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Slovakia: domestic demand boosts growth

Despite mediocre growth in the EU, the Slovak economy has been growing robustly over the past four years. However, in the second half of 2004 the former main driving force of economic expansion, exports, lost momentum and the high growth of imports of investment goods exceeded the export expansion. In addition, growing private consumption has supported imports of consumer goods. In 2005, just as in the year before, Slovakia has remained to be among the NMS with the fastest growing economies. Driven by domestic demand, GDP grew by 5.1% in the first quarter of 2005. Private consumption expanded by 5.5% and gross fixed capital formation by 5.8%, accompanied however by rising inventories. Foreign trade contributed negatively to overall GDP growth, as a result of real appreciation by some 7% in euro terms and rising unit labour costs.

Private consumption has been predominantly driven by wage rises due to pre-election populism; wage increases in foreign investment enterprises have encouraged overall wage and personal income growth as well. All in all, in the first months of 2005 wages expanded faster than labour productivity in all important sectors except construction. Falling interest rates have also supported private consumption. As a result, the increased purchasing power due to expanding wages coupled with higher borrowing may overheat the economy.

Gross industrial output nearly stagnated (0.3%) in the first quarter of 2005, while industrial employment, according to Labour Force Survey (LFS) data, rose by 2.4%: industrial labour productivity dropped by 2%. Along with the nominal wage growth by 12.2% this resulted in rising unit labour costs.[1] The stagnation in total industrial production is first of all related to the 11% output decline registered by VW Bratislava in the first quarter of 2005, as against massive growth in the same period a year earlier. Otherwise, foreign investment industrial companies, mostly operating in metallurgy, machinery & equipment and electrical & optical equipment, reported an output expansion by around 7% in the first quarter of 2005. Labour productivity in these FDI-dominated and export-oriented sectors rose and the increase in unit labour costs here was less pronounced than in other sectors.

The relatively robust expansion of the economy has been reflected in rising employment. Following stagnation in 2004, employment (LFS) rose by 2.3% in the first quarter of 2005. At the same time, the unemployment rate (LFS) dropped by 1.8 percentage points to 17.5% and new foreign greenfield investment has already created more new jobs.

1 Among other factors, rising industrial employment has been associated with new green-field investments, which will start production later on. Consequently, this is leading to a temporary fall in labour productivity in industry.

Moreover, a number of revisions in labour regulations in the past, targeted at more flexibility in the labour market, may have yielded positive results.

The general government budget deficit dropped by 0.4 percentage points to 3.3% of GDP in 2004. It seems that the good budget performance is related to the flat (19%) tax rate introduced at the beginning of 2004, which reduced tax evasion and improved tax collection. However, the budget deficit did not include the amount of SKK 24.7 billion, about 1.9% of GDP, that had to be paid to the Czech bank Československá Obchodní Banka AS as a result of a court decision. At the beginning of 2005, the reform of the pension system also introduced a privately managed second pillar based on personal accounts. As a result, the publicly managed first pillar will be driven into deficit. Despite these liabilities, the Slovak government has confirmed its target to reduce the budget deficit to 3% of GDP soon and to adopt the euro by 2009.

After a fall to EUR 0.6 billion in 2003, FDI inflows recovered to EUR 0.9 billion in 2004. As a result of EU membership, the low corporate tax rate, the rising number of industrial parks and the improved business climate, foreign investors are increasingly looking towards Slovakia.[2] The greatest number of investors has targeted the car and electro-technical industries as well as services. The largest projects are expected in the coming years thanks to two new car factories (PSA Peugeot-Citroen and KIA Hyundai), both located in Western Slovakia. If the two projects are fully realized as agreed in the deals with the Slovak government, they would bring in investments of some EUR 1.5 billion, create 10,000 new jobs and produce over 500,000 cars by 2007. As foreign investors are focusing on the country's more developed western regions, the eastern parts of the country with high unemployment are falling behind. So far, only the German automobile gear box manufacturer Getrag Ford has announced to invest a larger sum (EUR 300 million by 2006) in the poorer regions in the East. On 5 May 2005 the Korean tyre maker Hankook Tyre announced to build a new tyre facility in Levice (over 100 kilometres east of the capital Bratislava) with planned investments totalling EUR 510 million and creating some 1600 new jobs. For this year we expect a recovery of the FDI inflow thanks to the above large-scale projects and on account of the privatization of 66% stake in the power utility Slovenské elektrárne, which is finally taking shape. The latter should be acquired by the Italian company Enel for over EUR 800 million, probably in the second half of 2005. As a result, the total FDI inflow may reach some EUR 2 billion in 2005.

Backed by rising private demand and the strong investment expansion, GDP growth will remain high and reach about 5.5% in 2005. In 2006 GDP growth may even accelerate, additionally fostered by pre-election demand stimulation and by gradually rising industrial

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[2] Some investors (e.g. Hankook Tyre from Korea) are asking for incentives, which may not be compatible with EU regulations.

output, particularly related to FDI in car manufacturing. The inflation rate may go down further, if the gap between the increase in labour productivity and the growth in real incomes were diminishing. The current account deficit, at 3.5% of GDP in 2004, will rise this year, due to increasing repatriation of profits by FDI companies. In addition, the still strong Slovak koruna and recovering domestic demand will boost imports and temporarily hold back exports.

Table SK

Slovak Republic: Selected Economic Indicators

	2000	2001	2002	2003	2004 [1]	2004	2005	2005	2006
						1st quarter		forecast	
Population, th pers., mid-year	5400.7	5379.8	5378.6	5378.8	5382.2	.	.	.	.
Gross domestic product, SKK bn, nom.	934.1	1009.8	1098.7	1201.2	1325.5	308.7	332.5	1450	1580
annual change in % (real)	2.0	3.8	4.6	4.5	5.5	5.4	5.1	5.5	6
GDP/capita (EUR at exchange rate)	4061	4334	4784	5382	6149	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	9460	10050	10880	11180	12040	.	.	.	.
Gross industrial production									
annual change in % (real)	8.4	7.6	6.7	5.3	4.2	6.5	0.3	4	7
Construction industry									
annual change in % (real)	-0.4	0.8	4.1	6.0	5.7	2.5	12.5	.	.
Consumption of households, SKK bn, nom.	519.6	577.5	624.5	667.5	738.7	176.3	191.4	.	.
annual change in % (real)	-0.9	4.9	5.5	-0.8	3.5	3.0	5.5	5	6
Gross fixed capital form., SKK bn, nom.	242.3	291.0	303.5	308.4	327.2	68.2	74.4	.	.
annual change in % (real)	-7.2	13.9	-0.6	-1.5	2.5	0.9	5.8	7	10
LFS - employed persons, th, avg.	2101.7	2123.7	2127.0	2164.6	2170.4	2128.8	2177.4	.	.
annual change in %	-1.4	1.0	0.2	1.8	0.3	-0.1	2.3	.	.
LFS - employed pers. in industry, th, avg.	615.3	628.8	640.9	634.1	641.3	626.8	642.0	.	.
annual change in %	-2.4	2.2	1.9	-1.1	1.1	-1.6	2.4	.	.
LFS - unemployed, th pers., average	485.2	508.0	486.9	459.2	480.7	511.5	461.9	.	.
LFS - unemployment rate in %, average	18.6	19.2	18.5	17.4	18.1	19.3	17.5	17	16
Reg. unemployment rate in %, end of period	17.9	18.6	17.5	15.6	13.1	16.0	12.7	11	10
Average gross monthly wages, SKK	11430	12365	13511	14365	15825	14541	16022	.	.
annual change in % (real, gross)	-4.5	0.8	5.8	-2.0	2.5	2.7	7.2	.	.
Consumer prices, % p.a.	12.0	7.1	3.3	8.5	7.5	8.3	2.8	3	2.5
Producer prices in industry, % p.a.	10.8	6.5	2.1	8.3	3.4	2.9	2.5	3	2
General governm.budget, EU-def., % GDP [2]									
Revenues	47.6	45.5	45.2	35.4	35.1	.	.	.	.
Expenditures	59.8	51.5	50.8	39.2	38.5	.	.	.	.
Deficit (-) / surplus (+)	-12.3	-6.0	-5.7	-3.7	-3.2	.	.	-3.7	-4.0
Public debt in % of GDP [2]	49.9	48.7	43.3	42.6	43.6	.	.	44.2	44.9
Discount rate, % p.a., end of period	8.8	8.8	6.5	6.0	4.0	5.5	3.0	.	.
Current account, EUR mn	-761	-1950	-2043	-244	-1166	99	-138	-1800	-1700
Current account in % of GDP	-3.5	-8.4	-7.9	-0.8	-3.5	1.3	-1.6	-4.7	-4.0
Gross reserves of NB incl. gold, EUR mn [3]	4391	4748	8824	9717	10954	10019	13928	.	.
Gross external debt, EUR mn [4]	11637	12516	12655	14654	17404	14321	21724	.	.
FDI inflow, EUR mn	2089	1768	4397	506	891	276 I-II	34 I-II	.	.
FDI outflow, EUR mn	23	39	5	20	-122	-1 I-II	12 I-II	.	.
Exports of goods, BOP, EUR mn [5]	12879	14115	15270	19359	22354	4954	5580	25100	29400
annual growth rate in %	34.1	9.6	8.2	26.8	15.5	.	12.6	12	17
Imports of goods, BOP, EUR mn [5]	13860	16488	17517	19924	23526	4959	5844	27500	31700
annual growth rate in %	30.4	19.0	6.2	13.7	18.1	.	17.8	17	15
Exports of services, BOP, EUR mn	2436	2779	2958	2912	3001	458 I-II	525 I-II	.	.
annual growth rate in %	25.8	14.1	6.4	-1.5	3.0	.	14.7	.	.
Imports of services, BOP, EUR mn	1961	2244	2474	2703	2771	437 I-II	476 I-II	.	.
annual growth rate in %	13.2	14.5	10.3	9.2	2.5	.	9.1	.	.
Average exchange rate SKK/USD	46.20	48.35	45.34	36.77	32.26	32.43	29.16	.	.
Average exchange rate SKK/EUR (ECU)	42.59	43.31	42.70	41.49	40.05	40.58	38.28	38.0	37.0
Purchasing power parity SKK/USD	16.06	16.29	16.21	17.02	17.21	.	.	.	.
Purchasing power parity SKK/EUR	18.35	18.75	18.85	20.05	21.15	.	.	.	.

Notes: 1) Preliminary. - 2) According to ESA'95, excessive deficit procedure. - 3) From January 2002 new valuation of gold. - 4) Up to 2002 wiiw calculated from USD, from 2003 original data in EUR. - 5) Quarterly data refer to trade excluding value of goods for repair.

Source: wiiw Database incorporating national statistics; Eurostat; EU Economic Forecasts, Spring 2005; wiiw forecasts.