomic forecasts

		2011	2012	2013	2014	2015	2016	2017	2018	2019
Gross Domestic Product	current prices, EUR bn	70.4	72.4	73.8	75.6	78.1	79.9	82.6	86.8	90.3
Gross Domestic Product	real growth, %	2.8	1.6	1.4	2.5	3.6	2.8	2.3	2.5	1.2
Industrial output	real growth, %	5.3	7.4	3.8	8.7	7.0	4.4	5.4	4.0	1.6
Construction	real growth, %	-0.5	-11.9	-4.4	-2.8	20.2	-2.0	3.6	5.0	2.1
Retail sales	real growth, %	-2.6	-1.1	0.2	3.7	1.8	2.2	5.9	3.9	3.0
Unemployment rate	end of period, %	12.5	13.6	14.4	12.3	10.5	10.6	9.7	9.5	10.2
Average national wage	EUR, nominal, average	786	806	824	858	883	907	958	996	1039
Average national wage	average growth, real, %	-1.8	-1.2	0.9	4.2	3.2	3.0	3.8	1.7	2.2
Consumer prices	HICP, average, %	4.1	3.7	1.5	-0.1	-0.3	-0.3	1.6	2.2	2.1
Consumer prices	HICP, end of period, %	1.3	4.6	3.4	-0.3	-0.5	1.0	1.7	2.5	1.7
Foreign trade	current prices, EUR bn	1.0	3.6	4.2	4.7	3.3	4.4	3.6	3.2	3.3
Exports of goods	current prices, EUR bn	56.8	62.1	64.2	64.7	67.9	69.8	71.1	74.1	76.3
Imports of goods	current prices, EUR bn	55.8	58.6	59.9	60.0	64.6	65.4	67.5	70.9	73.1
Exports of goods	nominal growth, %	18.5	9.2	3.5	1.4	4.3	2.1	1.9	4.1	2.9
Imports of goods	nominal growth, %	18.6	4.9	2.5	0.8	6.9	0.5	3.2	4.9	3.0
Current account	current prices, EUR bn	-3.5	0.7	1.4	0.1	-1.0	0.0	-1.0	-1.2	-1.1
Current account	% of GDP	-5.0	0.9	2.0	0.1	-1.3	0.0	-1.3	-1.4	-1.2
Balance of goods	% of GDP	-0.1	3.5	4.1	3.8	2.4	4.3	3.0	3.0	3.2
Balance of services	% of GDP	-0.4	0.6	0.6	0.1	0.1	0.2	0.1	-0.1	-0.5
Income balance	% of GDP	-3.4	-1.7	-0.9	-2.2	-2.3	-3.2	-3.2	-2.9	-2.8
Public sector deficit	% of GDP	-4.1	-4.3	-2.7	-2.7	-3.4	-2.3	-2.1	-1.8	-1.9
Public debt	EUR bn	30.5	37.9	40.6	40.7	41.3	42.1	43.8	45.4	47.1
Public debt	% of GDP	43.3	52.4	55.0	53.9	52.9	52.7	53.0	52.3	52.1
External debt	% of GDP	78.5	75.8	81.9	89.7	86.1	81.2	78.8	77.7	80.4

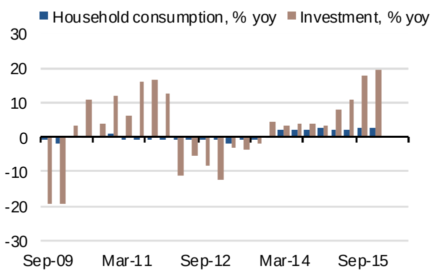
Source: SSO, NBS, MF, COLSAF, Economic & Strategy Research, Komerční banka
Note: KB forecasts are in blue

Macroeconomic indicators

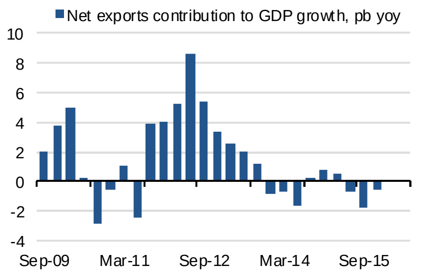
GDP (yoy)



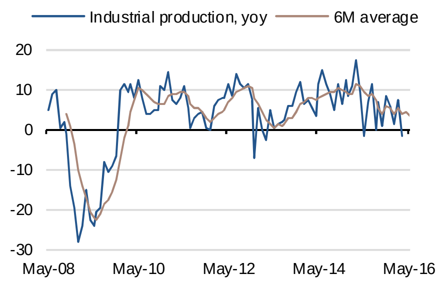
HH consumption, investment (yoy)



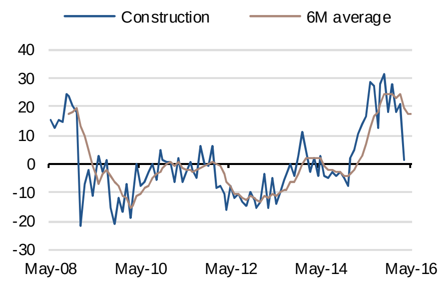
Net exports



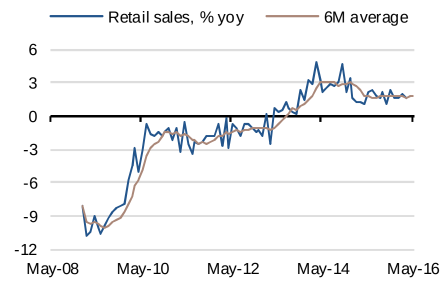
Industry (yoy)



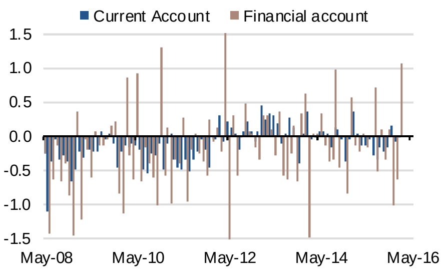
Construction (yoy)



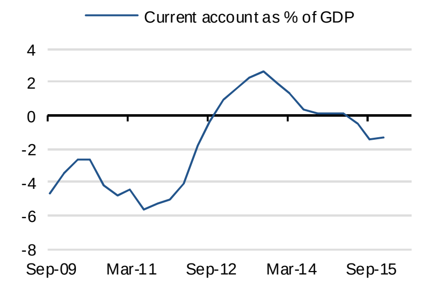
Retail sales (yoy)



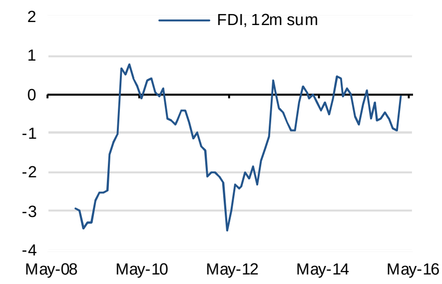
Balance of payments (EUR bn)



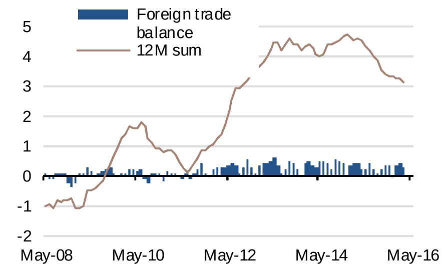
Current account (% of GDP)



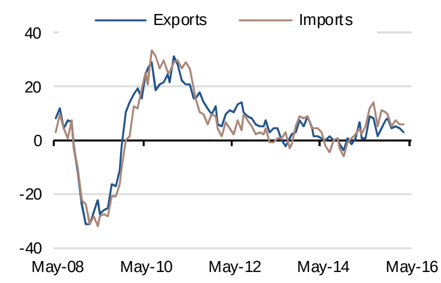
Foreign direct investments (EUR bn)



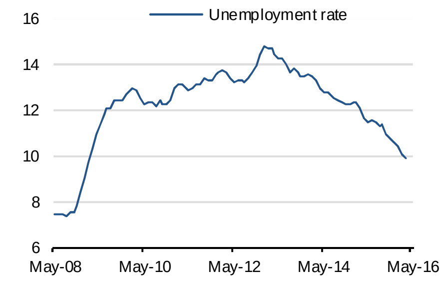
Foreign trade balance (EUR bn)



Export and import dynamics (yoy)

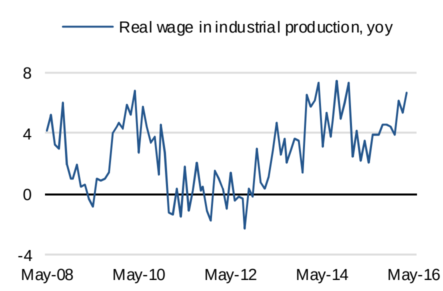


Unemployment rate (%)

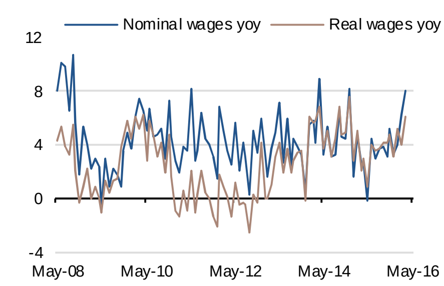


Source: Eurostat, SSO, NBS, Economic & Strategy Research, Komerční banka

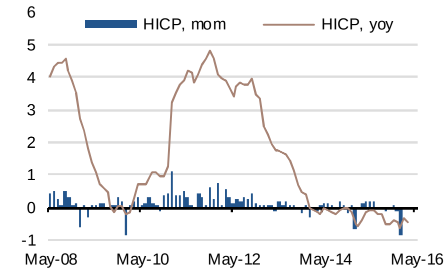
Real wages in industrial production (yoy)



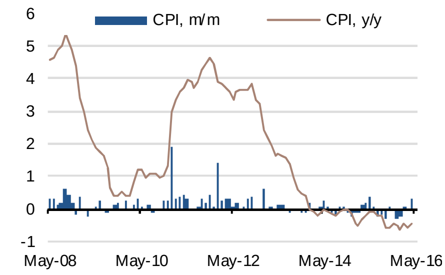
Wages in the economy (yoy)



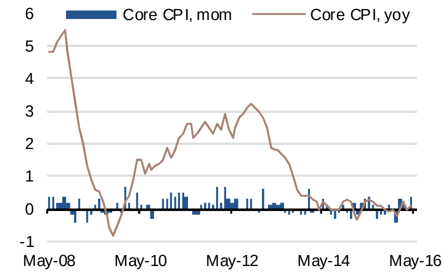
Consumer prices (HICP, %)



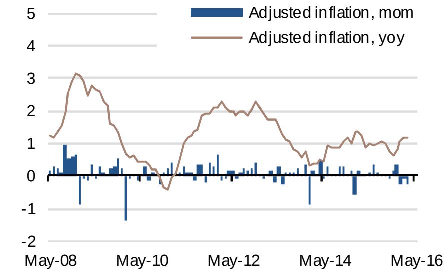
Consumer prices (%)



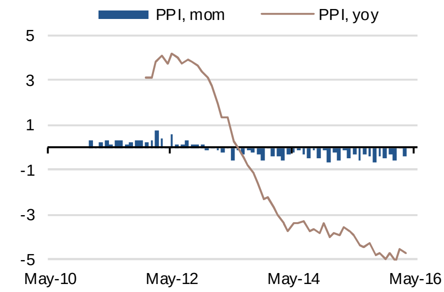
Core inflation (%)



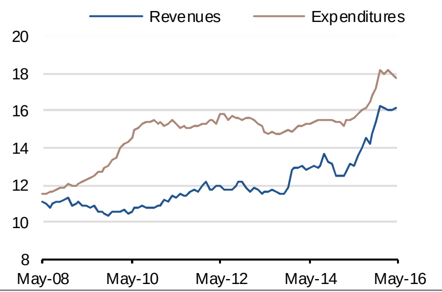
Adjusted inflation (%)



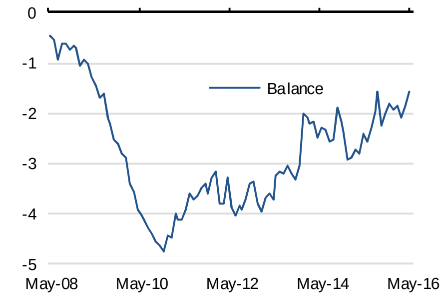
Producer prices (%)



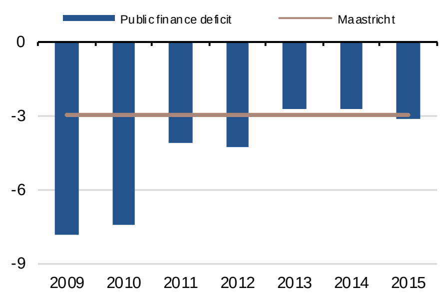
State budget (revenues, expenditures, in EURbn, cumulative for past 12M)



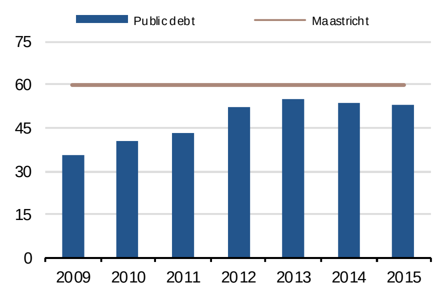
State budget (balance, in EURbn, cumulative for past 12M)



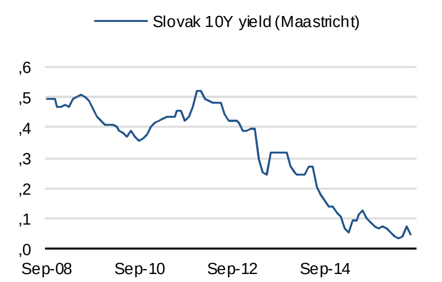
Public finance deficit (% of GDP)



Public debt (% of GDP)



Slovakia government 10Y bond yield (Maastricht)



Source: SSO, NBS, Eurostat, Economic & Strategy Research, Komerční banka

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