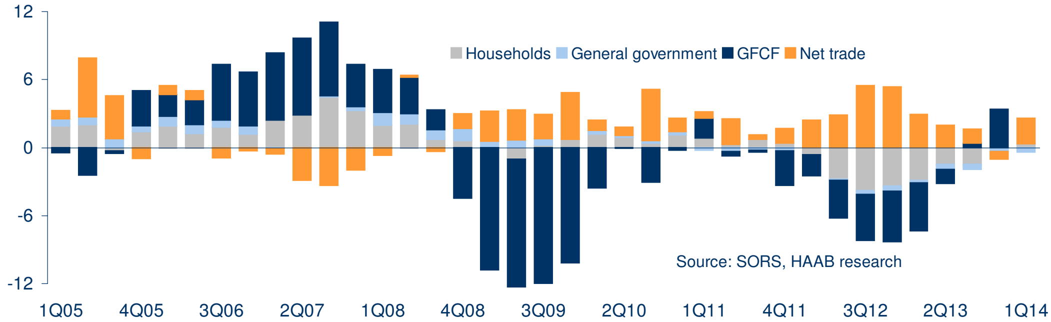
Growth Resumes, Policy Clarity Needed

Stronger external backdrop and stabilizing domestic demand have lifted our GDP forecasts for 2014 and 2015. Meanwhile, the aftermath of July's elections will be a litmus test for fiscal policy clarity, privatization and the ongoing banking sector clean-up. That said, ample fiscal cash reserve and the record C/A surplus, alongside further ECB easing prospects anchor near-term credit risks.

Recovery underway on exports and construction

The milder than expected Q1 GDP drop (-0.3% qoq, +1.2% in Q4) and a slower deceleration of yoy growth to 1.5% from 1.9% in Q4 reflects strong net trade contribution. While exports benefited from the EU recovery, construction also added to expansion amid the EU projects. That industrial output is not so much geared to exports and lags behind that of CEE peers' owes to the prolonged weakness of local demand. Although stabilizing, private consumption is still the weakest link amid higher unemployment, austerity, de-leveraging, and some pay-back to 2H13 when the measures to fight the grey economy and widen the VAT base made spending stronger. With the recent cabinet's collapse, and ensuing early elections in July, investment recovery is more challenging as political risks may also affect bank de-leveraging and policy-making. The weaker than expected EMU Q1 GDP, decelerating new export orders (PMI) and softer German growth in Q2 give the impression of less buoyant external demand.

Slovenia: contributions to quarterly changes in real GDP (in pps)



Upgrading 2014 and 2015 on stronger EU recovery, stabilizing domestic demand

In light of strengthening confidence gauges to 2011 levels, helped by successful bank capital hikes and better external backdrop, we lift 2014 and 2015 GDP forecasts by 1.2pp and 0.5pp to +0.4% and +1.0%, respectively. While the EU-funded investment and net trade are the key drivers of the recovery, we expect firms' de-leveraging and political uncertainty to subdue private capex. The latter is not just about the fragmented political scene, and doubts about the leadership of existing parties and new options being formed, but no real mandated government will be in place until the autumn (even as late as in Q4). The key difference between us and consensus is that we do not see a recovery in private spending given the stagnant labour markets, de-leveraging, higher tax burden and back-loaded austerity by the new government in entitlement area in 2015. The main downside risks stem from subsiding tailwind from foreign demand, limited job creation given the productivity boosts, and faster bank de-leveraging under the ongoing ECB's Asset Quality Review. Upside risks would include more active ECB easing (private quantitative easing, aimed at boosting bank credit) and the new government with a reformist agenda and a strong mandate to execute reforms.

Inflation to remain below EMU average

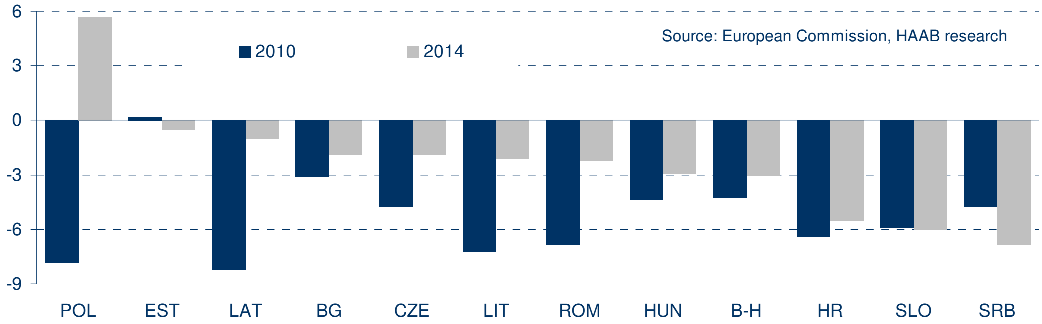
Inflation surprised on the downside on lower energy bills, weather-induced unprocessed food price deflation, weak demand, and the strong euro. Although food prices will become less of a downward force in the next quarters on higher agricultural prices, inflation is likely to stay at historic lows through 2014 before bouncing back above 1% at the turn of the year. Given the ongoing very low pressure from import prices, lagged impact of the large negative output gap and the labour market slack, both headline and core inflation will stay very low. Not only that will help smooth consumption, but Slovenia will have inflation below the EMU average that bodes well for competitiveness. With the strong euro largely blamed for protracted low inflation, the ECB cut the key rates by 10bp, and is eyeing targeted liquidity measures of reducing fragmentation and improving credit flows, should the situation warrant it.

Record high current account surplus, portfolio flows dominate financial accounts

The growing C/A surplus to date owes to export-driven goods trade surplus, higher travel income and transfers. Offsetting partly these improvements was larger income deficit amid melting income from direct investments and high debt servicing costs. Such trends support further increases in C/A surplus this year and next as the better outlook on foreign demand is accompanied by stronger EU funds utilization and subdued domestic demand. The decline in imports mainly reflects the finalization of one-off investment in the major energy facility.

The ongoing hefty portfolio inflow (state bond issues in February, April) were still not enough to balance the financial accounts as the banking sector's push to prop up capital ratios and improve net external asset position continues. While the sale of the retailer Mercator will foster FDI and help banks to de-leverage, the quality of F/A should change only gradually. Namely, the electoral period ahead suggests the planned privatisations are unlikely to be completed this year, with, however, most of them done for reform purposes rather than cash. Also, the new government's efforts in boosting competitiveness are required to encourage private FDI being the main instrument to help engineer badly needed corporate capital hikes as part of massive corporate restructuring by banks.

Slovenia: fiscal deficits (% of GDP)



Budget deficit higher than expected, new fiscal measures are needed

To make sure political uncertainty does not morph into a period of policy paralysis, the EC stressed reform priorities like a comprehensive action plan for banks, insolvency regulation amendments, privatizations, new fiscal rules. In order to cut the budget gap under 3% of GDP in 2015, Slovenia relies on the full-year impact of last year's VAT hike, cyclically higher direct taxes, and one-offs (4G telecom licence sales). While a further containment of public wage bill and subsidies brings comfort, interest costs are rising rapidly and the (entitlement) reform content on the expenditure side is missing again. That said, we see the budget gap before bank recaps around 4% of GDP in 2014-2015 given little substitution for the repealed 1pp/GDP real estate tax and political uncertainty having a transitory negative impact on (entitlement) reforms. Combined with our 1.0pp/GDP recap requirement for two small banks, total fiscal deficit hits 6% of GDP in 2014, with the main risk to that from the AQR for the involved banks and slow reform momentum. While the official agenda heads in the right direction, our concern is that a long period of lame duck administration, and backtracking on hitherto progress on the fiscal and reform side during 2H13, imply the challenge for 2015 is now all the greater even at a time when many had considered the outlook to be more rosy.

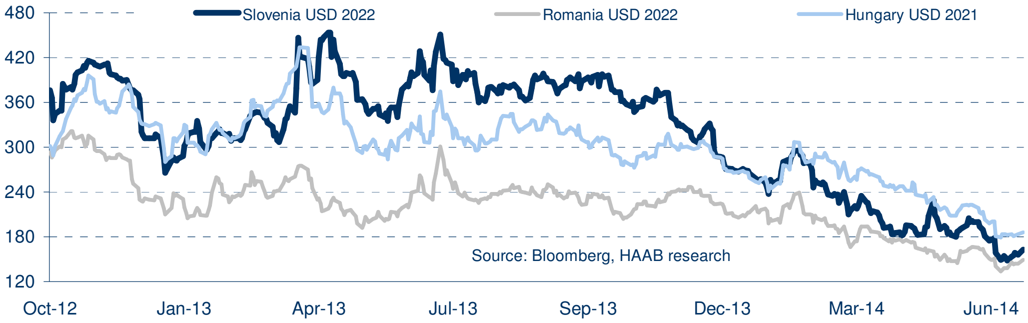
In need of credible medium-term restructuring and adjustment strategy

After a surge to 72% of GDP in 2013 on bank rescues, public debt will soar past 80% of GDP amid hefty sovereign (pre)funding operations to date, budget deficits and smaller-scale bank recaps. With the MinFin's cash reserve at ca.EUR5bn at the end of May, the sovereign secured about 70% of gross funding needs by end-2015, which puts Slovenia in one of the CESEE's most favourable position and removes any near-term refinancing risks. Not only the large cash cushion (15% of GDP) effectively lowers net debt to 65% of GDP, but the debt figures also include a temporary EUR1bn (~3% of GDP) of BAMC bonds until the bad bank sells off the assets it took over in the asset transfer. While the pace of public debt build-up should drop, we still think it requires a primary surplus of 1-1.5% of GDP to flatten public debt dynamics. Although finally the banking system capital issues appear to be manageable, the increased fragmentation on the political front and the absence of external pressure put a question mark over the medium-term policy direction and commitment to further reforms and privatization. Also, we do not indefinitely exclude a Troika bailout as the magic of the recent bank rescue and pre-funding-led cash boost never works the same the second time. Namely, at the current level of indebtedness, banking reforms must be executed thoroughly and expenditure challenges reversed on a recurrent basis in order to avoid the bailout package.

Slovenian bonds waxed and waned amid political uncertainty

Slovenian bonds underperformed somewhat relative to CESEE peers amid uncertainty about reform and fiscal policies after July's snap elections. This largely refers to privatisations of large state-owned enterprises, an area of long-standing political controversy. The EC's reservation over reforms details and adoption, requiring a clearer budgetary strategy, adds to a suspicion. Also, S&P has downgraded Slovenian outlook on policy-implementation risks to resolving economic and fiscal pressures, as well as potential further bank recaps. With a busy reforms schedule set by the EC with deadlines this summer, politics remain the key risk, especially if a new SDS-led administration will be formed as the latest polls suggest.

Slovenian spreads outperformance ends

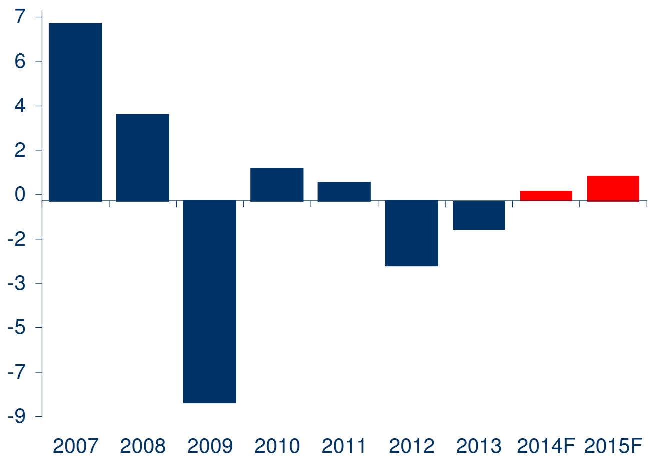


Watching political outcomes for yields outlook

Slovenian yields may remain flattish in the current benign external environment, but the lack of clarity on the political front at the time of renewed upside pressures on USTs gives the case for further differentiation. Our concern is that in the absence of external (markets) pressure, complacency has set in and major reforms could be diluted. In our bear case, difficulty in the set up of a ruling coalition might slow further fiscal consolidation, and delay reforms including key privatizations, which leads to a low-(potential) growth trap and would be credit negative. In the baseline, deescalating political uncertainty revives the reform momentum and privatization, but entitlement reforms are done in a gradual fashion due to the ongoing domestic demand adjustment. In the first case, we would expect the markets to price in further bank recaps and increased yields volatility until there is clarity about the policy direction of the new cabinet. The latter scenario would diminish volatility but still see Slovenian bonds underperform, whereby the strong fiscal buffer and record C/A surplus provide comfort. A bull case of the immediate formation of a government committed to continuing the implementation of reforms, alongside a further ECB easing prospects this year would see the political risk premium priced-out and Slovenian bonds to trade more in line with the EMU peripherals.

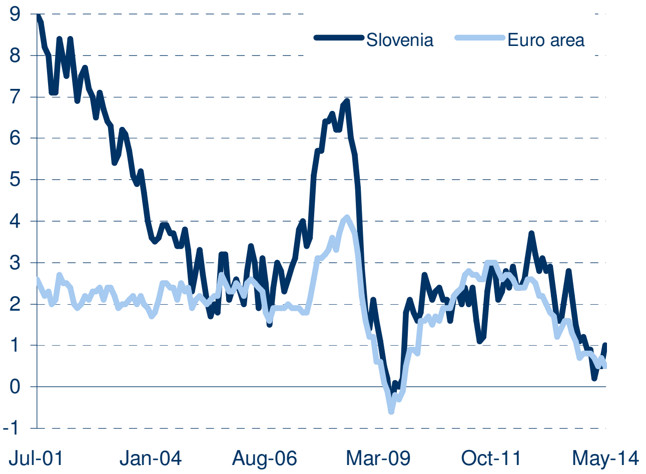
Slovenia's data trends

Real GDP growth (% YoY)



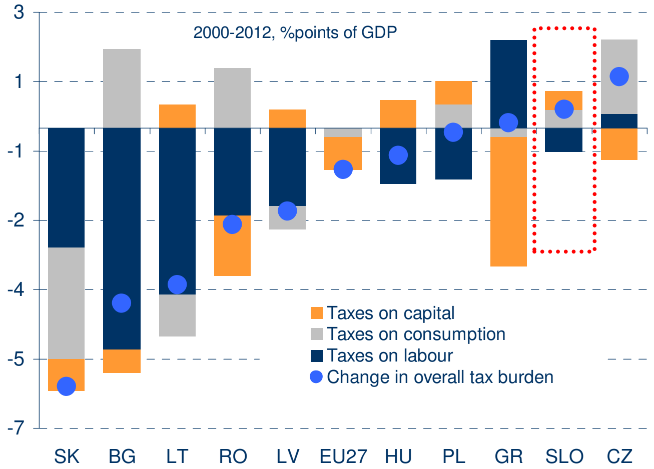
Economic confidence vs. GDP growth

CPI inflation dynamics (% YoY)

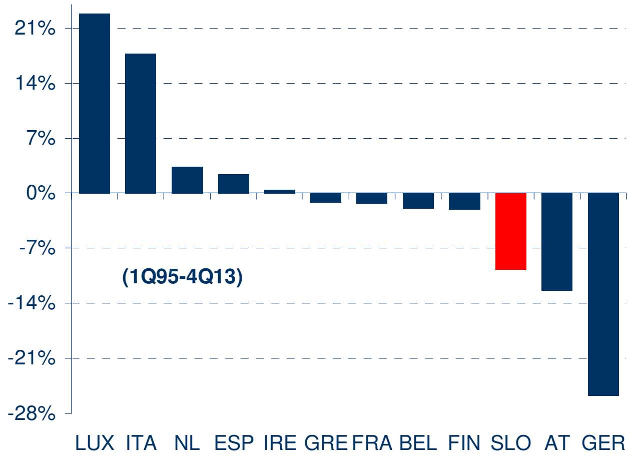


Business sentiment in manufacturing

Changes in the tax burden since 2000



Unit labour cost for the total economy



Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, ECB, European Commission, Bloomberg, HAAB research

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Activity									
Nominal GDP (EURbn, current prices)	34,6	37,2	35,4	35,5	36,2	35,3	35,3	35,3	35,9
Nominal GDP (USDbn)	47,4	54,8	49,4	47,1	50,3	45,4	46,9	48,5	48,1
GDP per capita (EUR)	17.208	18.527	17.428	17.335	17.633	17.183	17.134	17.152	17.439
GDP per capita (USD)	23.590	27.257	24.309	22.997	24.555	22.097	22.768	23.564	23.375
Real GDP (constant prices YoY, %)	7,0	3,4	-7,9	1,3	0,7	-2,5	-1,1	0,4	1,0
Private consumption (YoY, %)	6,2	2,5	-0,1	1,5	1,0	-4,8	-2,7	-0,8	-0,4
Fixed investment (YoY, %)	13,3	7,1	-23,8	-15,2	-5,5	-8,2	0,2	-0,4	1,0
Industrial production (YoY, %)	7,2	2,5	-17,3	7,1	1,3	-1,1	-0,7	1,8	2,4
Unemployment rate (ILO, average %)	4,9	4,4	5,9	7,3	8,2	8,9	10,1	10,6	10,6
Prices									
CPI inflation (average % YoY)	3,6	5,7	0,9	1,8	1,8	2,6	1,8	0,6	1,3
CPI inflation (end-year % YoY)	5,7	3,1	1,6	1,4	2,7	2,7	0,7	1,3	1,0
PPI inflation (average % YoY)	4,2	3,9	-1,3	2,1	4,5	0,9	0,3	1,0	1,5
Net wage rates (% YoY, nominal)	5,9	7,9	3,4	3,9	2,1	0,4	0,6	1,0	0,5
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	0,0	-1,9	-6,2	-5,9	-6,4	-4,0	-14,7	-6,0	-4,2
Public debt	23,1	22,0	35,0	38,7	47,1	54,4	71,7	78,6	83,4
Gross public funding needs	n/a	n/a	n/a	7,1	10,8	8,4	19,9	15,4	11,6
External balance									
Export of goods and services (EURbn)	24,167	25,480	20,919	23,566	26,292	26,712	27,392	28,186	28,939
Import of goods and services (EURbn)	-24,576	-26,197	-20,194	-23,116	-25,772	-25,163	-24,787	-25,223	-25,786
Merchandise trade balance (EURbn)	-1,456	-2,144	-0,441	-0,830	-0,957	-0,171	0,645	1,243	1,433
Merchandise trade balance (% of GDP)	-4,2	-5,8	-1,2	-2,3	-2,6	-0,5	1,8	3,5	4,0
Tourism receipts (EURbn)	1,666	1,827	1,804	1,925	1,975	2,008	2,039	2,080	2,118
Current account balance (EURbn)	-1,441	-2,028	-0,173	-0,050	0,146	1,026	2,101	2,478	2,737
Current account balance (% of GDP)	-4,2	-5,4	-0,5	-0,1	0,4	2,9	6,0	7,0	7,6
Net FDI (EURbn)	-0,3	0,3	-0,7	0,4	0,6	0,2	-0,6	0,9	0,5
FDI (% of GDP)	-0,7	0,9	-1,9	1,2	1,8	0,5	-1,7	2,4	1,4
FDI cover (%)	n/a	16,1	n/a	858,5	n/a	n/a	28,5	n/a	n/a
Gross international reserves (EURbn)	0,724	0,687	0,749	0,803	0,767	0,722	0,680	0,750	0,750
Import cover (months of imports)	0,4	0,3	0,4	0,4	0,4	0,3	0,3	0,4	0,3
Debt indicators									
Gross external debt (EURbn)	34,783	39,234	40,318	40,723	40,100	40,849	39,566	40,836	42,036
Government (EURbn)	3,036	3,736	6,559	8,167	8,715	11,063	15,432	17,832	20,282
Private (EURbn)	28,159	31,866	30,163	30,182	28,375	25,083	19,134	18,004	16,754
Gross external debt (% of GDP)	100,5	105,3	113,8	114,8	110,9	115,7	112,2	115,6	117,1
Gross external debt (% of exports)	143,9	154,0	192,7	172,8	152,5	152,9	144,4	144,9	145,3
Exchange rates and money									
EUR/USD (end-year)	1,46	1,40	1,43	1,34	1,30	1,32	1,37	1,34	1,32
EUR/USD (average)	1,37	1,47	1,39	1,33	1,39	1,29	1,33	1,37	1,34
Money supply M1 (% YoY)*	-6,6	-3,7	7,7	13,5	1,5	4,4	0,1	2,0	4,0
Broad money M3 (% YoY)*	5,0	8,9	2,6	2,4	3,5	-1,4	-1,3	0,5	1,0
Domestic credit (% YoY)	n/a	n/a	1,1	1,6	-4,6	-5,8	-21,1	-9,1	2,9
ECB reference rate (end-year %)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,15	0,15
EURIBOR 3M interest rate (average %)	4,27	4,64	1,22	0,81	1,39	0,58	0,22	0,25	0,20
SLO 5Y yield (average %)	-	-	-	3,03	3,96	4,55	4,35	2,20	2,50
SLO 10Y yield (average %)	-	4,49	4,35	3,84	4,98	6,01	5,87	3,50	4,00

* Since 2007 ECB data

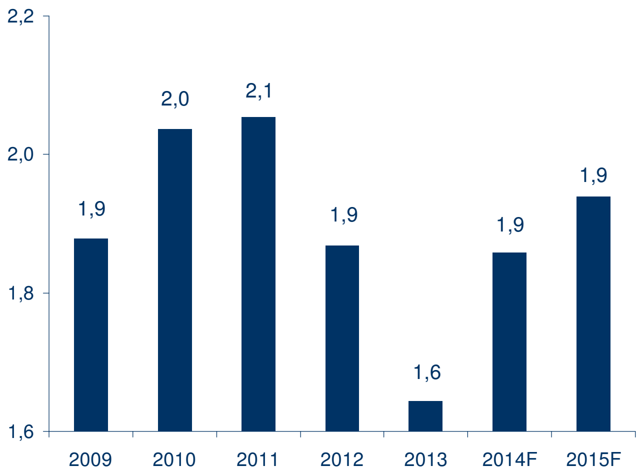
Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, IMF, HAAB research

SELECTED BANKING SECTOR DATA

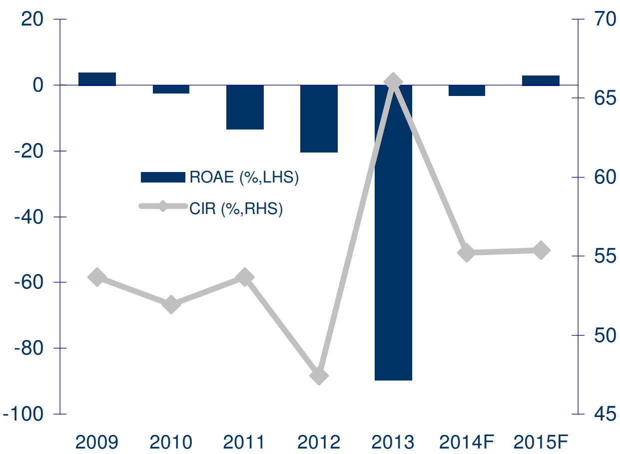
	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Balance sheet figures and ratios									
Assets (EURm)	n/a	47.628	51.612	50.319	48.748	46.119	40.442	38.420	38.612
Loans (EURm)	n/a	33.530	33.910	34.450	32.875	30.962	24.422	22.197	22.833
Loans (% YoY)	n/a	n/a	1,1	1,6	-4,6	-5,8	-21,1	-9,1	2,9
Loans (% of GDP)	n/a	90,0	95,7	97,1	90,9	87,7	69,2	62,9	63,6
Deposits (EURm)	n/a	20.612	23.570	23.507	24.170	23.856	22.550	22.776	23.117
Deposits (% YoY)	n/a	n/a	14,4	-0,3	2,8	-1,3	-5,5	1,0	1,5
Deposits (% of GDP)	n/a	55,3	66,5	66,2	66,9	67,5	63,9	64,5	64,4
Loans-to-deposit ratio (%)	n/a	162,7	143,9	146,6	136,0	129,8	108,3	97,5	98,8
Capital adequacy ratio (%)	n/a	11,7	11,6	11,3	11,6	12,1	14,0	15,0	15,5
P&L figures and ratios									
Net interest income (EURm)	n/a	945	932	1.038	1.018	886	711	732	747
Total operating income (EURm)	n/a	1.360	1.425	1.474	1.447	1.566	1.090	1.200	1.177
Net provisions (EURm)	n/a	278	500	810	1.207	1.599	3.724	661	411
Pre-tax profit (EURm)	n/a	306	161	-101	-537	-776	-3.354	-123	114
Net interest margin (%)	n/a	n/a	1,9	2,0	2,1	1,9	1,6	1,9	1,9
Cost-to-income ratio (%)	n/a	57,1	53,7	51,9	53,7	47,4	66,0	55,2	55,4
ROAE (pre-tax income/avg. equity, %)	n/a	n/a	3,9	-2,4	-13,3	-20,3	-89,5	-3,1	2,8
ROAA (pre-tax income/avg. assets, %)	n/a	n/a	0,3	-0,2	-1,1	-1,6	-7,7	-0,3	0,3
Non-performing loans (%)	n/a	3,2	5,2	7,3	11,5	16,5	13,4	13,0	14,0
Cost of risk (% of avg. loans)	n/a	n/a	1,5	2,4	3,6	5,0	13,4	2,8	1,8

Highlights: Private sector de-leveraging in Slovenia continues as loan stock fell -1.8% ytd in March led by accelerated de-leveraging in corporate sector (-3.4% ytd) amid persistent payment arrears and deteriorated profitability of companies which have delayed capex. Consequently, we think that successful restructuring of corporate sector is the main prerequisite for credit growth comeback. Deposit collection remained strong in 1Q14 (+3.1% ytd), driven by stable households and public deposit increase. However, forthcoming recapitalization initiatives for remaining banks with expected debt-to-equity swap will drive pressure on deposit decrease. Despite 14.5% yoy fall of interest income, banking sector's NIM increased almost 40 bps to 2.2% thanks to strong interest expense drop (-32.0% yoy). Former was driven by (i) system wide deposit rate reduction, (ii) refi cuts and (iii) premature redemption of debt in nationalized banks. Nevertheless, Slovenian banking sector will likely be loss making in 2014, given still elevated risk costs.

Net interest margin (%)



Profitability and efficiency (%)



All sources: Slovenian National Bank, IMF, central banks, Eurostat, HAAB research