Zdenek Lukas

Slovakia: good news, especially for the business community

The former main driving force of economic expansion, exports, has been losing momentum. Nevertheless, the GDP grew by above 5% in 2004. Both overall consumption and gross fixed capital formation increased by nearly 4%, accompanied by rising inventories. On the supply side, the GDP expansion in 2004 followed mainly from an increase in gross value added in industry and construction (both up some 10%). Gross industrial production grew by about 4.5%, whereas industrial employment rose only marginally. Industrial labour productivity increased by around 4.5%, less than average industrial gross monthly wages (up about 10%). In other words, unit labour costs in industry are likely to have increased by around 5% in SKK terms and by some 9% in euro terms. The former major contributor to industrial growth, carmaker VW Bratislava, expanded its production by only 1% in 2004; its major output expansion had taken place already in 2003 (+32%). Nevertheless, the rise in industrial output was mainly attributable to machinery and equipment as well as electrical and optical equipment, which both expanded by about 15%.

It was real appreciation (by more than 5% on annual average) which, possibly among other factors, slowed down export expansion and accelerated import growth. The competitiveness of Slovak tradable goods continues to rely on wage rates, which in euro terms are relatively low: gross monthly wages averaged some EUR 380 in 2004 compared to 346 in 2003. The National Bank of Slovakia (NBS) is fighting appreciation by lowering interest rates, but has so far not been able to stop it.

A number of factors fuel the demand for the Slovak currency: strengthening confidence in the success of the recent economic reforms, the continuation of high FDI inflows and interest rates still above those in the euro zone together with the expectation of further appreciation. On 2 February this year the Slovak koruna reached a new historical high of 38.1 SKK per EUR, which represented a year-on-year nominal appreciation by 7%.

In recent years, Slovakia has gained a reputation as a reform pioneer. Because of comprehensive tax reforms and favourable macroeconomic developments, in December 2004 Standard & Poor’s upgraded Slovakia’s rating from BBB+ to A-, the same rank as that of the Czech Republic and Hungary and better than Poland’s. The 19% tax rate on corporate profits and all types of personal income, introduced at the beginning of 2004, was supposed in particular to attract more foreign direct investors as well as to contribute positively to a reduction of the budget deficit. Yet it appears that the deficit climbed from 3.7% of GDP in 2003 to 5.5% in 2004. However, this result is bloated by the fact that in late

2004 the Slovak government had to pay the Czech bank Československá Obchodní Banka AS (CSOB) around EUR 620 million, or about 1.9% of the Slovak GDP, as a result of a court decision. It represents principal and interest from an unpaid loan that the CSOB provided to a Slovak agency set up in 1993 to assume the bank's bad debts.

If this extraordinary payment is left out, the deficit – calculated in accordance with the EU methodology (ESA 95) in per cent of GDP – was slightly lower than in 2003, mainly supported by higher GDP growth in 2004. The government confirmed its target to reduce the budget deficit to 3% in 2006 and to adopt the euro in 2009. The budget for 2005 projects a deficit of 3.8% of GDP. However, pre-election populism (parliamentary elections are due in autumn 2006) will slow down the budgetary consolidation. Higher indirect taxation starting from the beginning of 2004 and the ongoing price deregulation have resulted in relatively high inflation (7.5%). Fears that EU accession would accelerate inflation significantly have proved as not justified. Retail prices remained virtually unchanged after 1 May. The number of retailers is increasing, and competition among them exerts a downward pressure on prices. Besides, because consumers' purchasing power is only modestly rising, there is little scope for prices to go up.

The tax reform was accompanied by a radical reform of the pension and healthcare systems and of the provision of basic social benefits for long-term jobless, starting from the beginning of 2004. The latter contains a ceiling for transfer payments to families, which rises degressively with the number of children. It implied de facto a serious income squeeze for many Roma families and has resulted in social unrest in the eastern parts of the country in February 2004. Most of the about 300,000 Roma live in slums (mainly in Eastern Slovakia); they are trapped in a vicious circle of low education and poor job opportunities.

Most provisions of the reforms in the pension and healthcare systems have taken effect at the beginning of 2005. The pension reform contains a gradual increase in the statutory retirement age and introduces a privately managed second pillar of the pension system. The new pension scheme is mandatory for new entrants to the labour market, whereas currently employed workers can voluntarily join it. The reform of the healthcare system is based on obligatory and voluntary insurance. It is expected to result in a reduction of the financial burden for the state, greater financial transparency in the healthcare institutions, and an improvement in healthcare quality. The latter, however, may in fact materialize only for those patients who can afford voluntary insurance. The actual effects of the healthcare reform will soon become visible, whereas the impact of the pension reform will show only in the long run. In December 2004, the new regulatory framework for bankruptcies was approved. The crucial target is to accelerate bankruptcy procedures, strengthen creditors' rights and increase the proportion of claims that creditors can recover.

Following 1.8% growth in 2003, according to Labour Force Survey (LFS) data, employment stagnated in 2004 despite the relatively robust expansion of the economy. Compared to 2003, the unemployment rate (LFS) rose by 1.1 percentage points in 2004 and reached 18.5% on an annual average. FDI has so far not eased the tension on the labour market. FDI inflows had dropped to EUR 0.6 billion in 2003, but climbed to an estimated EUR 0.8 billion in 2004. The greatest number of investors has targeted the car and electro-technical industries as well as services. The increased is supposed to be closely related to Slovakia's accession to the EU, the low corporate tax rate, the rising number of industrial parks and the improved business climate. A further hike is expected in the coming years on account of two new car factories (PSA Peugeot-Citroen and KIA-Hyundai), both located in Slovakia's richer western region: the investments planned total some EUR 1.5 billion, and the projected car production amounts to over 500,000 units annually, implying the creation of almost 10 thousands new jobs by 2006. Whereas the core of FDI remains concentrated in the West of the country, the German automobile gear box manufacturer Getrag Ford has announced a plan to invest some EUR 300 million in the poorer region in the East (industrial park Kechnec close to Košice) where unemployment is high – and the link to the Hungarian highway system is close. The company intends to start producing new-technology transmissions in 2007, and including local sub-contractors the project should create over 2000 new jobs. Another two, already agreed, smaller projects with a total FDI volume of over EUR 40 million within five years are related to the car industry as well. In addition, Korea's electronics producer Nuritech Global will expand its FDI activities in Southern Slovakia. As for the years to come, the Slovak Investment and Trade Development Agency (SARIO) announced to mainly support FDI projects in the pharmaceuticals, IT and R&D sectors as well as in call centres.

Driven by a recovery of private demand and by strong investment expansion, GDP growth will remain high, about 5.3%, in 2005 and increase to around 5.5% in 2006. In addition, on the supply side the economic expansion will be supported by gradually rising industrial output, particularly relating to FDI in car production. The bulk of price and tax adjustments is over, and thus the inflation rate will go down to some 4% this year and to below 3% in 2006. The high unemployment rate will hardly change for the better this year. Nevertheless, there is hope that in the years to come foreign greenfield investment will, at least to some extent, also reach the poor eastern regions and gradually create more new jobs there. (The situation of the Roma, however, will remain unaffected by the new FDI projects.) The country's infrastructure is unbalanced and links between the eastern and western parts of the country are underdeveloped. In 2005 FDI inflows may reach EUR 1.5 billion, with the bulk flowing into job-creating greenfield investment. The current account deficit will rise in 2005, as profits earned by foreign-owned companies will progressively enlarge the deficit. In addition, the growth of exports may temporarily decelerate and that of imports accelerate, both in the context of further appreciation of the Slovak koruna.

Table SK

Slovak Republic: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 [1)]	2005	2006
								forecast	
Population, th pers., mid-year	5390.7	5395.3	5400.7	5379.8	5378.6	5378.8	5382.2	.	.
Gross domestic product, SKK bn, nom.	781.4	844.1	934.1	1009.8	1098.7	1201.2	1330	1460	1600
annual change in % (real)	4.2	1.5	2.0	3.8	4.6	4.5	5.3	5.3	5.5
GDP/capita (EUR at exchange rate)	3661	3546	4061	4334	4784	5382	6170	.	.
GDP/capita (EUR at PPP - wiiw)	8440	8740	9460	10050	10880	11180	12140	.	.
Gross industrial production									
annual change in % (real)	5.0	-2.6	8.4	7.6	6.7	5.3	4.5	5	7
Gross agricultural production									
annual change in % (real)	-6.0	-2.5	-12.3	9.9	1.5	-4.5	.	.	.
Construction industry									
annual change in % (real)	-3.5	-25.8	-0.4	0.8	4.1	6.0	4.2 I-XI	.	.
Consumption of households, SKK bn, nom.	424.1	473.0	519.6	577.5	624.5	667.5	.	.	.
annual change in % (real)	6.0	2.7	-0.9	4.9	5.5	-0.8	3.5	5	6
Gross fixed capital form., SKK bn, nom.	281.8	249.8	242.3	291.0	303.5	308.4	.	.	.
annual change in % (real)	11.0	-19.6	-7.2	13.9	-0.6	-1.5	4.0	7	10
LFS - employed persons, th, avg.	2198.6	2132.1	2101.7	2123.7	2127.0	2164.6	2160.5 I-IX	.	.
annual change in %	-0.3	-3.0	-1.4	1.0	0.2	1.8	-0.1 I-IX	.	.
LFS - employed pers. in industry, th, avg.	662.5	630.3	615.3	628.8	640.9	634.1	638.9 I-IX	.	.
annual change in %	-0.5	-4.9	-2.4	2.2	1.9	-1.1	0.7 I-IX	.	.
LFS - unemployed, th pers., average	317.1	416.8	485.2	508.0	486.9	459.2	489.3 I-IX	.	.
LFS - unemployment rate in %, average	12.5	16.2	18.6	19.2	18.5	17.4	18.5	18	17
Reg. unemployment rate in %, end of period	15.6	19.2	17.9	18.6	17.5	15.6	13.1	13	13
Average gross monthly wages, SKK	10003	10728	11430	12365	13511	14365	15105 I-IX	.	.
annual change in % (real, gross)	1.7	-2.8	-4.5	0.8	5.8	-2.0	1.7 I-IX	.	.
Consumer prices, % p.a.	6.7	10.6	12.0	7.1	3.3	8.5	7.5	4	2.5
Producer prices in industry, % p.a.	3.3	4.3	10.8	6.5	2.1	8.3	3.4	3	2
General governm.budget, EU-def., % GDP [2)]									
Revenues	57.1	49.8	47.6	45.5	45.2	35.4	34.6	.	.
Expenditures	60.7	56.8	59.8	51.5	50.8	39.2	40.1	.	.
Deficit (-) / surplus (+)	-3.7	-7.0	-12.3	-6.0	-5.7	-3.7	-5.5	-4.2	-3.5
Public debt in % of GDP [2)]	34.0	47.2	49.9	48.7	43.3	42.8	44.5	47	48
Discount rate, % p.a., end of period	8.8	8.8	8.8	8.8	6.5	6.0	4.0	.	.
Current account, EUR mn	-1764	-920	-761	-1950	-2043	-244	-1000	-1700	-1700
Current account in % of GDP	-8.9	-4.8	-3.5	-8.4	-7.9	-0.8	-3.0	-4.4	-3.9
Gross reserves of NB incl. gold, EUR mn [3)]	2493	3410	4391	4748	8824	9717	10954	.	.
Gross external debt, EUR mn [4)]	10146	10470	11637	12516	12655	14654	16242 X	.	.
FDI inflow, EUR mn	629	402	2089	1768	4397	636	800 [5)]	.	.
FDI outflow, EUR mn	130	-348	23	39	5	20	-110 [5)]	.	.
Exports of goods, BOP, EUR mn	9540	9603	12879	14115	15270	19359	22400	25800	30200
annual growth rate in %	30.7	0.7	34.1	9.6	8.2	26.8	16	15	17
Imports of goods, BOP, EUR mn	11634	10628	13860	16488	17517	19924	23500	27500	31700
annual growth rate in %	27.6	-8.6	30.4	19.0	6.2	13.7	18	17	15
Exports of services, BOP, EUR mn	2168	1937	2436	2779	2958	2912	2900	.	.
annual growth rate in %	6.7	-10.7	25.8	14.1	6.4	-1.5	0	.	.
Imports of services, BOP, EUR mn	2025	1732	1961	2244	2474	2703	2700	.	.
annual growth rate in %	9.2	-14.5	13.2	14.5	10.3	9.2	0	.	.
Average exchange rate SKK/USD	35.24	41.42	46.20	48.35	45.34	36.77	32.26	.	.
Average exchange rate SKK/EUR (ECU)	39.60	44.12	42.59	43.31	42.70	41.49	40.05	38	37
Purchasing power parity SKK/USD, wiiw	14.80	15.65	16.06	16.29	16.21	17.02	17.21	.	.
Purchasing power parity SKK/EUR, wiiw	17.19	17.90	18.28	18.67	18.77	19.97	20.36	.	.

Notes: 1) Preliminary. - 2) According to ESA'95, excessive deficit procedure. - 3) From January 2002 new valuation of gold. - 4) Up to 2002 wiiw calculated from USD, from 2003 original data in EUR. – 5) wiiw estimate.

Source: wiiw Database incorporating national statistics; AMECO Database; wiiw forecasts.