Zdenek Lukas

Slovakia:
Despite export-driven growth, high unemployment will persist

The recovery observed in the Slovak economy already in the first half of 2010 continued in the second half of the year. The GDP expanded by 4% in 2010 and the country returned on the path of fairly strong economic growth, in fact the highest among the EU countries. The economic expansion has basically been the result of the revival in external demand supported by improved competitiveness. As a result, the contribution of foreign trade to GDP growth was again positive, albeit lower than in 2009. The earlier contraction in aggregate demand, in the wake of the global financial and economic crisis and concerns about the future, had slashed inventories at the end of 2008 and in 2009. However, already during 2010 inventories were on the rise again. While gross capital formation expanded by above 10%, gross fixed capital formation rose only modestly (1%). In total, the economic growth in 2010 was mostly driven by an ongoing recovery in external demand and by a gradual rebuilding of inventories. Rising unemployment impaired the purchasing power of households and provoked consumers' caution.

As in other eurozone countries, the weakening of the euro had a positive impact on the economy, in particular as compared to other non-euro Visegrad countries (V-3). Among those, the Czech Republic is Slovakia's second most important trading partner after Germany, with a share of about 14% in total Slovak exports. Poland and Hungary each account for 7% of total Slovak exports. All in all, the V-3 countries account for 28% of the total Slovak exports. In 2010 the euro depreciated on average compared to 2009 by 5% year-on-year against the Czech koruna, by 2% against the Hungarian forint and by 8% against the Polish zloty. The euro depreciation against a basket of currencies had also boosted the competitiveness of Slovak tradable goods in other markets outside the euro area (totally one-half of exports). Thanks to the above mentioned euro depreciation, exports to the Czech Republic and Poland expanded by some 30% and 27% respectively in 2010, while total exports rose by just around 20%. At the same time, the trade surplus with the V-3 countries expanded from EUR 3.2 billion to above EUR 4.5 billion. Apart from the depreciation, the exports were also boosted by impressive productivity gains in manufacturing (implying falling unit labour costs) and low producer prices as well. A considerable deterioration in labour market was the dark side of rising export

competitiveness. However, since the second quarter of 2010, signs of a very slow recovery appeared with unemployment declining moderately and employment rising slightly. The increase in the number of those active in industry, construction, transport, administration and health service has somewhat relieved the pressure on the labour market.

Recovering external demand and rising competitiveness boosted growth in gross industrial output which expanded by nearly 20% in 2010. As a result, industrial production returned to the pre-crisis level. As in the past, foreign-owned enterprises in the automotive industry are the most important driving force of the economy. Expanding by 40% in 2010, the car output recovered significantly faster and more strongly than expected. Growth was exclusively export-driven as the amount of light vehicles (cars under 3.5 tonnes) nearly registered in Slovakia dropped by 22% in 2010. Above average growth was also recorded for machinery (48%), pharmaceutical products, electronic and optical equipments (both up by 23%). As opposed to industry, construction output continued to fall (by 5%) in 2010. However, the sector was slightly up in the last quarter of the year. Prospects are encouraging as highway construction (supported by EU transfers) could provide an important impetus to the construction industry.

Following outflows in 2009, foreign direct investments in Slovakia have not yet fully recovered. Most foreign investors repatriated the bulk of the profits abroad and just few of them reinvested their earnings in Slovakia. A number of investors had left the country in the last two years, with the consequences that investment was curbed, postponed or redirected to other more attractive destinations. Despite recovering economy, there is still not much room for a revival of FDI due to unused production capacities. Nevertheless, this year VW is starting production of the new small family car models in Slovakia and will invest here EUR 300 million. Besides, 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 plant. This – the biggest – private investment in Slovakia (totalling EUR 2.7 billion) is to be spent up until 2013. Due to the lack of domestic R&D expenditure, the FDI are the basic source of modernization and new technologies in the country. Financial support of R&D activities in the Slovak Republic is among the lowest in the EU.

The new centre-right government (in power since June 2010) cut the public-private partnership (PPP) projects prepared by the previous government to construct highways in Slovakia, arguing that these procedures would be too expensive. The new highway construction project is in the pipeline. In addition, the government is re-opening the door to strategic partners in selected companies with state participation. The ones most frequently

mentioned are the Rail Freight Transport ZSSK Cargo and the Bratislava Airport. (The latter was on the privatization agenda already in spring 2006.)

The present government inherited public finances in a very bad state. As budgetary expenditures rose faster than revenues, the general government deficit amounted to 8% of GDP in 2010. Despite the programme of medium-term fiscal stabilization, the costs of debt services are on the rise. Public debt 42% of GDP at the end of 2010. Gross external debt amounted to 74% of the GDP. The increase in the level of external debt is not surprising given the fact that the country is still recording current account deficits. The government intends to consolidate the budget through a mix of expenditure cuts and revenue enhancements. Budgetary revenues are to be supported by an increase of the VAT rate (from 19% to 20%). More money should be collected also by hiking excise taxes on tobacco and beer. In addition, the cancellation of many tax exemptions (mostly for craftsmen) should bring additional revenues. On the expenditure side, the budget of the ministries and other governmental agencies is to be cut by about 10% in 2011. The programme (taking effect in 2011) aims at gradually cutting the general government deficit to 3% of GDP by 2013. The higher VAT level is meant to be only temporary and should be eliminated after reaching that target. The government has not introduced sufficient structural measures aimed at long-term savings in budgetary expenditures. There are concerns, especially related to the long-term sustainability of the pension system (due to the ageing population and cuts in the private pillar of the pension system) and rising unemployment benefits. Past experience has shown that only several years of strong GDP growth have an effect on employment. Slovak cabinet approved a budget draft that envisages a general government budget deficit of 4.9% of the GDP in 2011. The envisaged cut in the deficit over the next three years is very large. The higher tax burden might undermine fragile growth prospects. Comprehensive reforms aimed at reducing public spending have not been on the agenda so far.

Driven by increasing confidence in industry and in trade, the economic sentiment indicator was up by 12 points in January 2011 year-on-year and so roughly reached the long-term average. It seems that there is sustained optimism in the ongoing recovery. As the companies expect continuing strong demand for the country’s exports, stocks are being rebuilt. The expected recovery in FDI will be modest as there are better places to invest in the world (such as Asia or Latin America). As for sustainable economic growth in the future, the crucial point is to avoid any measures that would threaten Slovakia’s regained competitiveness and thus might undermine its competitive position particularly within the EU. If the euro remains weak and Slovak productivity gains (low unit labour costs) persist, the GDP may continue to maintain growing by some 4% in 2011 and 2012. However, the

economic growth powered by massive consumption appetite will not return to the high rates seen a few years ago, as long-term debt burdens will damp demand and the whole international environment has also changed. The current account deficit and public debt will rise slightly over the forecast period. The main challenges for the government relate to fiscal consolidation, high unemployment and last but not least cronyism and corruption. The long-term sustainable economic growth will call for Slovakia to expand its own R&D activities.

Table SK

Slovakia: Selected Economic Indicators

	2005	2006	2007	2008	2009	2010 [1]	2011	2012	2013
								Forecast	
Population, th pers., average	5387.0	5391.4	5397.3	5406.6	5418.6	5430	5440	5450	5440
Gross domestic product, EUR mn, nom.	49314.2	55080.9	61555.0	67007.3	63050.7	66200	69500	73000	78200
annual change in % (real)	6.7	8.5	10.6	5.8	-4.8	4	4	4	5
GDP/capita (EUR at exchange rate)	7100	8300	10200	11900	11600	12200	12800	13400	14400
GDP/capita (EUR at PPP)	13500	15000	17000	18100	17200	18100	.	.	.
Consumption of househ., EUR mn, nom.	27823.8	30891.1	33902.0	37604.3	37714.3	38100	.	.	.
annual change in % (real)	6.5	5.9	6.9	6.1	0.3	0	2	3	5
Gross fixed capital form., EUR mn, nom.	13089.5	14588.8	16096.5	16575.9	12991.1	13300	.	.	.
annual change in % (real)	17.5	9.3	9.0	1.0	-19.9	1	5	8	8
Gross industrial production									
annual change in % (real)	0.8	15.7	17.0	3.3	-13.8	18.8	8	8	6
Gross agricultural production									
annual change in % (real)	-8.7	-2.9	-4.5	10.6	-12.3	-9.9	.	.	.
Construction industry									
annual change in % (real)	14.7	14.9	5.7	11.9	-11.2	-4.6	.	.	.
Employed persons - LFS, th, average	2215.2	2302.3	2357.7	2433.7	2366.3	2300	2320	2340	2360
annual change in %	2.1	3.9	2.4	3.2	-2.8	-3	1	1	1
Unemployed persons - LFS, th, average	430.0	355.4	295.7	255.7	323.5	400	.	.	.
Unemployment rate - LFS, in %, average	16.3	13.4	11.1	9.5	12.0	14.8	14	13	12
Reg. unemployment rate, in %, end of period	11.4	9.4	8.0	8.4	12.7	12.5	12	11	10
Average gross monthly wages, EUR [2]	573	623	669	723	745	765	.	.	.
annual change in % (real, gross)	6.3	3.9	4.4	3.4	1.4	2	3	.	.
Consumer prices (HICP), % p.a.	2.8	4.3	1.9	3.9	0.9	0.7	2	3	3
Producer prices in industry, % p.a.	3.4	3.0	-1.4	2.5	-6.6	0.1	1	2	2
General governm.budget, EU-def., % GDP									
Revenues	35.2	33.4	32.5	32.9	33.6	32	32.6	32.4	.
Expenditures	38.0	36.6	34.3	35.0	41.5	40	38.0	37.4	.
Net lending (+) / net borrowing (-)	-2.8	-3.2	-1.8	-2.1	-7.9	-8	-5.4	-5.0	-4.5
Public debt, EU-def., in % of GDP	34.2	30.5	29.6	27.8	35.4	42.1	45.1	47.4	47
Central bank policy rate, % p.a., end of period [3]	3.0	4.8	4.3	2.5	1.0	1.0	.	.	.
Current account, EUR mn	-3268	-3636	-2912	-4279	-2023	-2000	-3200	-3600	-4000
Current account in % of GDP	-8.5	-8.2	-5.3	-6.6	-3.2	-3.0	-4.6	-4.9	-5.1
Exports of goods, BOP, EUR mn	25654	33349	42260	47722	39715	48500	51000	54000	56000
annual growth rate in %	15.3	30.0	26.7	12.9	-16.8	22	6	5	4
Imports of goods, BOP, EUR mn	27571	35817	42916	48435	38528	48000	51000	54000	56000
annual growth rate in %	17.4	29.9	19.8	12.9	-20.5	25	7	5	4
Exports of services, BOP, EUR mn	3542	4322	5140	5796	4522	4340	4800	5400	6200
annual growth rate in %	18.1	22.0	18.9	12.8	-22.0	-4	10	12	15
Imports of services, BOP, EUR mn	3285	3790	4751	6269	5768	5200	5700	6400	7400
annual growth rate in %	18.0	15.4	25.4	32.0	-8.0	-10	10	12	15
FDI inflow, EUR mn	1952	3311	2636	2395	-35	-100	1000	1500	2000
FDI outflow, EUR mn	120	292	441	177	311	100	400	500	500
Gross reserves of NB excl. gold, EUR mn [4]	12567	9639	12280	12674	481	550	.	.	.
Gross external debt, EUR mn	22705	24449	30156	37286	45338	49000	.	.	.
Gross external debt in % of GDP	57.9	50.7	54.6	55.6	71.9	74.0	.	.	.
Average exchange rate EUR/EUR	1.2813	1.2359	1.1211	1.0377	1.0000	1.0000	1	1	1
Purchasing power parity EUR/EUR	0.6759	0.6814	0.6720	0.6835	0.6753	0.6746	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2.

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

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