SLOVAKIA: Domestic demand taking over export drive

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In the course of the current year, domestic demand has been taking over the role of the main engine of growth in Slovakia; it is expected to continue as such over the next two years. Growing household consumption will foster import growth, while global uncertainties will restrain export growth. The contribution of net exports will thus turn negative. For this and the next two years to come, we expect the GDP to grow by about 2.5% annually.

After sluggish growth in 2013, Slovak GDP rose quite dynamically in the first half of 2014, by 2.5%, and growth was also stable over the two quarters. The main growth driver was – in contrast to the former three years – domestic demand. Household consumption increased by 3.1% in the first half of 2014, thanks to improving conditions on the labour market and growing wages. Average real wages surged by 4.5%, the largest increase since 2007. This was due to practically zero inflation. Also public consumption went up by almost 5%. Gross capital formation surged by 13%, of which gross fixed capital formation increased by 5% (here strong growth rates were recorded for intangible fixed assets and 'other machinery and equipment'). On the other hand, the importance of net exports weakened: exports of goods and services rose by 6% but imports by even 8%. While goods exports to Germany (Slovakia's main trading partner) increased by 8% in the first half of 2014, exports to the Czech Republic (the second largest trade partner) declined by 3%. Exports to Russia (ranking 9th and accounting for 4% of goods exports but for 10% of imports) continued declining, by 7%, after a fall of 3% in 2013.

Looking at sectoral developments, industrial production grew by close to 6% in the first seven months of the year. The automotive industry – the largest sector of the Slovak economy – contributed most to the growing manufacturing performance, followed by basic metals and fabricated metal products, the electrical equipment industry as well as other manufacturing. Output of construction continued declining by almost 3% over the first seven months. Conversely, value added of services grew again.

On the labour market, where developments generally lag behind those in the real economy, trends were quite positive: Employment increased by 0.6% in the first half of 2014, the unemployment rate (LFS) dropped from 14.2% to 13.6%. However, this is still substantially higher than in most other EU countries and constitutes one of the major problems in Slovakia. In particular, the large share of long-term unemployed and the high youth unemployment, together with strong regional disparities, are of major concern. The minimum wage may rise by 8% next year (reaching EUR 380), which is a strong increase compared to previous years when it typically rose between 3% and 4%.

In 2013, the budget deficit fell to 2.8% of GDP and thus the EU's excessive deficit procedure against Slovakia was abrogated in June. It had been stipulated that the VAT rate should go down again from 20% to 19% when the budget deficit sinks below 3%, but the government kept the higher rate. For the next years, the deficit targets are set at 2.5% in 2015, 1.6% in 2016 and 0.5% in 2017 (as laid down in the Stability Programme from April 2014). However, further efforts are needed to reach these targets. The public debt level climbed to 55.4% of GDP in 2013, thus surpassing the 55% threshold of the debt-brake law.[1] The minister of finance thus needs to reduce the current year's state budget expenditures by 3% (with specified exemptions). It is expected that the debt level will remain below 57%, as this denotes the next threshold which would imply that the government is to submit a balanced general government budget. After selected changes in the government in July, former independent economy minister Malatiný was replaced by Pavol Pavlis, whose priority task is to seek foreign investment.

The Slovak banking sector, which is largely in foreign ownership, is stable and in good shape. In 2013, profitability increased and the capital adequacy ratio went up to 17.2% (end of 2013). Thus, there is no cause for concern over the forthcoming ECB stress test (results to be released at end of October). With the Single Supervisory Mechanism becoming effective in November this year, about 70% of Slovak banks will come under the direct supervision of the European Central Bank. While loans to households increased strongly in 2013, by 10%, loans to non-financial corporations grew only by 1.7%. In the second quarter of 2014, credit growth accelerated to 11.6% for households and 2.4% for non-financial corporations.

The wiiw forecast for 2014 is quite optimistic: we expect the Slovak GDP to grow by 2.4%, just as in our previous forecast. Domestic demand will be the main growth driver, while the contribution of net exports may turn negative. Growing household consumption will foster import growth, whereas global uncertainties will contain export growth. In general, the economic sentiment indicator showed a stop-and-go pattern in the first half of 2014: While it was stable from January to April, it grew between May and July but remained unchanged again in August. Nevertheless, new orders in main industrial sectors plummeted in July. For the next two years, we have revised our growth forecast downward and now assume GDP to grow by 2.5% in 2015 and 2.6% in 2016. This is because of less dynamic trade developments in the coming years, due to less growth expected globally. Domestic demand will be the main contributor to growth. However, with tensions increasingly growing worldwide and growth remaining sluggish in Europe, risks remain on the downside. Slovakia's links with Russia pose two risks: First, Slovakia imports gas from Russia almost exclusively via Ukraine, thus a possible interruption of gas supplies from Russia would have negative effects. Second, on the export side, possible future Russian counter measures to EU sanctions might hit Slovakia hard. Motor vehicles constitute the most important export products from Slovakia to Russia. Overall, however, Russia is only the 7th largest market for Slovak car exports (6% of total car exports): exports are focused mainly on Germany, the United Kingdom, China and France, which together account for half of Slovakia's car exports, while Italy and the United States take another 6% each, not taking into account indirect effects.

[1] Adopted in 2011, the fiscal responsibility law includes, amongst other things, a debt rule with various thresholds for the debt level and sanctions if surpassed.

Table 1 / Slovakia: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013	2014	2014	2015	2016
					January-June			Forecast	
Population, th pers., average 2)	5,391	5,398	5,408	5,413	5,411	5,417	5,420	5,430	5,440
Gross domestic product, EUR mn, nom.	65,897	68,974	71,096	72,134	34,746	35,403	74,000	77,000	81,000
annual change in % (real)	4.4	3.0	1.8	0.9	0.7	2.5	2.4	2.5	2.6
GDP/capita (EUR at exchange rate)	12,100	12,800	13,100	13,300	.	.	13,700	14,200	14,900
GDP/capita (EUR at PPP)	18,300	18,900	19,400	19,700	.	.	.	.	.
Consumption of households, EUR mn, nom.	37,757	39,025	40,307	40,821	20,145	20,626	.	.	.
annual change in % (real)	-0.7	-0.5	-0.2	0.0	-0.3	3.1	2.0	3.0	3.5
Gross fixed capital form., EUR mn, nom.	13,851	15,957	14,298	13,761	6,050	6,345	.	.	.
annual change in % (real)	6.5	14.3	-10.5	-4.3	-6.2	5.0	3.0	4.0	4.5
Gross industrial production									
annual change in % (real)	8.2	5.3	7.9	4.9	2.1	6.0	4.0	3.0	3.0
Gross agricultural production									
annual change in % (real)	-8.2	8.7	-5.7	2.0	.	.	.	.	.
Construction industry									
annual change in % (real)	-4.6	-1.8	-12.6	-5.2	-11.2	-1.8	.	.	.
Employed persons, LFS, th, average 3)	2,318	2,351	2,329	2,329	2,328	2,343	2350	2390	2430
annual change in %	-2.1	1.5	0.6	0.0	-0.1	0.6	1.0	1.5	1.5
Unemployed persons, LFS, th, average 3)	389	368	378	386	388	370	.	.	.
Unemployment rate, LFS, in %, average 3)	14.4	13.5	14.0	14.2	14.3	13.6	13.5	13.0	12.0
Reg. unemployment rate, in %, end of period	12.5	13.6	14.4	13.5	14.3	12.8	12.5	12.0	11.0
Average monthly gross wages, EUR	769	786	805	824	804	839	.	.	.
annual change in % (real, gross)	2.2	-1.6	-1.2	1.0	1.0	4.5	.	.	.
Consumer prices (HICP), % p.a.	0.7	4.1	3.7	1.5	2.0	-0.1	0.2	1.5	2.5
Producer prices in industry, % p.a.	0.4	4.5	1.9	-1.0	-0.1	-3.5	-3.0	1.0	1.5
General governm.budget, EU-def., % of GDP									
Revenues	32.3	34.1	33.7	35.9	.	.	34.0	.	.
Expenditures	39.8	38.9	38.2	38.7	.	.	36.8	.	.
Net lending (+) / net borrowing (-)	-7.5	-4.8	-4.5	-2.8	.	.	-2.8	-2.7	-2.5
Public debt, EU-def., % of GDP	41.0	43.6	52.7	55.4	.	.	55.2	55.0	54.6
Central bank policy rate, % p.a., end of period 4)	1.00	1.00	0.75	0.25	0.50	0.15	.	.	.
Current account, EUR mn	-2,454	-2,597	1,584	1,547	1,676	917	1,100	800	100
Current account, % of GDP	-3.7	-3.8	2.2	2.1	4.8	2.6	1.5	1.0	0.1
Exports of goods, BOP, EUR mn	48,273	56,783	62,308	64,362	31,844	32,411	65,000	66,000	67,000
annual change in %	21.5	17.6	9.7	3.3	4.5	1.8	1.5	1.5	1.0
Imports of goods, BOP, EUR mn	47,494	55,768	58,730	60,078	28,898	29,838	61,000	62,000	64,000
annual change in %	22.5	17.4	5.3	2.3	1.1	3.3	2.0	2.0	2.5
Exports of services, BOP, EUR mn	4,396	4,749	5,570	5,603	2,584	3,036	6,200	6,600	7,100
annual change in %	1.2	8.0	17.3	0.6	-2.0	17.5	10.0	7.0	7.0
Imports of services, BOP, EUR mn	5,140	5,121	5,263	5,454	2,584	3,064	6,300	6,900	7,400
annual change in %	-4.2	-0.4	2.8	3.6	3.1	18.6	15.0	10.0	7.0
FDI inflow (liabilities), EUR mn	1,336	2,511	2,199	445	-702	-32	.	.	.
FDI outflow (assets), EUR mn	715	513	-58	-319	37	7	.	.	.
Gross reserves of NB excl. gold, EUR mn	541	659	620	670	846	702	.	.	.
Gross external debt, EUR mn	49,262	52,934	53,755	59,684	60,547	64,785	.	.	.
Gross external debt, % of GDP	74.8	76.7	75.6	82.7	83.9	87.5	.	.	.
Purchasing power parity EUR/EUR	0.6691	0.6758	0.6776	0.6794	.	.	.	.	.

1) Preliminary. - 2) According to census May 2011. - 3) From 2012 data according to census May 2011. - 4) Official refinancing operation rates for euro area (ECB).

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