

## **Slovakia: robust expansion backed by growing competitiveness**

In the election year 2002, GDP rose by 4.4%; the major contributory aspect was 5.4% growth in private consumption, mostly fuelled by strongly rising household incomes. In the current year, however, domestic demand is losing momentum in its role as the main driving force behind the economic expansion. After a break in 2002, the new government has resumed to increase regulated prices. That has resulted in higher inflation, lower real wages and finally in the weakening of private consumption. Rather unexpectedly, and despite the real currency appreciation, Slovakia has so far managed to maintain its high GDP growth, as foreign sales have risen significantly. The foreign trade deficit has considerably diminished, although the EU economy remains depressed. According to the GDP concept, the foreign trade balance (goods and services in real terms) in the first quarter of 2003 even shifted to a surplus, accounting for 2.2% of GDP. That contributed significantly to the GDP growth of 4.1% in the first quarter of the year. Growth in private consumption decelerated to 2.6%, while gross fixed capital formation dropped by 2%.

The most important supply-side contributor to the GDP growth was gross industrial production, with an expansion of 8.8% in the first four months of 2003. At the same time, labour productivity rose by about 9%, while real wages dropped by 2%. Consequently, the country's competitiveness has improved primarily on account of declining unit labour costs, despite the real appreciation of the Slovak koruna. Growth rates were highest in production of electrical and optical equipment (17.9%), rubber and plastic products (16.5%) and leather and leather products (15.0%). However, with 8.9% growth transport equipment, due to its high share, contributed most to the growth of manufacturing output. Car production (VW Bratislava) dominates this latter sub-sector, where sales soared by 51%. Mostly thanks to performance abroad, output of the construction sector was up 1.9% in the first four months of 2003.

The situation on the labour market is slowly improving. The registered unemployment rate fell to 15.4% at the end of April 2003. A part of the drop went on account of more rigorous registration rules. Furthermore, the relatively strongly expanding economy is absorbing more labour. Also the new green-field investments are gradually creating more jobs.

The postponement of price deregulation resulted in a historically low inflation rate of 3.3% in 2002. However, the growth in regulated prices of housing, energy, water and public transport at the beginning of 2003 is fuelling inflation. In the first five months of 2003, consumer prices rose by 7.6% compared to 4.2% in the corresponding period in 2002. The core inflation (which excludes items whose prices are regulated and the impact of changes

in taxation) amounted to 3.4%. Higher levies on fuels, beer and tobacco, taking effect on 1 July 2003, will additionally drive the inflation rate upward in the second half of the year.

The government deficit (including the costs of bank restructuring) accounted for more than 6% of GDP in the first quarter of 2003. The planned budget deficit for 2003, equivalent to less than 5% of GDP, will require greater fiscal prudence. The government is striving to fundamentally reform the tax system as of January 2004. The reform's main element is the introduction of a unified 19% rate for personal income tax, corporate profit tax, for income from capital and from other sources as well. Currently, the corporate tax amounts to 29%. In addition, companies would have free hand to decide on an own depreciation timetable for tax issues. The distribution of benefits from the personal income tax reform would be progressive in favour of higher incomes. The expected decline in revenues is to be compensated by unifying the current two-tier value added tax at the current upper rate of 20%. At the present time most goods and services are taxed at 14%. The impact on the 2004 budget is to be neutral. The administration believes that reducing corporate tax will stimulate stronger economic growth, stabilize budgetary revenues, and last but not least, attract more FDI, which would eventually bring additional growth impulses. However, in the first stage after introducing the reform, a part of the population may have to cope with lower real incomes (mostly due to higher taxation for staples), despite the envisaged compensation for socially weak groups. Another very important reform step to be implemented in the short run is the stabilization of budgetary expenditures, such as healthcare, pension system, education and public administration.

The foreign trade deficit was nearly halved in the first four months of 2003 as compared to the same period a year earlier. Exports were up 21%, whereas imports rose 13%. Remarkably, exports to Germany increased most, by more than 40%. Germany is the largest single trading partner, absorbing 31% of Slovak exports. With nearly 40% growth, car exports dominated. Supported by FDI, exports are gradually shifting to high-value-added branches such as manufacturing of transport, electrical and optical equipment, which together account already for 43% of merchandise exports. The smaller foreign trade deficit resulted in a lower current account deficit, equivalent to 1.8% of GDP in the first quarter of 2003: less than one third of the figure for the same period last year.

Total FDI inflows in 2002 amounted to USD 4 billion, the highest annual sum in Slovak history. The lion's share, USD 2.7 billion, was invested by Gaz de France and Ruhrgas in a 49% stake in the Slovak gas utility. By concluding the deal, the largest part of the Slovak privatization programme has been completed. Consequently, the desired enduring strong FDI inflow in the future can be achieved just by green-field investment. The tax reform mentioned above may contribute to attracting future FDI. In spring 2003, the French car maker PSA Peugeot Citroen started to build an auto factory with a final annual output capacity of 300,000 cars in the Trnava industrial park, some 40 kilometres northeast of

Bratislava. Total FDI into this project, creating at least 3000 new jobs, is to amount to EUR 0.7 billion by 2006.

Thanks to the export expansion, GDP will grow by 4% in 2003. The expected upturn in EU demand may accelerate export growth in 2004. Furthermore, domestic demand will also increase. Thus, for 2004 we expect higher GDP growth (5%). The inflation rate will exceed 8% this year due to the above-mentioned price and tax adjustments. The current account deficit will decrease substantially, to 3% of GDP in 2003 and to 2% in 2004. Simultaneously, the external position benefits from the weak US dollar that relieves the negative trade balance in fuels.

Slovakia's small open economy is certainly very dependent on foreign capital and external relations in general. Accession to the EU will affect the country in many ways. While backward regions of Northern, Southern and Eastern Slovakia will benefit from an inflow of EU structural funds, Bratislava is in the best shape to take advantage of opportunities offered by the large EU market. The best scenario is that expanding exports backed by a rising number of FDI enterprises will gradually emerge as the main driving force of GDP growth. The country appears attractive to foreign investors mostly due to its abundance of cheap, skilled and disciplined labour force, good transport networks, etc. Slovak policy makers will be challenged to find the middle ground between rising, or at least sustainable, competitiveness and possible social hardships.

Table SK

## Slovak Republic: Selected Economic Indicators

	1998	1999	2000	2001	2002 <sup>1)</sup>	2002 1st quarter	2003	2003 forecast	2004 forecast
Population, th pers., mid-year	5390.7	5395.3	5400.7	5379.8	5378.6	.	.	.	.
Gross domestic product, SKK bn, nom.	775.0	835.7	908.8	989.3	1073.6	244.8	268.4	1170	1280
annual change in % (real)	4.0	1.3	2.2	3.3	4.4	3.9	4.1	4	5
GDP/capita (USD at exchange rate)	4080	3740	3642	3804	4403	.	.	.	.
GDP/capita (USD at PPP - wiiw)	11070	11430	11280	12030	12820	.	.	.	.
Gross industrial production									
annual change in % (real)	5.0	-2.7	8.6	6.9	6.5	1.1	11.0	8	8
Gross agricultural production									
annual change in % (real)	-5.9	-2.5	-12.3	8.2	.	.	.	.	.
Goods transport, mn t-kms	17808	19996	19829	18501	18182	4070	4074	.	.
annual change in %	0.8	12.3	-0.8	-6.7	-1.7	.	0.1	.	.
Gross fixed capital form., SKK bn, nom.	280.9	252.9	267.9	309.6	319.8	68.4	69.9	.	.
annual change in % (real)	11.0	-18.5	1.2	9.6	-0.9	-0.8	-2.0	3	7
Construction industry									
annual change in % (real)	-3.5	-25.8	-0.4	0.8	4.1	-3.4	3.0	.	.
Dwellings completed, units	8234	10745	12931	10321	14213	2763	2239	.	.
annual change in %	14.8	30.5	20.3	-20.2	37.7	16.6	-19.0	.	.
Employment total, th pers., average <sup>2)</sup>	2198.6	2132.1	2101.7	2123.7	2127.0	2104.6	2130.8	.	.
annual change in %	-0.3	-3.0	-1.4	1.0	0.2	0.2	1.2	.	.
Employment in industry, th pers., average <sup>2)</sup>	662.5	630.3	615.3	628.8	640.9	640.8	637.2	.	.
annual change in %	-0.5	-4.9	-2.4	2.2	1.9	2.2	-0.6	.	.
Reg. unemployed, th pers., end of period	428.2	535.2	506.5	533.7	504.1	546.3	478.7	.	.
Reg. unemployment rate in %, end of period	15.6	19.2	17.9	18.6	17.5	19.1	16.5	17	16
LFS - unemployment rate in %, average	12.5	16.2	18.6	19.2	18.5	19.4	18.4	18	17
Average gross monthly wages, SKK	10003	10728	11430	12365	13511	12287	13082	.	.
annual change in % (real, gross)	1.7	-2.8	-4.5	0.8	5.8	3.7	-1.0	.	.
Retail trade turnover, SKK bn <sup>3)</sup>	379.4	442.1	481.1	301.1	328.0	75.1	72.2	.	.
annual change in % (real)	8.6	9.8	2.3	4.5	5.8	5.9	-6.3	.	.
Consumer prices, % p.a.	6.7	10.6	12.0	7.1	3.3	4.7	7.6	8	7
Producer prices in industry, % p.a.	3.3	4.3	10.8	6.5	2.1	2.1	8.5	.	.
Central government budget, SKK bn									
Revenues	177.8	216.7	213.5	205.4	220.4	47.9	46.4	.	.
Expenditures	197.0	231.5	241.1	249.7	272.0	63.1	64.2	.	.
Deficit (-) / surplus (+)	-19.2	-14.8	-27.6	-44.4	-51.6	-15.2	-17.8	.	.
Deficit (-) / surplus (+), % GDP	-2.5	-1.8	-3.0	-4.5	-4.8	-6.2	-6.6	.	.
Money supply, SKK bn, end of period									
M1, Money	147.2	153.9	187.2	228.5	246.1	210.3	240.9	.	.
M2, Money + quasi money	466.1	523.6	601.5	680.3	713.7	666.0	710.3	.	.
Discount rate, % p.a., end of period	8.8	8.8	8.8	8.8	6.5	7.8	6.5	.	.
Current account, USD mn	-1982	-980	-702	-1746	-1939	-312.4	-126.2	-900	-700
Current account in % of GDP	-9.0	-4.9	-3.6	-8.5	-8.2	-6.1	-1.8	-2.9	-2.0
Gross reserves of NB incl. gold, USD mn <sup>4)</sup>	2923	3425	4077	4189	9196	4735	9758	.	.
Gross external debt, USD mn	11900	10518	10804	11043	13188	11200	13811	.	.
Exports total, fob, EUR mn <sup>5)</sup>	9540.6	9602.2	12879.5	14115.4	15252.3	3401.6	4207.3	16800	18000
annual growth rate in %	11.9	0.6	34.1	9.6	8.1	-0.4	23.7	10	7
Imports total, fob, EUR mn <sup>5)</sup>	11634.7	10627.7	13859.8	16487.8	17515.2	3860.5	4359.1	18000	18800
annual growth rate in %	12.3	-8.7	30.4	19.0	6.2	0.5	12.9	3	4
Average exchange rate SKK/USD	35.24	41.42	46.20	48.35	45.34	48.17	38.96	37.7	37.3
Average exchange rate SKK/EUR (ECU)	39.60	44.12	42.59	43.31	42.70	42.24	41.80	41.5	41
Purchasing power parity SKK/USD, wiiw	12.99	13.55	14.92	15.28	15.57	.	.	.	.
Purchasing power parity SKK/EUR, wiiw	14.07	14.77	15.48	15.94	16.17	.	.	.	.

Notes: 1) Preliminary. - 2) Based on Labour Force Survey. - 3) From 2001 according to NACE, excluding VAT. - 4) From January 2002 new valuation of gold. - 5) Converted from the national currency to EUR at the official exchange rate; from 1998 new methodology.

Source: wiiw Database incorporating national statistics; wiiw forecasts.