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Slovakia: very high growth, few changes in policy

Backed by the booming economy, the new left-leaning government of Robert Fico (in office since June 2006) has basically continued to pursue the economic policy designed and implemented by the former centre-right government. In that era (1998-2006) Slovakia gained a reputation as a reform pioneer with domestic austerity policies geared to achieve fiscal stability and a better external balance. Attracting foreign investment was instrumental in sustaining strong economic growth. Whereas foreign investors applauded the previous government, most Slovaks could not conceal their disappointment. Although the standard of living rose on the country average, the gap between the rich and the poor and between the rich western and the poor eastern regions widened. Social disparities were an important factor in the election victory of the social democrats, who pledged to pursue a socially balanced policy. Despite minor changes in economic policy, the new government has not lost touch with the economic fundamentals established by the earlier policy makers.

The recent spending increases have focused on poor people and young families. At the end of 2006 an extra payment was given to Slovak pensioners. Starting with 2007, the government has increased one-time payments for first-born children (by EUR 300 to about EUR 430); the circle of people on supplementary benefits has widened. Under the booming economy and high budget revenues, it is quite easy to finance these items. However, the new cabinet has also raised budgetary expenditures on agriculture by one half in 2007, and those on the Government Office by 150%. On the other hand, spending on establishing a ‘knowledge economy’ – i.e. expenditures on education and research and development – is to rise less than the growth of total budgetary expenditures. In March 2006, the former government had introduced new measures to implement the Action Plan for R&D and Innovation, covering the period 2006 to 2010; the current policymakers, however, have not considered this as a priority although Slovakia lacks in particular investment into education and a broader application of IT. Besides, the government intends to weaken the financial position of all six profit-oriented healthcare insurance companies, of which two are state-owned. The government seeks to ban health insurers from making profit: any net profit should be completely re-invested into the heavily undercapitalized healthcare system. The Slovak healthcare system is facing an alarming lack of personnel because higher salaries paid abroad have resulted in an exodus of healthcare staff.

Changes in the widely discussed and bashed flat-tax system have been less radical than announced before the June elections. The core issue, the VAT rate on medicine, has dropped from 19% to 10%. Individuals with incomes considerably exceeding the average (personal monthly incomes between SKK 47,600 and SKK 80,000) have now to pay higher taxes than under the tax scheme valid up until the end of 2006. On the whole, this modification has (moderately) affected only a marginal circle of people; for instance, individuals earning around SKK 80,000 (EUR 2200) per month, which is equivalent to 4.4 times the average gross monthly wage, are now paying about SKK 1500 (EUR 40) more taxes than earlier. Foreign direct investors have not been affected by the recent tax changes.

The economy is growing strongly, and growth is even accelerating. In the third quarter of 2006, GDP grew by 9.8% as against 6.7% in the second quarter. Supported by rising real wages and credits to private households, private consumption rose by 6.5%. Gross fixed capital formation and rising inventories, mostly of ‘work in progress’, were another driving force behind the economic expansion. The increase in work in progress has been driven by rising industrial investment, in particular FDI. In the entire year 2006 GDP grew by about 7.5%. As exports are starting to gather momentum, foreign trade is again contributing positively to overall GDP growth, following two years of negative contribution (GDP concept). That holds true despite the persistent appreciation of the domestic currency: following several stages of appreciation, on 4 January 2007 the Slovak koruna hit a new record against the euro of 34.32 SKK/EUR. [1] The export goods produced by the new FDI-led manufacturing plants that are coming now on stream seem to be sufficiently competitive to withstand the ongoing appreciation.

On the supply side, the GDP growth in 2006 followed chiefly from an increase in gross value-added in services (such as retailing, hotels and restaurants) and in industry. Gross industrial production was up by 10% in 2006, accompanied by a 2% rise in industrial employment. Industrial labour productivity rose by about 8%, more than average industrial gross monthly wages (up some 6%). As a result, unit labour costs (ULCs) in industry dropped by about 2% in SKK terms. However, accounting for the 3.5% appreciation of the Slovak koruna in 2006 on average, ULCs rose by about 2% in euro terms. Foreign investment enterprises in machinery and equipment and in the automobile industry registered the highest rates of production increases (by around 25%). Two new car makers, PSA Peugeot Citroën and KIA (a Hyundai associate), started production last year.

Based on the commitment to the EU, the first reactor of the nuclear power station in Western Slovakia (Jaslovské Bohunice) was closed at the end of 2006. This implies that Slovakia must now import electricity.

Rising prices of energy, healthcare and housing rents and increased consumer borrowing have had an impact on inflation. The inflation rate (CPI) rose to 4.5% in 2006, compared

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[1] Slovakia was admitted into the ERM-II already in November 2005. The central exchange rate parity was set at SKK 38.455 to the euro, with a +/-15% fluctuation band. The lower compulsory intervention rate is SKK 32.6868/EUR and the upper intervention rate is SKK 44.2233/EUR.

with 2.7% in 2005. Despite the socially motivated increase in budgetary expenditures, the general government budget probably ended 2006 with a deficit below 3% of GDP. This is mostly due to the strong GDP growth and higher tax revenues collected. But the risk of overheating is moderate. Headline inflation, excluding energy and unprocessed foodstuffs, has been nearly unchanged during the past several months while the country's external position is gradually improving.

The strong economic expansion has been reflected in rising employment. Following a 2% increase in 2005, employment (LFS) rose by nearly 4% in 2006. The unemployment rate (LFS) dropped by 1.9 percentage points in 2005 and by 2.7 percentage points in 2006, to 13.5%. Demand for labour has been on the rise in both domestic and foreign-owned companies; in particular new foreign greenfield investment has already created many new jobs. However, with foreign investors focusing on the country's more developed western regions, the eastern parts of Slovakia with high unemployment are falling further behind. Regional disparities remain large or are even widening.

Slovakia continues to attract FDI. After rising to EUR 1.7 billion in 2005, FDI inflows increased even more strongly in 2006, to more than EUR 3 billion. The majority of investors has targeted car manufacturing (Volkswagen, PSA Peugeot-Citroën and KIA Hyundai). Another significant FDI influx is associated with the entry of foreign investors to the electronics (Samsung), electrical engineering, metal processing and wood and paper industries.

Exports are gradually becoming a major driving force behind Slovakia's economic expansion. Supported by strong private demand and investment expansion, GDP growth will remain high and reach about 7% in the years to come. Along with rising labour demand the unemployment rate will continue to decline. On the basis of the current development of oil prices, a decline in fuel prices can be expected. Besides, the central bank is ready to tighten its monetary policy. The inflation rate may go down in the near future. The government intends to drive the fiscal deficit below the Maastricht-defined ceiling of 3% of GDP this year in order to qualify for euro adoption by 2009. Strong GDP growth and high tax revenues will support this ambition. The current account deficit, at more than 7% of GDP in 2006, is expected to decline thanks to strongly expanding exports.

Table SK

Slovak Republic: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006 [1]	2007	2008
								forecast	
Population, th pers., mid-year	5400.7	5379.8	5378.8	5379.0	5382.2	5386.7	5390	.	.
Gross domestic product, SKK bn, nom. [2]	941.3	1020.6	1111.5	1212.7	1355.3	1471.1	1630	1800	1960
annual change in % (real) [2]	0.7	3.2	4.1	4.2	5.4	6.0	7.5	7	7
GDP/capita (EUR at exchange rate) [2]	4093	4380	4839	5434	6288	7077	8133	.	.
GDP/capita (EUR at PPP - wiiw) [2]	9520	10150	10990	11500	12360	13410	14550	.	.
Gross industrial production									
annual change in % (real)	8.4	7.6	6.7	5.3	4.2	3.6	10	12	10
Gross agricultural production									
annual change in % (real)	-12.3	9.9	1.5	-2.4	5.6	-6.0	.	.	.
Construction industry									
annual change in % (real)	-0.4	0.8	4.1	6.0	5.7	14.7	16	.	.
Consumption of households, SKK bn, nom. [2]	524.3	583.7	634.3	676.9	754.4	829.8	.	.	.
annual change in % (real) [2]	0.9	5.4	5.2	0.1	3.8	7.2	7	7	5
Gross fixed capital form., SKK bn, nom. [2]	242.3	291.0	303.5	302.8	327.1	394.6	.	.	.
annual change in % (real) [2]	-9.6	12.9	0.3	-2.3	5.0	17.5	8	10	8
LFS - employed persons, th, avg.	2101.7	2123.7	2127.0	2164.6	2170.4	2216.2	2300	.	.
annual change in %	-1.4	1.0	0.2	1.8	0.3	2.1	4	.	.
LFS - employed pers. in industry, th, avg.	615.3	628.8	640.9	634.1	641.3	649.1	660	.	.
annual change in %	-2.4	2.2	1.9	-1.1	1.1	1.2	2	.	.
LFS - unemployed, th pers., average	485.2	508.0	486.9	459.2	480.7	427.5	360	.	.
LFS - unemployment rate in %, average	18.6	19.2	18.5	17.4	18.1	16.2	13.5	12	11
Reg. unemployment rate in %, end of period	17.9	18.6	17.5	15.6	13.1	11.4	9.4	8	7
Average gross monthly wages, SKK [3]	11430	12365	13511	14365	15825	17274	18800	.	.
annual change in % (real, gross) [3]	-4.5	1.0	5.8	-2.0	2.5	6.3	3.9	.	.
Consumer prices, % p.a.	12.0	7.1	3.3	8.5	7.5	2.7	4.5	3	2
Producer prices in industry, % p.a.	10.8	6.5	2.1	8.3	3.4	4.7	8.4	5	4
General governm. budget, EU-def., % GDP [4]									
Revenues	39.8	36.8	35.7	35.6	35.9	33.9	33.1	32.4	32.1
Expenditures	51.7	43.3	43.3	39.4	38.9	37.1	36.5	35.4	35.0
Deficit (-) / surplus (+)	-11.8	-6.5	-7.7	-3.7	-3.0	-3.1	-3.4	-3.0	-2.9
Public debt in % of GDP [4]	49.9	49.2	43.3	42.7	41.6	34.5	33.0	31.6	31.0
Discount rate, % p.a., end of period	8.8	8.8	6.5	6.0	4.0	3.0	4.8	.	.
Current account, EUR mn [5]	-761	-1950	-2043	-244	-1214	-3288	-3200	-2500	-3000
Current account in % of GDP	-3.4	-8.3	-7.8	-0.8	-3.6	-8.6	-7.3	-4.9	-5.1
Gross reserves of NB incl. gold, EUR mn	4391	4748	8824	9717	10954	13067	10164 XI	.	.
Gross external debt, EUR mn	11637	12516	12655	14654	17421	22705	23075 IX	.	.
Gross external debt in % of GDP	52.7	53.1	48.6	50.1	51.5	59.6	.	.	.
FDI inflow, EUR mn	2089	1768	4397	593	1016	1694	3500	.	.
FDI outflow, EUR mn	23	39	5	20	-114	126	400	.	.
Exports of goods, BOP, EUR mn [5]	12879	14115	15270	19359	22248	25743	33500	45000	50000
annual growth rate in %	34.1	9.6	8.2	26.8	14.9	15.7	30	34	11
Imports of goods, BOP, EUR mn [5]	13860	16488	17517	19924	23485	27713	35500	46000	50500
annual growth rate in %	30.4	19.0	6.2	13.7	17.9	18.0	28	30	10
Exports of services, BOP, EUR mn [5]	2436	2779	2958	2912	3000	3542	4300	.	.
annual growth rate in %	25.8	14.1	6.4	-1.5	3.0	18.1	20	.	.
Imports of services, BOP, EUR mn [5]	1961	2244	2474	2703	2785	3285	3800	.	.
annual growth rate in %	13.2	14.5	10.3	9.2	3.0	18.0	16	.	.
Average exchange rate SKK/USD	46.20	48.35	45.34	36.77	32.26	31.02	29.70	.	.
Average exchange rate SKK/EUR (ECU)	42.59	43.31	42.70	41.49	40.05	38.59	37.23	35.0	33.5
Purchasing power parity SKK/USD	16.07	16.26	16.21	16.59	17.19	17.09	17.10	.	.
Purchasing power parity SKK/EUR	18.30	18.70	18.80	19.60	20.38	20.37	20.81	.	.

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

1) Preliminary. - 2) According to ESA'95 FISIM-adjusted. - 3) From 2006 including incomes of armed forces. Growth rates based on comparable data. - 4) According to ESA'95, excessive deficit procedure. - 5) Calculated from USD.

Source: wiiw Database incorporating national statistics; Eurostat; European Commission (Autumn 2006); wiiw forecasts.