UniCredit Bank

Weekly

N . o . t . e . s

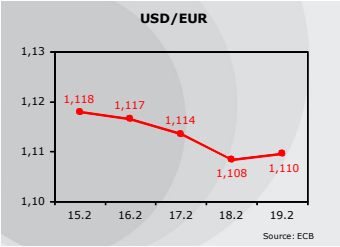
English translation by an external party

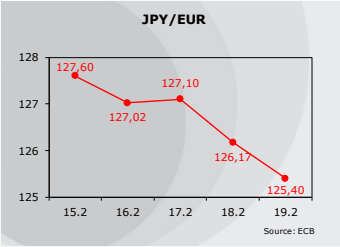
HIGHLIGHTS OF THE WEEK 07/2016

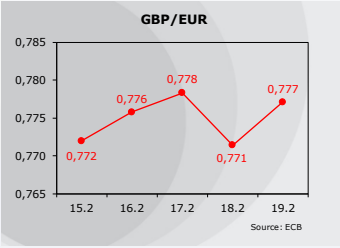
> Chart of the Week: Economies of Slovakia and the Czech Republic would be affected relatively the most by the Schengen break-up

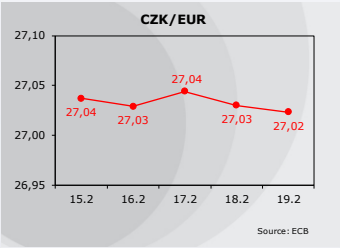
> VAT and oil returning deflation in January back to a historical low

WEEK ON THE MARKETS









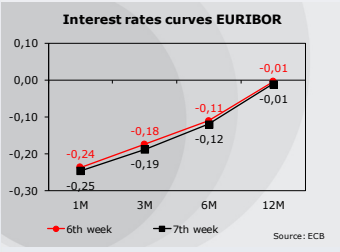
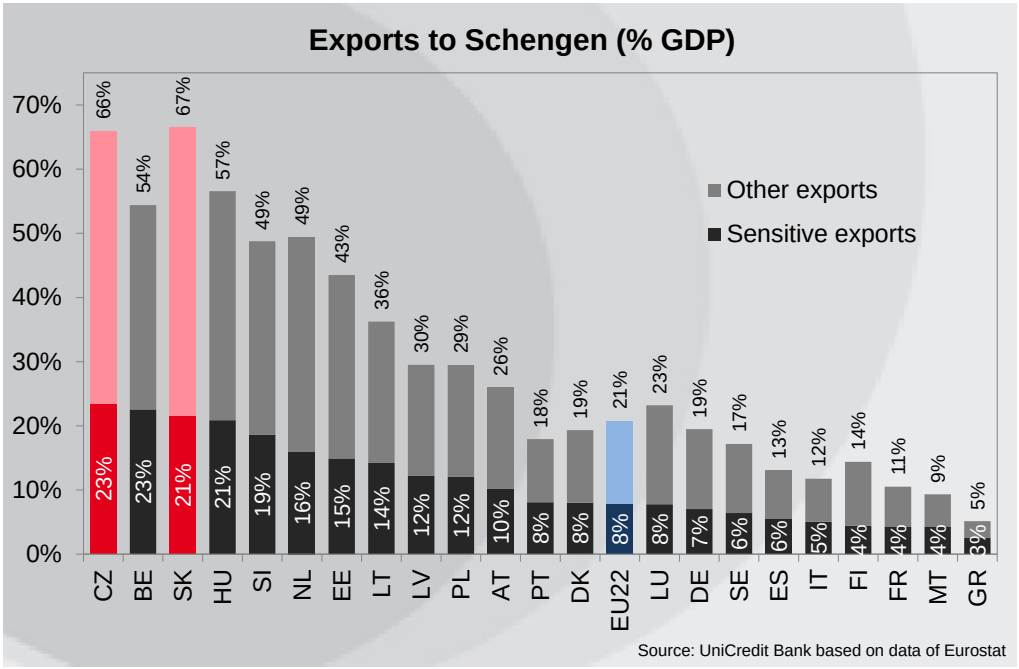


CHART OF THE WEEK



Source: UniCredit Bank based on data of Eurostat

Currently, another summit of EU leaders takes place, dominated mainly by topics of migration crisis and Brexit (or withdrawal of Great Britain from the EU). The intensive influx of refugees from countries in the Middle East exacerbate tensions in Europe. As a result of this unpleasant situation, various proposals leading towards closing of EU countries keep turning up more and more often in many European countries. The Schengen system of free movement of goods and people has been endangered. Its break-up would cause restrictions on the four essential principles on which the EU depends – free movement of people, goods, services, and capital. Such action would undoubtedly have also a negative impact on the performance of EU economies - due to the extreme openness of their economies, the countries most affected by such action would include Slovakia and the Czech Republic.

The current *Chart of the Week* focuses on only one of the channels through which the countries would feel the negative impacts of the Schengen break-up – restrictions on the free movement of goods. The importance of internal trade among the Schengen countries varies from one country to another – while only 35% of exports of Malta or Greece is headed towards the remaining Schengen countries, it is as much as 79% in the case of Luxembourg. Schengen represents a significant share in exports also in many CEE countries – Slovakia with 77%, Czech Republic and Estonia with 76%, Poland with 71%, or Hungary with 69%. On average of the 22 EU countries that are also members of the Schengen area, 57% of their exports is directed to other Schengen countries. Besides the share in exports, also the scope of openness of their economies is vital for the overall importance of Schengen in individual countries.

Together with the neighbouring Czech Republic, Slovakia's movement of goods across borders is the most intense out of all EU countries; this intensity is measured by the volume of export to the GDP - exports to Schengen countries account for as much as two thirds of performance of their economies. A well above average share of exports to Schengen countries is reported also by the Benelux countries – Belgium (54% of the GDP) and the Netherlands (49%), or by some other Central European countries – Hungary (57%) and Slovenia (49%). On the contrary, in the case of Greece and Malta, which profit mainly from tourism, it is less than 10% of the GDP; a relatively low share in economy performance is reported also by large, quite closed European economies in southern Europe – France, Italy or Spain (11-13%).

Also the existence of Schengen contributed to the fact that the volume of Slovakia's foreign trade has nearly doubled in the last 10 years (2005-2014) and export, after adjustment for imports, accounted for more than one third of the overall growth of Slovak economy. Together with the Czech Republic, Slovakia would clearly be one of the countries most affected by reintroduction of checks at the borders. Total losses would depend on the extent by which the volume of goods transported would be reduced due to the poorer traffic fluidity. Our consideration is based on distribution of the goods exported into two categories broken down by their sensitivity to potential delay at the borders. The low-sensitive items category includes, for instance, means of transport or machines. On the contrary, sensitive items include basic foodstuffs and non-durable consumer goods (having a 100% weight assigned), as well as semi-finished products, processed food and semi-durable consumer goods (having a 50% weight assigned). Export of sensitive items so defined in Slovakia and the Czech Republic is almost threefold higher than the EU average, accounting for more than 20% of the performance of their economies.

Decline in the export of sensitive items by 5% would (based on historical links) cost the Slovak economy 0.3% of the GDP, i.e. around EUR 200 million of created values a year at current prices. At one extreme, if we consider a 10% slump in the export of sensitive items, the GDP losses would be double.

We have included in our considerations also a potential situation (of low probability though) that the countries of the Visegrad Group would respond together to the Schengen break-up by creating some "small Schengen" of V4 countries, maintaining free crossing of borders among them. As shown by our analysis, Slovakia would be the country most interested in implementing such compensatory action, as it directs relatively the highest volume of goods to the surrounding V4 countries (mainly to the Czech Republic); on the contrary, such initiative would have an almost unmeasurable benefit for Poland. In any case, the "small Schengen" of V4 countries would cushion the negative impacts of the Schengen break-up relatively poorly, doing very little in the field of exports. In the event of restrictions on exports of sensitive items across controlled borders by 5%, the GDP reduction would reach "only" 0.2% instead of 0.3%, or, in nominal terms, performance of the economy at current prices would not be decelerated by EUR 200 million but only by EUR 150 million.

However, the direct economic losses, which would probably be overcome without major difficulty even by the most affected countries, such as Slovakia and the Czech Republic, are not the most severe risk arising from the Schengen break-up. It is mainly the fact that the end of Schengen does not have to be an isolated action but rather the beginning of a process of gradual disintegration of the European Union that seems risky. The recently published analysis on Brexit - Britain departing from the European Union - prepared by our UniCredit colleagues implies that Britain, whose economy is substantially less export-oriented and substantially less exposed to other EU countries, such as Slovakia and the Czech Republic, would lose 6% of the performance of its economy. Therefore, we may assume that the losses that could arise in Slovakia and the Czech Republic in the event of EU disintegration or exit from this unit would be many times higher. (lk)

ECONOMIC CALENDAR

Week	Indicator	Period	Market Consensus	UniCredit Bank Estimate	Reality
7.	Consumer prices (February 15)	January	-0.5% yoy	-0.2% mom -0.6% yoy	-0.2% mom -0.6% yoy
	Unemployment (February 15-20)	January	-	10.75%	-
8.	Harmonised index of consumer prices (February 25)	January	-	-0.2% mom -0.5% yoy	-
	Producer prices (February 26)	January	-	-4.7% yoy	-

Source: Bloomberg, Reuters, NBS, SOSR, UPSVaR, MinFin SR, UniCredit Bank Slovakia

ECONOMY

VAT and oil returning deflation in January to a historical low

CONSUMER PRICES

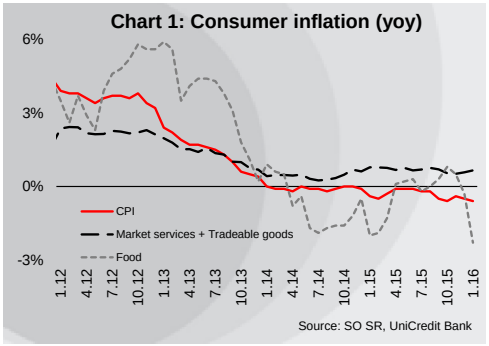
In accordance with our expectations, deflation in Slovakia deepened slightly in January, equalising the existing low of the last year's October. According to data of the Statistical Office of the SR, consumer prices went down by -0.2% mom in January 2016, being lower by -0.6% compared to the same period a year ago. Slovakia has thus reported a yoy growth of price more than two years ago, in December 2013. However, deflation in Slovakia is still relatively moderate, driven solely by supply-side factors. Such form of deflation is not harmful to the economy; just the opposite, it supports household consumption, when the falling energy and food prices increase the available resources of households for other expenses.

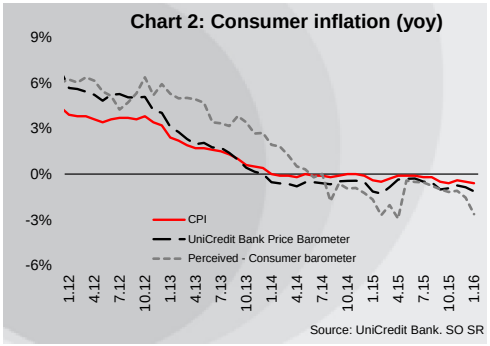
The grounds of the price decline in January must be sought mainly on the part of administrative measures and falling energy prices. Deflation in Slovakia is still solely of supply-side nature. On the contrary, the demand-pull inflation (measured by the index of prices of tradable goods (without fuels) and market services (without imputed lease) – calculation of UniCredit Bank) slightly accelerated in January, rising by 0.4% compared to December, with the dynamics of its yoy growth accelerating from 0.6% to 0.7%.

Since January 2016, the VAT rate on selected food has been reduced from 20% to 10%. This fact has been reflected also in the end prices of such food, with a considerable mom decline in prices being reported in January mainly by prices of meat, as well as prices of milk, cheese and eggs, and of bread and crops. On the contrary, prices of other food were rising in January, as they usually do at the beginning of the year. On the aggregate, prices of food went down by 1.1% in January and the dynamics of their yoy decline accelerated from -0.3% to -2.3%. Contribution of the VAT reduction to overall inflation has been calculated by the Statistical Office at -0.32 pp, i.e. theoretically, if we consider full translation of the lower VAT rate into end prices, consumer prices would not be falling in January.

However, inflation was not pushed down at the beginning of the year only by food but also by energy prices. Regulated energy prices changes, as usually, in January – due to the falling prices of energy commodities, mainly the prices of gas went down (by -3.5%); however, also prices of electricity (-0.8%) and heat (-0.2%) have been slightly lower since January. The extent of reduction of regulated energy prices has reached the extent at the beginning of previous year (due to the decline in prices of electricity and partially also of heat which has been slower than last year), and the yoy decline in regulated prices moderated from -1.8% to -1.1%.

However, decline was reported not only by regulated energy prices at the beginning of the year. A major slump in oil prices on global markets at the turn of the years has been reflected gradually in the end prices of fuels in Slovakia, even during January. Prices of fuels at Slovak fuel stations went down by another -5.1% in January, with the dynamics of their yoy growth moderating negligibly from -14% to -13%. The slump in prices of oil and fuels from the beginning of the last year repeated almost identically. Fuels themselves were thus reducing the overall yoy inflation by 0.27 pp.





The UniCredit Bank Price Barometer (i.e. the perceived inflation measured through frequently bought goods and services), went down considerably in January – by as much as -0.6% mom (due to the higher weight of food and fuels); compared to the same period a year ago, its decline deepened from -0.9% to -1.1%. According to the consumer barometer of the Statistical Office, perception of the decline in prices increased further - in January, consumers perceived a price decline at as much as -2.6%, while "only" at -1.5% in December (calculated from the balance of responses). So far, a more considerable price decline has been perceived by consumers only in February and May 2015. Deepening of the perception of deflation (probably also due to the reduced VAT on food, i.e. frequently bought items) has been translated also into the inflation expectations; they fell to historically low levels, with consumers expecting a price decline by as much as -2.7% in the following 12 months.

OUTLOOK

There is still no stronger inflation driver and this situation should persist also for most of 2016. Low prices of oil and other energy commodities, besides the direct impact through prices of fuels and regulated energy prices, decelerate also the recovery of demand-pull inflation. On the contrary, return of food prices to the positive is hindered by tax alterations (reduction of VAT on selected food). In spring months, the yoy deflation in Slovakia could slightly accelerate towards -1%, reporting new historical lows. However, later the effect of low oil prices should gradually start wearing off and inflation ought to start moving towards zero, and a slightly positive inflation could be finally (after nearly three years) reported at the end of the year. The speed at which inflation will return to the positive will depend mainly on the development of oil prices on global markets – a faster and broader correction accelerated the return of inflation to the positive; on the contrary, potential return of oil prices to a declining trajectory (a less plausible scenario, which is no longer taken into account) would postpone the return of inflation to the positive. (lk)

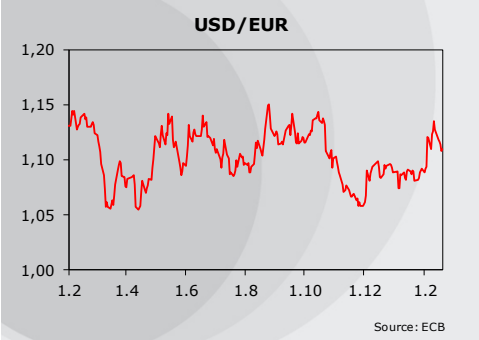
ECONOMIC OUTLOOK

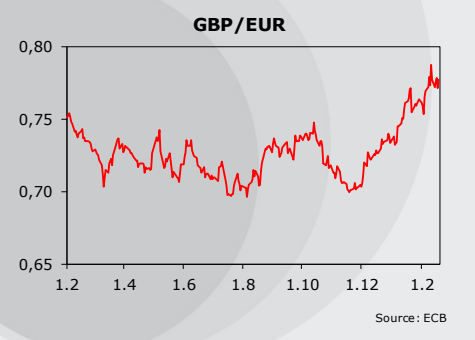
Slovakia	2011	2012	2013	2014	2015E	2016F	2017F
Real GDP growth	**2,8**	**1,5**	**1,4**	**2,5**	**3,6**	**3,0**	**3,0**
GDP per capita	13 052	13 398	13 643	13 947	14 287	14 788	15 291
Household consumption	**-0,6**	**-0,4**	**-0,8**	**2,4**	**2,5**	**2,9**	**2,6**
Government consumption	-1,7	-2,6	2,2	5,9	3,8	1,7	0,5
Gross investments	7,6	-14,0	1,5	2,6	11,4	-2,5	6,8
Exports	12,0	9,3	6,2	3,6	6,4	5,6	4,1
Imports	9,6	2,5	5,1	4,3	8,1	4,1	4,5
Industrial Production	**6,9**	**13,4**	**5,3**	**3,7**	**5,9**	**5,5**	**6,5**
Construction	-1,7	-12,5	-5,3	-4,2	16,3	2,7	6,5
Retail Sales	-2,8	-1,0	0,1	3,6	1,7	2,3	2,5
CPI (average)	**3,9**	**3,6**	**1,4**	**-0,1**	**-0,3**	**0,3**	**1,5**
CPI (Dec.)	4,4	3,2	0,4	-0,1	-0,2	0,9	1,6
Real Estate inflation	-3,0	-1,1	-0,9	-0,8	0,3	2,3	2,4
Average Wage level	786	805	824	858	880	904	930
Nominal Wage growth	**2,2**	**2,4**	**2,4**	**4,1**	**2,5**	**2,8**	**2,9**
Real Wage growth	-1,6	-1,2	1,0	4,2	2,8	2,5	1,4
Employment growth (LFS)	1,5	-1,0	0,0	1,5	2,2	1,0	1,0
Unemployment (average, LFS)	**13,5**	**14,0**	**14,2**	**13,2**	**11,6**	**10,8**	**9,9**
Fiscal deficit (% of GDP)	-4,1	-4,2	-2,7	-2,8	-2,7	-2,0	-1,0
Public Debt (% of GDP)	43,3	51,9	54,6	53,5	53,0	52,9	51,7
Foreign Direct investment (EURbn)	2,8	3,2	-0,3	0,2	2,0	2,5	3,3
ECB Refi rate (%, Dec.)	**1,00**	**0,75**	**0,25**	**0,05**	**0,05**	**0,05**	**0,50**
3M EURIBOR (%, Dec.)	1,2	0,2	0,3	0,1	-0,2	-0,2	0,5
3Y SK gov't bonds(%,Dec.)	2,7	0,3	0,7	-0,1	-0,6	0,0	1,5
10Y SK gov't bonds(%,Dec.)	5,2	3,9	2,7	1,2	0,7	1,0	2,0

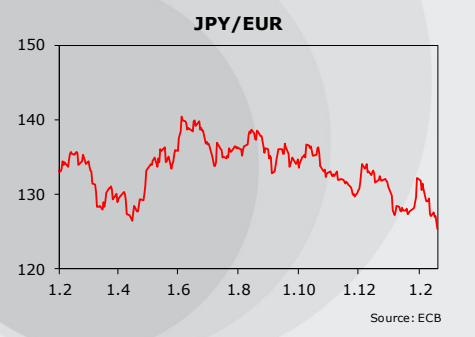
Abroad	2011	2012	2013	2014	2015E	2016F	2017F
Eurozone GDP	**1,5**	**-0,6**	**-0,4**	**0,9**	**1,5**	**1,9**	**1,6**
German GDP	**3,1**	**0,9**	**0,5**	**1,6**	**1,5**	**2,1**	**1,4**
Czech R GDP	1,7	-1,0	-0,9	2,0	4,3	2,3	3,0
USA GDP	1,7	2,8	1,9	2,4	2,5	2,6	2,4
Eurozone Inflation	2,7	2,5	1,3	0,4	0	0,9	1,4
EUR/USD (average)	**1,39**	**1,28**	**1,33**	**1,33**	**1,11**	**1,08**	**1,16**
EUR/USD (Dec)	1,32	1,31	1,37	1,21	1,09	1,12	1,18
EUR/CZK (Dec)	25,8	25,1	27,5	27,7	27,0	27,0	26,5
EUR/HUF (Dec)	304,2	285,8	300,2	315,5	314,0	320,0	325,0
EUR/PLN (Dec)	4,5	4,1	4,2	4,3	4,3	4,2	4,2

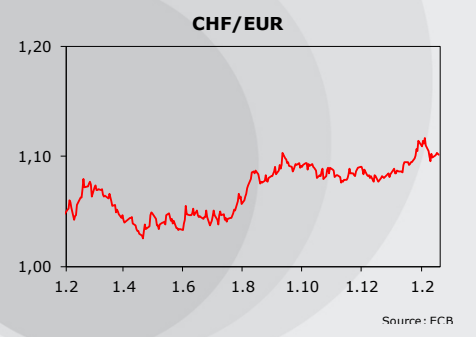
Source: NBS. SOSR. ÚPSVaR. MinFin SR. Eurostat. ECB
Forecasts: UniCredit Bank Slovakia – Slovakia. Eurozone. USA (EURIBOR. USDLIBOR. Brent. USD/EUR); UniCredit Group (CEE Economic Research. CIB) – Eurozone. USA

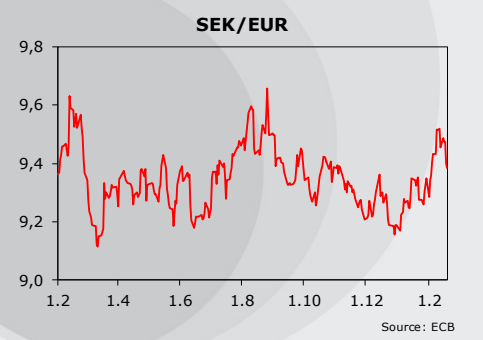
FOREIGN EXCHANGE

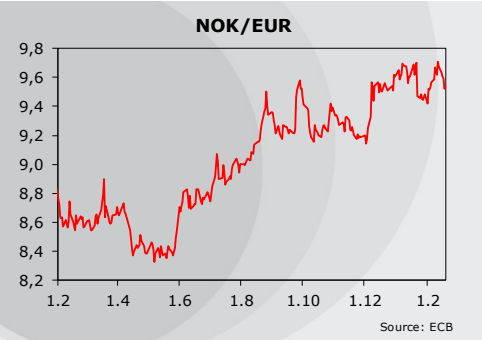


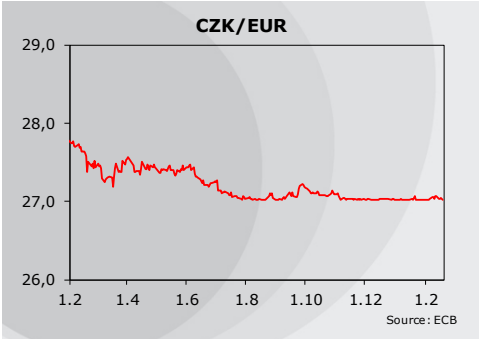


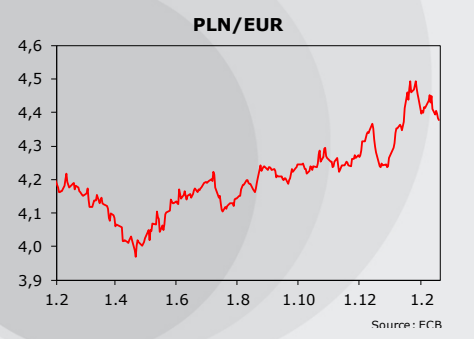


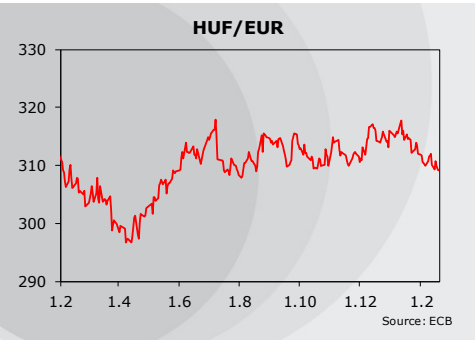


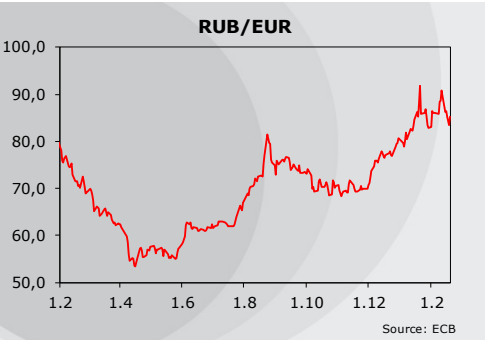






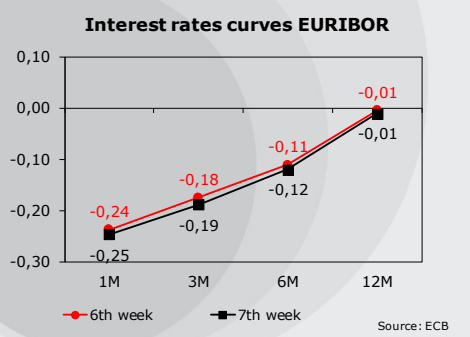




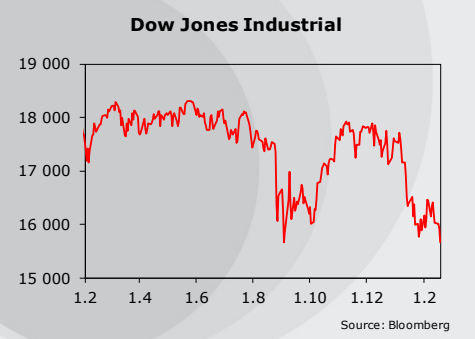


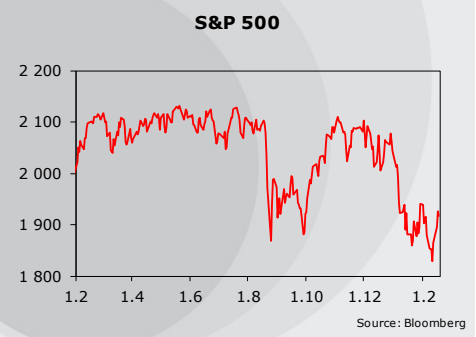
MONEY MARKET

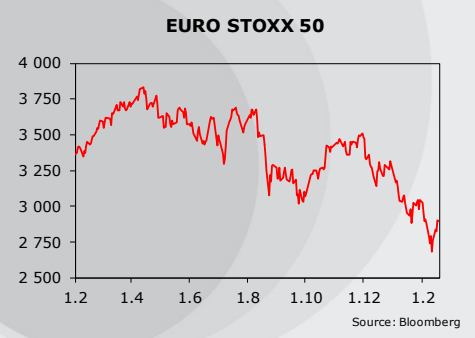
MONEY MARKET

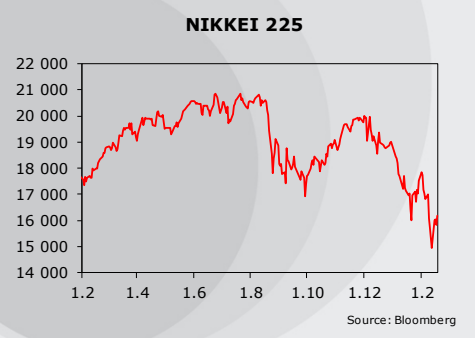


EQUITY









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