Zdenek Lukas

Slovakia:
After gloom, still no boom

At the beginning of the turbulent year 2009 Slovakia adopted the euro, which definitely eased the impact of the financial crisis on Slovak banking. The financial sector in Slovakia was hardly affected by the turmoil. Some 95% of bank assets are in foreign ownership, with a dominance of the traditionally conservative Austrian banks not engaged in toxic transactions. However, the strongly export-oriented Slovak economy was hit hard by the sharp contraction in foreign demand in the wake of the global economic crisis. Over the year the Slovak government adopted several anti-crisis measures chiefly targeted at the support of consumption and employment. According to the implementation report of the National Reform Programme for 2008-2010, it is expected that the total amount spent on anti-crisis measures in 2009 reached EUR 1.5 billion or 2.3% of GDP.

GDP contracted by 5% in 2009. The volume of exports and imports (goods and services) dropped by 20% and 21%, respectively. Still, contribution of foreign trade to GDP was positive. Gross capital formation declined by 21%, gross fixed capital formation was down by 12%. The difference is accountable to falling inventories, which were the main explanatory component of the GDP decline. Stagnating real wages and consumers' caution resulted in a stagnation of private consumption, whereas government consumption (and the budget deficit) increased. Following FDI inflows of EUR 2.4 billion in 2008, foreign direct investment came to a standstill in 2009. Some investors left the country; for instance, the large investor Molex Slovakia, producing car components in the Kechnec Industrial Park (located on the southeast border with Hungary) closed down its production after nine years of operation.

On the supply side, the GDP contraction followed mostly from a decline in gross value-added in manufacturing. Slovak car makers hardly profited from the car scrapping subsidies introduced in several EU countries including Slovakia. Foreign demand both 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 was disappointing. The excessive dependence on the automotive industry may also backfire – especially in times of crisis. Mainly due to the fall in car production (-27%), gross industrial production was down by 15% in 2009, accompanied by some 8% decline in industrial employment and stagnating real wages. As a result, labour productivity in industry fell by about 7% and unit labour costs (ULCs) rose in 2009. Because of the strong appreciation of the Slovak koruna before adopting the euro, Slovak export goods became less competitive. Nevertheless, in March 2009, the French automaker PSA Peugeot Citroen introduced its new C3 Picasso on the market. Four months later Korean carmaker Kia Motors Slovakia launched a new version of its Kia cee'd model. Following the record production of above 580,000

cars in 2008, output was down to some 470,000 cars in 2009. Only the electronics industries and coke and refinery products registered modest growth in 2009.

Gross output of construction dropped by 11% in 2009. Prospects are, however, encouraging: in 2009 the government launched the first public-private partnership (PPP) projects for the construction of one highway and one less ambitious double-track road connecting Bratislava with underdeveloped eastern Slovakia. The first PPP, signed with an international consortium led by a French company, will construct a total length of 75 kilometres with an investment value of over EUR 3 billion. The second PPP, signed with an international consortium (Granvia), will build 52 kilometres of the dual-carriage way worth EUR 930 million. In addition, the Slovak electric utility company Slovenské elektrárne (66% of shares owned by the Italian energy company Enel) will complete the third and fourth units of the Mochovce nuclear power station. This biggest private investment (EUR 2.7 billion) is to be spent up to 2013.

The labour market situation has been worsening, particularly in industrial regions where the demand crisis in industry resulted in layoffs, first of part-time workers and later on of regular workers. In 2009 the unemployment rate (LFS) rose by 2.8 percentage points to 12.3% year-on-year; the number of employed persons dropped by close to 3%. In 2010 the unemployment rate will continue to rise because the labour market follows the development of the real economy with a time lag. The consumer price index (HICP) has been falling continuously. At 0.9%, the annual inflation recorded in 2009 is the lowest in history. The main reasons behind are low energy prices, falling prices of manufacturing products and building materials as well as food.

As a result of the sharp GDP decline, the budgetary revenues in 2009 were down by 7% as the collection of the most important VAT dropped by 17% year-on-year. Revenues from excise taxes contracted by some 4% and those from income taxes stagnated. Driven by expenditures for the anti-crisis package, total budgetary expenditures in 2009 rose by 11% year-on-year. As a result, instead of the originally assumed deficit of EUR 1 billion, the general government deficit amounted to EUR 2.8 billion, or 6.3% of GDP. The trade balance slightly improved in 2009, as imports dropped more strongly than exports. In addition, shrinking profits of foreign investors improved the income balance and in this way contributed to reducing the current account deficit to some 3% of GDP. However, gross external debt and public debt have been rising rapidly.

The three foreign-owned enterprises in the automotive industry have remained the flagships of the Slovak economy and are important driving forces for other industrial sectors. Slovakia's biggest car maker VW Bratislava (with annual sales of about EUR 5 billion) is optimistic and preparing new investment. Starting in 2011, VW will produce its New Small Family models in Slovakia and invest here EUR 300 million. The VW annual production capacity is to gradually rise to 400 thousand cars. PSA and Kia are also fighting the crisis by expanding the production of new car models. Partly based on purposive optimism, the Slovak Ministry of Economy expects the output to increase to 540 thousand cars in 2010 with a further expansion to 900 thousand units in 2012. Taking into account the investment intentions in car production as well as in construction (highways, nuclear

power station), we expect a modest recovery in FDI inflows in 2010 (about EUR 1 billion) with further FDI growth in the years to come.

Starting in 2010 the Slovak authorities are to implement deficit reducing measures, aimed at a reduction of the annual average deficit by 0.75% to 1% of GDP over the period 2010-2013. With reference to the EU's Stability and Growth Pact, the National Fiscal Consolidation Strategy (NFCS), approved by the government on 14 December 2009, has envisaged the reduction of the general government deficit from 6.3% to 5.5% in 2010 and step-by-step to 3% of GDP in 2012. These targets are probably out of reach, however, mainly because of (i) the consolidation being solely backed by strong growth of budgetary revenues, a plan relying on unrealistically high GDP growth; (ii) the absence of measures on the budgetary expenditure side; and (iii) the absence of binding limits on budgetary expenditures. In addition, despite the very limited ability to absorb EU funds, the government believes to be able to finance some expenditures by an ambitious drawing of EU funds. Another concern is the long-term sustainability of the pension system, which is not warranted by the NFCS. The system faces deficits induced by the ageing of the population. Last but not least, the deficit consolidation will be undermined by rising unemployment-related transfers as the unemployment rate will increase in 2010 and remain unchanged beyond. Should the global economic rebound projected for 2010 really materialize, the Slovak economy may slightly expand in 2010 and somewhat more forcefully in 2011. Perhaps in 2012 a strong growth in foreign demand may drive a higher economic expansion. Past experience shows that only several years of strong GDP growth has employment supporting effects.

In this context, the wage development will be a crucial competitiveness factor because in the past, in the course of massive currency appreciation, Slovakia was losing part of its low-cost advantages. During the period November 2005 to May 2008 the central exchange rate parity (SKK/EUR) appreciated by 28% and that was finally accepted as the conversion rate for accession to the eurozone in 2009. No wonder that unit labour costs (ULCs) rose rapidly in euro terms, though Slovakia still has lower average wages and ULCs than other Central European competitors (the Czech Republic, Hungary, Poland). However, this important comparative advantage has been rapidly diminishing.

In the short run, Slovakia's competitiveness against those neighbouring countries may theoretically be restored by wage reduction or price deflation; in the longer term, wages should rise less than in the competing countries. However, a drop in real wages would reduce the population's purchasing power prior to the parliamentary elections in mid-2010 and thus will be difficult to implement. In the long run, given the excessively strong domestic currency, the highly export-oriented manufacturing sector may remain vulnerable. Sustainable economic growth has to be backed by investments in new, advanced technology for the knowledge economy coupled with a restructuring of the labour market in order to regain competitiveness in international markets and to revitalize export expansion.

To sum up, the most challenging issues in the future relate to (i) deteriorating competitiveness of exports and (ii) rising public debt and gross external debt leaving little scope for countercyclical measures. Public and gross external debt will rise and the overall external position will deteriorate.

Table SK

Slovakia: Selected Economic Indicators

	2004	2005	2006	2007	2008	2009 [1]	2010	2011	2012
								Forecast	
Population, th pers., average	5382.4	5387.0	5391.4	5397.3	5406.6	5418.2	5420	5430	5440
Gross domestic product, EUR mn, nom.	45128.2	49280.0	55045.5	61547.1	67221.0	64500	66400	70400	76100
annual change in % (real)	5.0	6.7	8.5	10.6	6.2	-5	1	3	4
GDP/capita (EUR at exchange rate)	6300	7100	8300	10200	12000	11900	12300	13000	14000
GDP/capita (EUR at PPP)	12300	13500	15000	16900	18100	17400	.	.	.
Consumption of househ., EUR mn, nom.	25384.3	27750.8	30815.7	33860.3	37554.9	37500	.	.	.
annual change in % (real)	4.2	6.5	5.9	7.1	6.1	0	2	3	4
Gross fixed capital form., EUR mn, nom.	10836.0	13089.5	14588.8	16096.5	16715.6	14700	.	.	.
annual change in % (real)	4.8	17.5	9.3	9.1	1.8	-12	1	4	6
Gross industrial production									
annual change in % (real)	3.8	-1.4	15.0	17.2	3.2	-15	2	5	7
Gross agricultural production									
annual change in % (real)	12.5	-8.7	-2.9	-4.5	10.6	-6.1	.	.	.
Construction industry									
annual change in % (real)	5.6	14.7	14.9	5.7	11.9	-11	.	.	.
Employed persons - LFS, th, average	2170.4	2215.2	2302.3	2357.7	2433.7	2360	2310	2310	2330
annual change in %	0.3	2.1	3.9	2.4	3.2	-3	-2	0	1
Unemployed persons - LFS, th, average	480.7	430.0	355.4	295.7	255.7	330	.	.	.
Unemployment rate - LFS, in %, average	18.1	16.3	13.4	11.1	9.5	12.3	13	13	12
Reg. unemployment rate, in %, end of period	13.1	11.4	9.4	8.0	8.4	12.7	13	13	12
Average gross monthly wages, EUR [2]	525	573	623	669	723	730	.	.	.
annual change in % (real, gross)	2.5	6.3	3.3	4.3	3.3	0.1	.	.	.
Consumer prices (HICP), % p.a.	7.5	2.8	4.3	1.9	3.9	0.9	1.5	2	2
Producer prices in industry, % p.a.	1.7	3.4	3.0	-1.4	2.5	-6.6	1	2	2
General governm.budget, EU-def., % GDP									
Revenues	35.3	35.2	33.5	32.5	32.5	31.3	.	.	.
Expenditures	37.6	38.0	36.9	34.4	34.8	37.5	.	.	.
Net lending (+) / net borrowing (-)	-2.4	-2.8	-3.5	-1.9	-2.3	-6.3	-6	-5.5	-5
Public debt, EU-def., in % of GDP	41.5	34.2	30.5	29.3	27.7	37.0	40	43	43
Discount rate of NB, % p.a., end of period [3]	4.0	3.0	4.8	4.3	2.5	1.0	.	.	.
Current account, EUR mn	-2656	-3268	-3636	-3141	-4279	-1900	-2500	-3000	-3500
Current account in % of GDP	-7.8	-8.5	-8.2	-5.7	-6.6	-2.9	-3.8	-4.3	-4.6
Exports of goods, BOP, EUR mn	22248	25654	33349	42171	47722	38000	39000	40000	42000
annual growth rate in %	14.9	15.3	30.0	26.5	13.2	-20	2	2	5
Imports of goods, BOP, EUR mn	23485	27571	35817	43009	48435	37000	39000	40000	42000
annual growth rate in %	17.9	17.4	29.9	20.1	12.6	-24	5	3	6
Exports of services, BOP, EUR mn	3000	3542	4322	5140	5796	4600	4800	4900	5100
annual growth rate in %	3.0	18.1	22.0	18.9	12.8	-21	4	3	4
Imports of services, BOP, EUR mn	2785	3285	3790	4752	6269	6000	6300	6600	7000
annual growth rate in %	3.0	18.0	15.4	25.4	31.9	-4	5	5	6
FDI inflow, EUR mn	2441	1952	3311	2108	2395	0	1000	1500	2000
FDI outflow, EUR mn	-17	120	292	149	177	400	300	400	500
Gross reserves of NB excl. gold, EUR mn [4]	10605	12567	9639	12280	12674	481	.	.	.
Gross external debt, EUR mn	17421	22705	24449	30156	37286	50000	.	.	.
Gross external debt in % of GDP	49.6	57.9	50.8	54.6	55.5	78	.	.	.
Average exchange rate EUR/EUR	1.328	1.281	1.236	1.121	1.038	1.000	1.00	1.00	1.00
Purchasing power parity EUR/EUR	0.679	0.676	0.681	0.677	0.687	0.683	.	.	.

Notes: Slovakia introduced the euro on 1 January 2009. Up to and including 2008 all time series in SKK as well as the exchange rates and PPP rates have been divided for statistical purposes by the conversion factor 30.126 (SKK per EUR) to a 'statistical' EUR (euro-fixed). - Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary and wiiw estimates. - 2) From 2006 including wages of armed forces. - 3) 2-week limit rate of NB for REPO tenders, from 2009 official refinancing operation rates for euro area (ECB). - 4) From January 2009 (euro introduction) only foreign currency reserves denominated in non-euro currencies.

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