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Slovakia:
late revenge of the overambitious conversion rate

The strongly export-oriented Slovak economy was hit hard by the sharp contraction in foreign demand in the wake of the global financial and economic crisis. GDP contracted by 5.6% in the first quarter of 2009, whereas it had still increased by 2.5% in the last quarter of 2008. Germany and the Czech Republic, whose markets are of key importance for Slovak exports, are both in recession. The volume of Slovak exports and imports (goods and services) dropped by 24.3% and 22.6%, respectively. Gross capital formation declined by 16.4%, gross fixed capital formation was down by 4.1%. The difference is accountable to falling inventories, which were the main explanatory component of the GDP decline. Only modestly (by 1.6%) rising real wages and consumers' caution resulted in a slight decline in private consumption. Stimulated by relatively weak currencies in neighbouring Hungary, Poland and the Czech Republic, cross-border shopping of Slovaks increased strongly and as a consequence domestic retail sales (except for motor vehicles) dropped by some 10% in the first quarter of the year.

On the supply side, the GDP contraction followed chiefly from a decline in gross value-added in industry. Unlike the Czech automotive industry, Slovak car makers have so far not been strongly profiting from the car scrapping subsidies introduced in several EU countries. As yet, foreign demand for low-cost cars (such as small models of KIA, Citroen or Peugeot) and luxury cars (VW Touareg, Audi Q7 and Porsche Cayenne) produced by foreign-owned companies in Slovakia has been disappointing. Driven by the fall in car production (-44.3%), gross industrial production was down by 23.5% in the first four months of 2009, accompanied by decline by some 4% in industrial employment and stagnating real wages. Labour productivity in industry plunged by double-digit percentages. In addition, shortly before fixing the conversion rate, the Slovak koruna (SKK) appreciated by around 10% against the euro in the second quarter of 2008. As a result unit labour costs rose by about one-quarter in the first quarter of 2009 and consequently Slovak export goods became less competitive. This is reflected in exports falling more rapidly than imports.

After a period of strong growth, the inflow of foreign direct investment has been sharply declining this year. According to the Slovak Agency for Investment and Business Development (SARIO), in the first quarter of 2009 there were only two FDI projects in the pipeline, in the total value of EUR 8 million – as compared to nine foreign investment projects worth EUR 103 million which were assisted by SARIO in the first quarter of 2008.

Since the end of 2008 the cabinet has taken a number of fiscal policy steps targeted at lessening the impact of the global crisis on the economy.[1] A social package (higher child-birth benefits, pension indexation) focusing on boosting domestic demand was implemented at the beginning of 2009. The measures with the largest burden on the general government budget include a higher basic tax allowance on personal income tax and higher tax credit. Slovakia has also introduced a car-scrapping bonus (EUR 2000 per new car with a ceiling price of EUR 25,000). Efforts at improving the business environment have focused on (1) relieving the tax burden by way of a higher non-taxable part of the income-tax base or by a shortened period to refund excess VAT paid by corporation and (2) raising the limit for state-guaranteed loans for enterprises (in particular SMEs). Measures of employment support include subsidies provided to employers who temporarily curb their operations.

Slovakia's commercial banks have so far not been directly affected by the global financial and economic crisis, because Slovak banks' exposure to highly toxic assets is marginal. Anti-crisis measures in the banking sector are therefore minimal and comprise (1) an unlimited deposit guarantee for private persons and (2) stricter supervisory rules for liquidity transfers by daughter banks to their foreign mother banks.

Besides, there have been cash injections for the Slovak cargo and railway company, the Slovak Guarantee and Development Bank as well as the Export-Import Bank in the value of EUR 310 million. According to the ESA 95 EU methodology, these expenditures do not represent a burden on the general government deficit but increase the debt. To support economic growth the government intends to facilitate a more effective absorption of EU funds with the help of better prepared big investment projects including public-private partnership (PPP). Co-financing is to be secured.

The projected public expenditures for the anti-crisis package amount to EUR 0.7 billion in 2009-2010 (according to the ESA 95 EU methodology). Calculated per year, that would correspond to some 0.5% of annual GDP. Furthermore, the government is expecting additional financial transfers of EU funds in the total amount of EUR 242 million for 2009-2010 attached to the anti-crisis package. Should the drawing of EU funds really rise in line with the projections, a pro-growth effect of 2.4% in 2009 and 1.9% in 2010 can be expected. However, given the current delay in the preparation of a very large and ambitious infrastructure project (highway construction via PPP), that target does not appear very realistic.

Despite the anti-crisis package, GDP will contract by about 5% this year, mostly on account of the slump in foreign demand. Worsening labour market conditions will result in rising unemployment, although the support for employment may mitigate this development. Given the pro-growth and stabilization measures and the co-financing needs of the EU-funded projects, as well as lower budgetary revenues due to the recession, the general government deficit will exceed 5% of the GDP

[1] The bulk of them has been summarized in the 'Stability Programme of the Slovak Republic for 2008-2012', authorized by government decision No. 316 on 29 April 2009; see parts I.4 and I.5.

both in 2009 and 2010. Public debt will rise and account for nearly 40% of the GDP in 2010. FDI inflows will decline sharply in 2009. The trade balance will slightly improve, as imports will drop more strongly than exports. In addition, shrinking profit for foreign investors will improve the balance of income and in this way contribute to the lessening of current account deficit. Should the global economic rebound projected for 2010 really materialize, the Slovak economy may stagnate in 2010 and slightly expand in 2011.

The most challenging issue in the future relates to the excessively strong SKK/EUR conversion rate that was fixed in June 2008. Nevertheless, the government cheered the strong central parity, because wages converted to euro have been higher than otherwise – and the campaign for the 2010 parliamentary elections has already started. Based on the strong currency appreciation, GDP per capita calculated in euro rose by 18% to EUR 12000 in 2008 as compared to 2007.

One year ago the government also made use of currency appreciation to eliminate inflationary risks and thus to comply with the Maastricht inflation criterion. Today, however, Slovak exporters are disadvantaged compared to their competitors in the Czech Republic, Poland and Hungary, where the local currencies have depreciated. In addition, a high proportion of domestic demand has been covered by imports from cheaper sources, mostly Hungary and Poland. The excessively strong Slovak koruna at the time of the conversion has rendered the highly export-oriented Slovak manufacturing sector (in particular the automotive industry) vulnerable in the future.

In the short and medium term, Slovakia's competitiveness may theoretically be restored by domestic wage and price deflation. However, the wage drop would diminish consumer demand and, in terms of GDP growth, would counteract possible gains in foreign trade achieved through improving competitiveness. Lowering the deliberately elevated purchasing power of the population in the wake of the approaching parliamentary elections in 2010 may be a difficult task. In the long run, sustainable economic growth has to be backed by investments in new, advanced technology for the knowledge economy in order to regain competitiveness and to revitalize export expansion.

Table SK

Slovak Republic: Selected Economic Indicators

	2005	2006	2007	2008 [1)]	2008	2009	2009	2010	2011
					1st quarter		Forecast		
Population, th pers., average	5387.0	5391.4	5397.3	5406.0	.	.	.	.	.
Gross domestic product, EUR-SKK mn, nom. [2)]	49315.2	55081.9	61501.1	67331.0	15602.0	14648.0	64200	64500	65700
annual change in % (real) [2)]	6.5	8.5	10.4	6.4	9.3	-5.6	-5	0	1
GDP/capita (EUR at exchange rate)	7100	8300	10200	12000	.	.	.	.	.
GDP/capita (EUR at PPP)	13500	15000	16700	17700	.	.	.	.	.
Consumption of househ., EUR-SKK mn, nom. [2)]	27691.8	30753.1	33795.3	37436.5	9072.0	9272.0	.	.	.
annual change in % (real) [2)]	6.6	5.9	7.1	6.1	8.4	-1.2	0	2	2
Gross fixed capital form., EUR-SKK mn, nom. [2)]	13089.5	14588.8	16048.5	17465.3	3556.0	3419.0	.	.	.
annual change in % (real) [2)]	17.6	9.3	8.7	6.8	7.5	-4.1	-2	1	3
Gross industrial production									
annual change in % (real) [3)4)]	3.6	9.8	13.2	1.3	12.7	-23.0	-18	0	2
Gross agricultural production									
annual change in % (real)	-8.7	-2.9	-4.5	5.0	.		.	.	.
Construction industry (build.& civil engin.)									
annual change in % (real) [3)4)]	14.7	14.9	5.7	11.9	11.2	-13.6	.	.	.
Employed persons - LFS, th, average	2215.2	2302.3	2357.7	2433.7	2391.3	2388.2	.	.	.
annual change in %	2.1	3.9	2.4	3.2	2.8	-0.1	.	.	.
Unemployed persons - LFS, th, average	430.0	355.4	295.7	255.7	280.5	281.0	.	.	.
Unemployment rate - LFS, in %, average	16.3	13.4	11.1	9.5	10.5	10.5	13	14	14
Reg. unemployment rate, in %, end of period	11.4	9.4	8.0	8.4	7.6	10.3	11	12	12
Average gross monthly wages, EUR-SKK [5)]	573	623	669	723	679	710	.	.	.
annual change in % (real, gross)	6.3	3.3	4.3	3.3	6.2	1.6	.	.	.
Consumer prices (HICP), % p.a.	2.8	4.3	1.9	3.9	3.4	2.3	2	2	3
Producer prices in industry, % p.a. [4)6)]	5.4	5.7	-1.2	2.8	3.2	-5.1	-3	0	2
General governm.budget, EU-def., % GDP [7)]									
Revenues	35.4	33.5	32.5	32.7	.	.	.	.	.
Expenditures	38.2	36.9	34.4	34.9	.	.	.	.	.
Net lending (+) / net borrowing (-)	-2.8	-3.5	-1.9	-2.2	.	.	-5.0	-5.0	-3.0
Public debt, EU-def., in % of GDP [7)]	34.2	30.4	29.4	27.6	.	.	.	.	.
Discount rate of NB, % p.a., end of period	3.0	4.8	4.3	2.5	4.3	1.5	.	.	.
Current account, EUR mn	-3268	-3636	-3141	-4279	-392	-582	-3000	-3300	-3500
Current account in % of GDP	-8.5	-8.2	-5.7	-6.6	-2.8	-4.0	-4.7	-5.1	-5.3
Exports of goods, BOP, EUR mn	25654	33349	42171	47722	11575	9089	41000	41000	42000
annual growth rate in %	15.3	30.0	26.5	13.2	.	-21.5	-15	1	3
Imports of goods, BOP, EUR mn	27571	35817	43009	48435	11385	9141	40000	41000	43000
annual growth rate in %	17.4	29.9	20.1	12.6	.	-19.7	-17	2	5
Exports of services, BOP, EUR mn	3542	4322	5140	5796	1265	1026	5900	6000	6200
annual growth rate in %	18.1	22.0	18.9	12.8	.	-18.9	2	2	3
Imports of services, BOP, EUR mn	3285	3790	4752	6269	1350	1417	6500	6700	6900
annual growth rate in %	18.0	15.4	25.4	31.9	.	5.0	3	3	3
FDI inflow, EUR mn	1952	3311	2108	2395	-133	.	.	.	.
FDI outflow, EUR mn	120	292	149	177	44	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	12567	9639	12280	12674	12018	182	.	.	.
Gross external debt, EUR mn	22705	24449	30156	37286	31261	39028 Feb	.	.	.
Gross external debt in % of GDP	57.9	50.7	54.7	55.4	46.4	60.8	.	.	.
Average exchange rate EUR-SKK/EUR	1.281	1.236	1.121	1.038	1.097	1.00	1.00	1.00	1.00
Purchasing power parity EUR-SKK/EUR	0.676	0.681	0.683	0.702	.	.	.	.	.

Note: Slovakia has introduced the Euro from 1 January 2009. For statistical purposes all time series in SKK as well as the exchange rates and PPP rates have been divided by the conversion factor 30.126 (SKK per EUR) to EUR-SKK.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Enterprises with more than 20 employees. - 4) Quarterly data and forecasts according to NACE Rev. 2. - 5) From 2006 including wages of armed forces. - 6) Until 2003 domestic output prices. - 7) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.