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Slovakia: robust investment-led growth ahead of an export offensive

The coalition government formed by four centre-right parties in 2002 survived until June 2006, despite the loss of the parliamentary majority already in December 2003. On 17 June 2006, three months earlier than scheduled, parliamentary elections were held. This had no impact on the volatility of the exchange rate and the Slovak koruna has remained relatively strong against the euro. As expected, the populist Social-Democratic party Smer led by Robert Fico won the elections, but fell short of a majority. Nevertheless, Mr. Fico was relatively quickly able to form a coalition government on 28 June: Smer has associated with the nationalistic Slovak National Party (SNS) and the Movement for a Democratic Slovakia (HZDS). The seats in the new cabinet and parliamentary posts are to be divided according to the parties' performances in the elections. Smer will get 11 ministries, the SNS will receive 3 seats and the HZDS will get two posts. The two controversial leaders Ján Slota (SNS) and three-time ex-prime minister Vladimír Mečiar (HZDS) will serve neither in the cabinet nor in any official state post. Under this arrangement the government may try to make some change to the liberal economic policy pursued so far. However, backed by the booming economy, most political parties in Slovakia have basically supported the current course of the economy and any potential changes would not be significant. In addition, Mr. Fico has already confirmed a continuation of the current pro-European democratic policy and all obligations related to the OECD and NATO.

Despite the government crisis at the beginning of 2006, Slovakia has remained a fast growing economy. Growth even speeded up in the first quarter of 2006, when GDP rose by 6.3% as compared to 5.4% in the first quarter of 2005. Driven by rising industrial investment led by FDI and by stepped-up infrastructure investment, gross fixed capital formation soared by 16.1%. Rising real wages and credits to private households fuelled private consumption, up 6.6%. The strong domestic demand was partly covered by rising imports. As a result, foreign trade contributed negatively to overall GDP growth, even though exports increased significantly as well, supported by rising labour productivity and by a shift towards high value-added exports. As a result of increasing repatriation of profits of FDI and of the expanding foreign trade deficit, the current account deficit deteriorated, accounting for some 8% of GDP in 2005 and in the first quarter of 2006. In addition, higher prices of imported energy contributed to the deficit.

The increase in household consumption and consumer borrowing as well as higher oil prices have been largely responsible for intensified inflationary pressures. At the same time, fiscal policy has eased. As a result, the inflation rate (CPI) rose by 4.3% in the first quarter of 2006, compared to 2.8% in the same period of the previous year. The rising costs of the pension reform and pre-election 'sweets' have expanded budgetary expenditures. Thus, the general government budget deficit is likely to rise to more than 3% of GDP this year, against 2.9% in 2005.

The strong economic growth for the sixth consecutive year has in the end supported growth in employment as demand for labour has been on the rise. Total employment (according to the Labour Force Survey, LFS) increased by 3.7% in the first quarter of 2006, against 2.3% in the same period a year earlier. The unemployment rate (LFS) fell by 2.6 percentage points, to 14.9% in the first quarter of 2006. However, regional disparities remain large. Whereas in the Bratislava region the jobless rate is at about 2%, southern-central Slovakia has to cope with a rate of around 30%. This situation is reflected in regional income disparities – which are growing, although the purchasing power per capita is rising. The wealthiest region is Bratislava, followed by the Žilina district in the north-west and the urban agglomeration Košice in the east of the country. Purchasing power is lowest in southern-central Slovakia and in districts in the remote east.

Gross industrial output increased by 8.2% in the first four months of 2006. Industrial employment, according to LFS data, rose by just about 2%, whereas industrial labour productivity was up by some 6%. Along with nominal wage growth of only 3.3% this resulted in declining unit labour costs. In particular foreign investment companies, primarily operating in machinery & equipment and electrical & optical equipment branches, reported above-average production growth rates (around 20%). Car manufacturing has temporarily lost momentum as the front-runner in the expanding industrial production, but the automotive sector still accounts for one quarter of total industrial production, and exports and employs more than 60 thousand persons.

Following a big investment in 2005, VW Bratislava plans an annual production of 240,000 cars in Slovakia in 2006, up from 218,000 in 2005. Altogether, VW has so far invested EUR 1.3 billion in Slovakia over the past 15 years. In addition, the new car plant PSA Peugeot Citroen (in the western Slovak town Trnava) – with total investments envisaged at EUR 1 billion – started production in June and is to produce 60,000 cars in 2006; by the end of the decade production is to be gradually stepped up to 450,000 cars annually. In May KIA, the Hyundai associate, started trial production in its first European plant in Žilina (north-western Slovakia). The company is to invest EUR 0.7 billion and to achieve its full production capacity of 300,000 cars per year in 2009. On the whole, all three car factories could produce around one million cars annually by the end of this decade. As a result, they would make Slovakia the world's biggest car producer per capita. With newly starting production or expanding manufacturing, all carmakers located in Slovakia are looking for qualified workers. However, at the same time carmakers situated in Hungary, such as

Suzuki in Esztergom and Audi in Györ, are also interested in hiring in Slovakia; thus the labour market in the wider Slovak-Hungarian border region is facing bottlenecks of skilled industrial workers. The low labour mobility within Slovakia (even from regions suffering unemployment to those where labour is in high demand) has exacerbated the scarcity of labour in the country's western and south-western regions. If Slovak workers take a job abroad, they usually head for the Czech Republic, Great Britain and Ireland.

The improved business climate, the liberal employment act, weak trade unions as well as low labour costs have been attracting foreign investors. FDI inflows recovered to EUR 1.7 billion in 2005. At the end of April 2006, after a privatisation process taking five years, the Italian company Enel acquired a 66% stake in the power utility Slovenské elektrárne. Altogether, the Italian company already paid EUR 840 million (SKK 31.3 billion) to a state account and has pledged to invest around EUR 1.9 billion by 2013. This deal and expanding investment in the automotive sector may result in total FDI inflows exceeding EUR 2 billion in 2006.

Supported both by rising private demand and strong investment growth, GDP growth will speed up to 6.5% this year and will remain strong in 2007. The supply side, in particular FDI-led car production (mostly for export), should assure strong GDP growth. Along with rising labour demand the unemployment rate will continue to decline. In the course of its pre-election campaign, the Slovak government confirmed its target of adopting the euro by 2009. As a result of positive macroeconomic indicators, the Slovak koruna will probably return to its appreciation trend in the long run. In the years to come, the current account deficit will face rising income outflow pressure as foreign owners of Slovak companies in the energy and banking sectors will repatriate their growing profits.

Table SK

Slovak Republic: Selected economic indicators

	2001	2002	2003	2004	2005 [1)]	2005	2006	2006	2007
						1st quarter		forecast	
Population, th pers., mid-year	5379.8	5378.8	5379.0	5382.2	5386.7	.	.	.	.
Gross domestic product, SKK bn, nom. [2)]	1020.6	1111.5	1212.7	1355.3	1472.1	339.6	368.8	1630	1800
annual change in % (real) [2)]	3.2	4.1	4.2	5.4	6.1	5.4	6.3	6.5	6.5
GDP/capita (EUR at exchange rate) [2)]	4380	4839	5434	6287	7082	.	.	.	.
GDP/capita (EUR at PPP - wiiw) [2)]	10150	10990	11290	12010	12910	.	.	.	.
Gross industrial production									
annual change in % (real)	7.6	6.7	5.3	4.2	3.6	0.3	9.7	9	9
Gross agricultural production									
annual change in % (real)	9.9	1.5	-2.4	1.1	.	.	.	.	.
Construction industry									
annual change in % (real)	0.8	4.1	6.0	5.7	14.7	12.5	14.4	.	.
Consumption of households, SKK bn, nom. [2)]	583.7	634.3	676.9	754.4	829.8	197.4	221.5	.	.
annual change in % (real) [2)]	5.4	5.2	0.1	3.8	7.2	7.0	6.6	7	4
Gross fixed capital form., SKK bn, nom. [2)]	291.0	303.5	302.8	327.1	382.6	75.1	89.1	.	.
annual change in % (real) [2)]	12.9	0.3	-2.3	5.0	13.8	4.7	16.1	17	18
LFS - employed persons, th, avg.	2123.7	2127.0	2164.6	2170.4	2216.2	2177.4	2257.5	.	.
annual change in %	1.0	0.2	1.8	0.3	2.1	2.3	3.7	.	.
LFS - employed pers. in industry, th, avg.	628.8	640.9	634.1	641.3	649.1	642.0	653.4	.	.
annual change in %	2.2	1.9	-1.1	1.1	1.2	2.4	1.8	.	.
LFS - unemployed, th pers., average	508.0	486.9	459.2	480.7	427.5	461.9	395.8	.	.
LFS - unemployment rate in %, average	19.2	18.5	17.4	18.1	16.2	17.5	14.9	14.5	14
Reg. unemployment rate in %, end of period	18.6	17.5	15.6	13.1	11.4	12.7	11.4	10	9
Average gross monthly wages, SKK	12365	13511	14365	15825	17274	16022	17223	.	.
annual change in % (real, gross)	1.0	5.8	-2.0	2.5	6.3	7.2	3.1	.	.
Consumer prices, % p.a.	7.1	3.3	8.5	7.5	2.7	2.8	4.3	4	3.5
Producer prices in industry, % p.a.	6.5	2.1	8.3	3.4	4.7	2.5	9.5	8	6
General governm.budget, EU-def., % GDP [3)]									
Revenues	36.8	35.7	35.6	35.9	34.7	.	.	33.0	32.5
Expenditures	43.3	43.3	39.4	38.9	37.7	.	.	35.7	34.6
Deficit (-) / surplus (+)	-6.5	-7.7	-3.7	-3.0	-2.9	.	.	-2.7	-2.1
Public debt, EU-def., in % of GDP [3)]	49.2	43.3	42.7	41.6	34.5	.	.	34.3	34.7
Discount rate, % p.a., end of period	8.8	6.5	6.0	4.0	3.0	3.0	3.5	.	.
Current account, EUR mn [4)]	-1950	-2043	-244	-1214	-3288	-199	-742	-2500	-2500
Current account in % of GDP	-8.3	-7.8	-0.8	-3.6	-8.6	-2.2	-7.5	-5.7	-5.0
Gross reserves of NB incl. gold, EUR mn	4748	8824	9717	10954	13067	13928	13657	.	.
Gross external debt, EUR mn	12516	12655	14654	17421	22705	21724	23114 Jan	.	.
FDI inflow, EUR mn	1768	4397	593	1016	1694	44 I-II	316 I-II	.	.
FDI outflow, EUR mn	39	5	20	-114	126	12 I-II	40 I-II	.	.
Exports of goods, BOP, EUR mn [4)]	14115	15270	19359	22247	25742	5590	7125	33000	42000
annual growth rate in %	9.6	8.2	26.8	14.9	15.7	12.8	27.4	28	27
Imports of goods, BOP, EUR mn [4)]	16488	17517	19924	23484	27711	5939	7759	35000	43500
annual growth rate in %	19.0	6.2	13.7	17.9	18.0	19.7	30.7	26	24
Exports of services, BOP, EUR mn [4)]	2779	2958	2912	3000	3542	525 I-II	580 I-II	.	.
annual growth rate in %	14.1	6.4	-1.5	3.0	18.1	14.7	10.3	.	.
Imports of services, BOP, EUR mn [4)]	2244	2474	2703	2785	3285	476 I-II	526 I-II	.	.
annual growth rate in %	14.5	10.3	9.2	3.0	18.0	9.1	10.5	.	.
Average exchange rate SKK/USD	48.35	45.34	36.77	32.26	31.02	29.16	31.17	.	.
Average exchange rate SKK/EUR (ECU)	43.31	42.70	41.49	40.05	38.59	38.28	37.46	37.0	36.0
Purchasing power parity SKK/USD	16.30	16.21	17.03	17.91	17.77	.	.	.	.
Purchasing power parity SKK/EUR	18.70	18.80	19.96	20.97	21.17	.	.	.	.

Notes: 1) Preliminary. - 2) Revised GDP data (FISIM adjustment). - 3) According to ESA'95, excessive deficit procedure. - 4) Calculated from USD.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts and European Commission (Spring 2006).