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Slovakia:
in good shape on the threshold of the eurozone

The Maastricht criteria mastered

On 7 May 2008 the European Commission declared that Slovakia meets all the Maastricht criteria required to adopt the euro, and gave green light to join the eurozone. The average harmonized inflation rate over the reference period, April 2007 to March 2008, amounted to 2.2% and was thus well below the reference indicator of 3.2%. The appreciated domestic currency has acted as a buffer cushioning the steep increases in global energy and food prices. The fiscal deficit was 2.2% of GDP in 2007. The public debt ratio decreased to 29.4% of GDP. Last but not least, the average long-term interest rate amounted to 4.5% in March 2008 (year-on-year), when the reference value was set at 6.5%. That rate has in fact been below the reference value since Slovakia's EU accession in 2004.

Strengthening currency

The Slovak koruna has been part of the European Exchange Rate Mechanism (ERM) II since 26 November 2005. At that time the European Central Bank (ECB), in accordance with the Slovak authorities, set the central exchange rate parity at SKK 38.46 to the euro, with a ± 15% fluctuation band. Driven by robust economic growth and capital inflows, the central parity appreciated by 8.5% to SKK 35.44 against the euro by March 2007. With continuing improvements in the economic fundamentals as well as the Commission's recent approval for joining the eurozone, the koruna was hitting new highs against the euro almost every day. Upon the request of the Slovak administration, on 29 May the ECB appreciated the central parity by another tremendous 17.6% to SKK 30.13 to the euro. Nobody had expected that it would be set beyond the market level (31.11 SKK/EUR on 28 May). The currency immediately reacted to the new central parity by jumping to a new high of 30.08 SKK/EUR, before easing slightly. The standard fluctuation band of ± 15% continues to be observed around the central parity. Overall, the central rate of the SKK has appreciated by 27.6% within the past 30 months. The session of the EU finance ministers will announce the final conversion rate on 8 July.

Robust growth

In the first quarter of 2008 GDP grew by 8.7% year-on-year. Household consumption was the main driver behind the growth (8.4% y/y) based on strong wage growth (real wages rose by 6.2% y/y) and by higher employment. Foreign trade contributed less to GDP growth than earlier. The growth of gross industrial output eased and amounted to 6.8% in the first quarter of 2008 whereas industrial employment (LFS data) rose by some 2.7%; industrial labour productivity increased by about 4%.

With nominal wages up by some 8%, unit labour costs (ULCs) rose by about 4% in SKK terms and even more in EUR terms. Nevertheless, the competitiveness of Slovak tradable goods continues to rely on low wage rates as gross monthly wages averaged only some EUR 620 in the first quarter of 2008. Foreign investment enterprises in the automotive industry and in electrical & optical equipment are the most important driving forces of the Slovak economy. As agreed with the EU, Slovakia should shut down the second V1 reactor in the nuclear power station Jaslovské Bohunice at the end of this year. In order to avoid dependency on imported electricity, the Slovak administration is now looking for an opportunity to postpone the shutdown.

Potential risks after euro adoption

The crucial question is, why did the ECB agree to appreciate the Slovak exchange rate parity so massively? In recent months the EU administration has several times expressed concern about the sustainability of inflation convergence as the main challenge after Slovakia's joining the eurozone. A strong currency counteracts the inflation imported from global energy and agro-food markets. However, as of 1 January 2009 the entire burden of controlling the domestic inflation will shift to fiscal policy. At the same time, domestic and foreign price levels will converge due to inflation that is higher than in other euro countries. Despite massive appreciation, Slovakia will enter the eurozone with a price level amounting to just some 65% of the EU average. Also the government cheered the strong central parity, because wages converted to euro will be higher than otherwise – and the campaign for the 2010 parliamentary elections will start next year. Nevertheless, Slovakia will have the lowest average salary in the eurozone (slightly above EUR 700) as well as one of the lowest GDPs per capita (together with Portugal). At comparable productivity, wages and ULCs in Slovakia are still lower than in other Central European competitors (the Czech Republic, Hungary, Poland). However, this important comparative advantages is rapidly diminishing, as the real appreciation has been stronger than in these neighbour countries. Looking beyond next year, Slovakia will probably lose its low-cost advantages fairly soon.

The strong currency benefits importers and indirectly also consumers, while it puts exporters at a disadvantage. Slovakia is an open economy and a large part of its foreign trade is conducted with eurozone countries, in particular Germany. In fact, the strong currency may undermine domestic entrepreneurship, especially in small- and medium-sized enterprises. The pressure for rationalization will rise, with possibly negative effects on the domestic labour market. This phenomenon may be exacerbated by the diminishing attractiveness of jobs abroad as the wage gap in EUR terms has markedly declined, fuelled by the appreciating koruna and strong wage increases. All in all, the labour market will remain tight, Slovakia's external position will deteriorate and economic growth will slow down in the years to come.

Short- and medium-term prospects still rather bright

GDP growth will ease to 7.5% in 2008 and will slow down to some 6% later on. Domestic demand, with well above 5% growth, is likely to remain the main driving force of economic expansion in the coming years. Growth of gross fixed capital formation should remain robust at about 6%, supported by further FDI in the car and electronics industries and the subsequent arrival of related subcontractors. The annual harmonized consumer price index (HCPI) in 2008 will rise to 4%. Because of the strong conversion rate and weakening inflationary pressures in the food sector, the HCPI will ease somewhat in 2009. The general government deficit will stabilize at a level below 3% of the GDP by 2010. The foreign trade surplus will turn into a deficit owing to the very strong currency. In addition, increasing repatriation of profits by FDI companies as well as expanding domestic demand covered by imports will deteriorate the external position over the next years. Even so, Slovakia will remain among the fastest expanding economies in the European Union.

Table SK

Slovak Republic: Selected Economic Indicators

	2004	2005	2006	2007 1)	2007	2008	2008	2009	2010
					1st quarter			Forecast	
Population, th pers., mid-year	5382.6	5387.3	5391.2	5399.0	.	.	.	.	.
Gross domestic product, SKK bn, nom. 2)	1361.7	1485.3	1659.6	1851.8	418.9	472.5	2030	2200	2390
annual change in % (real) 2)	5.2	6.6	8.5	10.4	8.3	8.7	7.5	6	6
GDP/capita (EUR at exchange rate)	6317	7144	8264	10157	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	12360	13560	14990	17000	.	.	.	.	.
Gross industrial production									
annual change in % (real)	4.1	3.8	9.9	13.0	15.1	6.8	10	8	7
Gross agricultural production									
annual change in % (real)	5.6	-6.3	0.9	.	.	.	.	.	.
Construction industry									
annual change in % (real)	5.7	14.7	14.9	5.7	21.2	11.5	.	.	.
Consumption of households, SKK bn, nom. 2)	764.9	836.1	928.5	1020.1	242.6	273.8	.	.	.
annual change in % (real) 2)	4.2	6.5	5.9	7.1	6.3	8.4	7	6	6
Gross fixed capital form., SKK bn, nom. 2)	326.4	394.3	436.2	476.3	98.2	104.5	.		
annual change in % (real) 2)	4.8	17.6	8.4	7.9	11.0	2.4	6	6	5
LFS - employed persons, th, avg.	2170.4	2216.2	2301.4	2357.3	2326.6	2391.3	.	.	.
annual change in %	0.3	2.1	3.8	2.4	3.1	2.8	.	.	.
LFS - employed pers. in industry, th, avg.	641.3	649.1	666.4	690.9	687.1	705.7	.	.	.
annual change in %	1.1	1.2	2.7	3.7	5.2	2.7	.	.	.
LFS - unemployed, th pers., average	480.7	427.5	353.4	291.9	303.0	280.5	.	.	.
LFS - unemployment rate in %, average	18.1	16.2	13.3	11.0	11.5	10.5	10	10	9
Reg. unemployed, th pers, end of period	383.2	333.8	273.4	239.9	264.5	229.6	.		
Reg. unemployment rate in %, end of period	13.1	11.4	9.4	8.0	8.9	7.6	7	7	6
Average gross monthly wages, SKK 3)	15825	17274	18761	20146	18511	20443	.	.	.
annual change in % (real, gross)	2.5	6.3	3.3	4.3	4.2	6.2	5	.	.
Consumer prices, % p.a.	7.5	2.7	4.5	2.8	2.8	4.0	3.8	3.5	3.5
Producer prices in industry, % p.a.	3.4	4.7	8.4	2.0	3.4	4.9	4.5	4	4
General governm.budget, EU-def., % GDP 4)									
Revenues	35.4	35.3	33.5	34.7	.	.	.	.	.
Expenditures	37.8	38.1	37.2	36.9	.	.	.	.	.
Net lending (+) / net borrowing (-)	-2.4	-2.8	-3.6	-2.2	.	.	-2.5	-2.8	-3.0
Public debt, EU-def., in % of GDP 4)	41.4	34.2	30.4	29.4	.	.	.	.	.
Discount rate, % p.a., end of period	4.0	3.0	4.8	4.3	4.5	4.3	.	.	.
Current account, EUR mn 5)	-2656	-3268	-3127	-2920	-3	-91	-3500	-4400	-5500
Current account in % of GDP	-7.8	-8.5	-7.0	-5.3	0.0	-0.6	-5.4	-6.0	-7.0
Gross reserves of NB incl. gold, EUR mn	10954	13067	10145	12907	12437	12688	.	.	.
Gross external debt, EUR mn	17421	22705	24449	30156	26386	.	.	.	.
Gross external debt in % of GDP	49.6	57.9	50.9	54.7	.	.			
FDI inflow, EUR mn	2441	1952	3324	2387	-50	-184 I-II	2000	.	.
FDI outflow, EUR mn	-17	120	294	281	40	29 I-II	200	.	.
Exports of goods, BOP, EUR mn 5)	22248	25654	33099	42032	9803	11556	51000	58000	65000
annual growth rate in %	14.9	15.3	29.0	27.0	37.9	18.6	21	13	12
Imports of goods, BOP, EUR mn 5)	23485	27571	35120	42665	9752	11241	51000	59000	68000
annual growth rate in %	17.9	17.4	27.4	21.5	27.5	17.0	19	16	16
Exports of services, BOP, EUR mn 5)	3000	3542	4313	5130	1049	840 I-II	6000	6600	7300
annual growth rate in %	3.0	18.1	21.7	18.9	11.9	26.1 I-II	17	10	10
Imports of services, BOP, EUR mn 5)	2785	3285	3710	4742	1019	920 I-II	5700	6800	7800
annual growth rate in %	3.0	18.0	12.9	27.8	27.6	39.3 I-II	20	20	15
Average exchange rate SKK/USD	32.26	31.02	29.72	24.69	26.24	22.09	.	.	.
Average exchange rate SKK/EUR (ECU)	40.05	38.59	37.25	33.77	34.37	33.06	31.6	30.2	30.2
Purchasing power parity SKK/USD	17.23	17.20	17.13	17.05	.	.	.	.	.
Purchasing power parity SKK/EUR	20.47	20.33	20.53	20.17	.	.			

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) From 2006 including wages of armed forces. - 4) According to ESA'95, excessive deficit procedure. - 5) Calculated from USD.

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