

## Development of Macroeconomic Situation in Slovak Republic with Focus on Stability of Financial Sector

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### State of Issue

In connection with the Covid-19 pandemic, the Slovak economy fell by 4.8%. The first wave of the pandemic (Spring 2020) represented a significant shock to the economy. However, 2020 eventually ended with a smaller-than-expected economic downturn. The second wave (Autumn-Winter 2020) was much larger from an epidemiological point of view, but milder in terms of its impact on the economy. Several important sectors have seen a relatively rapid recovery. The main difference compared to the 1st wave was the different impact on individual sectors. While some sectors were less affected, others faced a similar deterioration as in the 1st wave.

The second wave also had a lesser effect on the financial sector. Compared to the 1st wave, banks approached lending more freely. After the tightening, after the outbreak of the pandemic, credit standards returned to almost their pre-crisis level, especially in retail. Investors' pre-crisis risk appetite has also returned to financial markets. This was also reflected in changes in the investment portfolios of Slovak pension and mutual funds. The share of the equity component and the risk parameters of bond portfolios increased. The pre-crisis level of the inflow of contributions to pension funds also resumed.

However, economic development continues to be primarily influenced by the pandemic and the expectations associated with it. Concerns remain about the 3rd wave of the pandemic. This is also evidenced by weakening of the *Economic Sentiment Index*, which reflects the expectations of consumers and representatives of key economic areas. According to experts, another pandemic wave could come in August 2021, but if it comes it should be milder.

### Causes and Analysis

The macroeconomic situation is monitored by the National Bank of Slovakia (NBS), which supervises also the financial market. Its regular *Financial Stability Report* then informs about current trends and risks in the domestic financial sector. Besides financial stability, situation regarding the state budget is also important. In May 2021, the Slovak parliament approved an amendment to *the Act on the State Budget*. Total spending for 2021, due to pandemic, will thus increase by more than EUR 3.7 billion.

According to the NBS, the financial sector remained stable during the pandemic and provided support for a rapid economic recovery. Banks, despite uncertainty, have helped finance corporate revenue shortfalls. The flow of corporate loans was hit by the 1st wave only temporarily (5.2% y-o-y in Q2 2020); in the 2nd wave loans grew even slightly faster than before the crisis (5.1% y-o-y in Q4 2020, in the pre-crisis year 2019 it was 4.4% y-o-y). The financing of companies during the pandemic was also helped by state guarantee schemes. Thanks to the available financing and compensation from the state support scheme, the liquidity of many companies has even increased. However, a certain weakening of credit growth cannot be ruled out in the coming months.

Housing loans also continued to grow at an almost pre-crisis pace. In April 2020, household loans to households amounted to EUR 31.8 billion, in December 2020 to EUR 33.8 billion and in April 2021 to EUR 34.9 billion. However, the decline in consumer credit deepened (from EUR 5.6 billion in April 2020 to EUR 5.3 billion in December 2020), mainly as a result of lower household consumption. In April 2021, however, it had already risen to EUR 5.8 billion. Unlike other parts of the financial market, consumption financing was hit harder during the 2nd wave.

The macroeconomic situation in Slovakia is gradually returning to normal with the improving pandemic situation. The total value of foreign trade exceeded the pre-pandemic level. In June 2021, the trade surplus amounted to EUR 297 million. Nevertheless, it decreased by almost two thirds year-on-year. Car exports have remained the main driver and thanks to it the foreign trade has been in surplus for more than a year. However, the stabilization period will take some time.

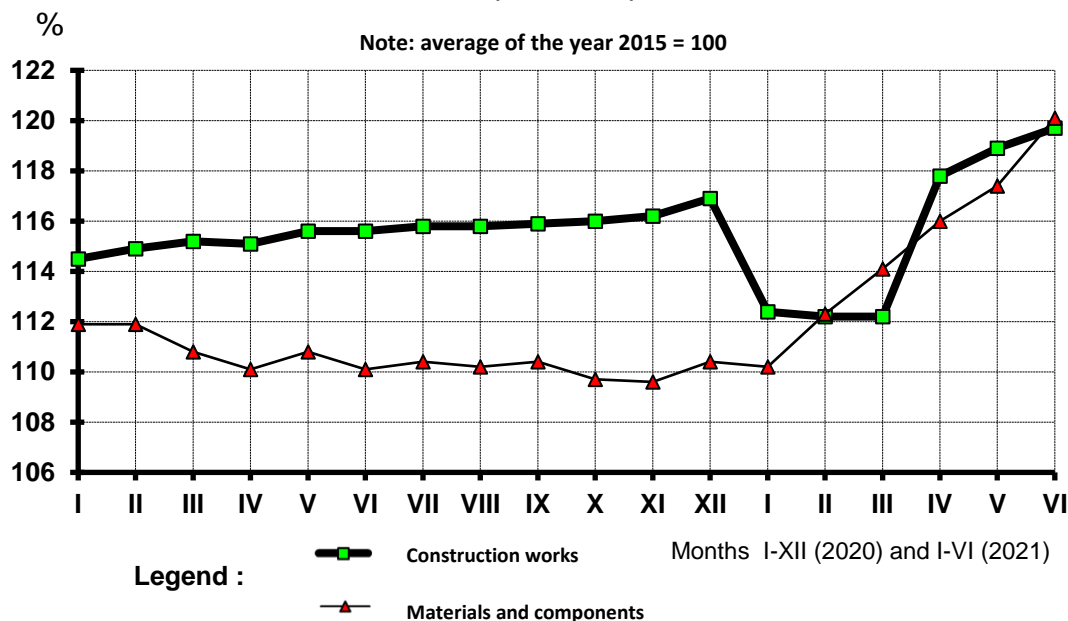
The 2nd wave also had a milder effect on the financial sector, which remained stable and helped finance the economic recovery. Banks, with the support of state guarantees, have contributed to financing the shortfall in corporate revenues. The flow of corporate loans was slightly faster in the 2nd wave than before the crisis. The growth of housing loans also continued at an almost pre-crisis pace, but consumer loans continued to decline. So far, the pandemic has negatively affected clients' ability to repay loans only to a limited extent. According to the NBS, difficulties with repayment after the end of deferrals may concern 0.7% of the retail loan portfolio and 0.9% of corporate loans.

The Covid-19 pandemic had a negative impact on the banking sector's profit, which fell by a quarter y-o-y in 2020. However, in the 1Q 2021, it increased y-o-y due to a lower intensity of provisions and due to a decrease in regulatory costs. According to the NBS, banks should be able to cope with the losses caused by the pandemic. Even in the case of unfavorable developments, the banking sector should remain resilient. Although an unfavorable scenario may lead to a decline in profits, capital adequacy should not fall below pre-crisis levels. During 2020, banks' capital adequacy increased y-o-y from 18.2% to 19.7% due to the responsible policy of banks. The ability to generate profit in the event of adverse developments varies considerably between banks with the major banks being in a better position. The dynamics of loans in 1Q 2021 maintained the favorable pace of 4Q 2020. The overall growth of loans was caused by faster lending to companies. The average y-o-y growth of loans to private firms during 1Q 2021 reached 4.2%, while in 2020 it did not exceed 3%. In terms of company size, micro-firms and small firms predominated. The growth of loans, in the case of smaller firms, was supported by the state guarantee schemes.

The stress testing also confirmed the resilience of insurance companies, although there was a decline in this sector during the pandemic. Insurance companies faced a decline in interest in life insurance. Clients in pension and mutual funds were exposed to significant losses after the crisis broke out, but these losses later eased. Apart from temporary fluctuations, the asset management sectors were not significantly affected by the crisis. After a slump in the 1st half of 2020, the volume of contributions reached a pre-crisis trajectory. However, in conditions of low interest rates, the portfolio was regrouped in favor of more profitable but riskier assets.

The Slovak economy is affected by the impact of the pandemic also indirectly. Partners of domestic companies located in the affected countries sometimes reduce supplies or limit their activities. This has an impact on the domestic economy. Graph 1 shows the development of price indices in the period 2020-2021. In the current period of recovery, the price level is rising due to growing demand.

**Graph 1: Development of construction works, materials and components price indices (2020 - 2021)**



Source: Statistical Office, Slovak Republic (2021)

Industrial production, as one of the most important business indicators, increased by 36.7%, y-o-y, in May 2021. The development by sectors was affected by an increase in manufacturing by 43.2%, and electricity, gas, steam and air-conditioning supply by 9%. The highest rise recorded the following industrial branches - manufacture of transport equipment (by 57.2%) and manufacture of basic metal and fabricated metal products (by 58.1%). The whole production was affected by a decrease in mining and quarrying and in manufacture of pharmaceutical products. In June 2021, industrial production increased by 13.7% y-o-y. Overall, the situation in the industry is improving. The economy has already managed to exceed the pre-pandemic level of production from June 2019 by 4.1%. Of the fifteen industries, 13 industries recorded y-o-y production growth.

The trade balance of the SR has been developing relatively favorably since January 2021. In June 2021, the trade surplus reached almost EUR 300 million. Given the persisting uncertainty in world markets regarding the pandemic, future developments cannot be predicted. However, if the crisis with the supply of raw materials and components subsides, then the economy could maintain a positive trade balance in the coming months.

In June 2021, employment in Slovakia decreased y-o-y in many sectors. The largest decrease was in the case of accommodation (-6%), wholesale (-4.1%), construction (-3.1%), and retail (-2.9%). On average in the 1st half of 2021, compared to the same period of 2020, employment increased only in information and communication activities (+2.2%) and in selected market services (+0.5%). In both of these areas employment also increased y-o-y in June.

A challenging task is a process of transformation to a “green” economy. Loans to firms, for which meeting greenhouse gas emission reduction targets may lead to an increase in operating costs, account for one tenth of the total portfolio. Banks are gradually beginning to take this risk into account when

providing loans. The transformation will also bring new business opportunities for banks. The NBS also monitors developments in the credit and real estate market and is ready to take measures to stabilize the situation. In particular, growth in housing loans remained relatively strong during the crisis, and in March 2021 its volume again approached historical records. If imbalances continued in these markets, intervention would be justified.

### **Future Expectations and Implication**

The NBS is succeeding in fulfilling the long-term effort for macroeconomic stability. For the near future it will be important how the country's economic recovery, after the specific regime during the Covid-19 period, will manifest itself. The first signals indicate recovery. However, the situation regarding the global supply for domestic firms remains a problem. It seems that the future will require new approaches to economic development - to carry out structural reforms, strengthen the quality of education and ensure the attractiveness of the country.

As a result of a significant increase in state budget expenditures the general government deficit is projected to increase from the planned 7.4% of GDP to over 10%. Simultaneously, Slovakia is facing a crisis in public finances and their long-term sustainability is becoming problematic. Reforms are discussed, but so far no significant changes have taken place. The government's vision is expressed in *the Government's Program Announcement* and *the Recovery and Resilience Plan*. The government is counting on pension reform and the introduction of spending limits. The recovery plan also seeks to change the structure of the economy. In April 2021, some economists (including NBS Governor P. Kažimír) called on the government to adopt *the Pension Act* and an amendment to *the Act on Budgetary Responsibility*. They consider these laws important for the long-term sustainability of public finances. If these systemic and structural changes are implemented soon, with stable pandemic situation, then the economy could return to dynamic development. The expected growth can only be stopped by a weak vaccination of the population or by the spread of a more infectious delta variant.

Stress testing has confirmed the resilience of the banking sector, but the development of non-performing loans remains uncertain. The difficulty of repayment after the end of deferrals may concern 0.7% of the retail loan portfolio and 0.9% of corporate loans. These figures may not be final as the crisis is not over. According to the NBS estimates, under expected economic growth, up to 1.3% of retail loans and 3.3% of corporate loans may run into repayment problems. However, in the worst scenario it can be substantially more.

In the longer term, the impact of low interest rates and rising government debt may be felt. The Slovak financial sector was already under the influence of low interest rates before the crisis. However, during the crisis, this influence intensified. In banks, the decline in interest margins accelerated as a result of competition in the housing loan market and the decline in consumer credit. To maintain profitability, the risk parameters of the investment profile of pension and mutual fund assets increased. In the following years, a positive development in profitability can be expected.

The pandemic requires finding ways to further develop the Slovak economy after the crisis. In addition to domestic resources, there is also a chance to use a financial support from the European Union (EU). In total, the SR is to receive EUR 780 million. The country has already received the first tranche of EU funding to mitigate the effects of the pandemic. So far, EUR 76 million has come from the REACT-EU program.

Regarding the overall outlook, state authorities are optimistic. They are convinced that in the near future the economy will grow relatively dynamically. This optimism is also reflected in the official predictions. In 2021, the NBS expects GDP to grow by 4.5%, in 2022 GDP should grow by 5.9% and in 2023 by 3.8%. The Ministry of Finance also expects economic growth of 4.6% for this year.

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