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Slovakia: booming economy looking ahead to the euro

Fast growth backed by FDI

Slovakia remains one of the top expanding economies in Europe. Rising wages, credits and social transfers to households have boosted private consumption. Robust domestic and foreign investment in industry as well as infrastructure projects are fuelling gross fixed capital formation. In addition, since mid-2006, foreign trade has been contributing positively to GDP growth as exports are rising faster than imports. Boosted by rising production capacities at foreign-owned firms, exports of cars and TV sets expanded at the highest pace. Driven by very strong foreign demand, sales of chemicals (mostly plastics and plastic products) and semi-finished goods such as steel, iron, copper and paper are also enjoying high growth. Notwithstanding some slowdown, import growth remained high in 2007 as private consumers, encouraged by rising incomes and the appreciating Slovak koruna, purchased more foreign consumer goods. Furthermore, particularly foreign-owned assembling plants import parts, components and accessories of motor vehicles, and producers of electro-technical equipment purchase equipment and components abroad. Despite profit repatriation by foreign investors, the current account deficit dropped by more than 2 percentage points in 2007 (to below 5% of GDP).

Competitive economy, but strong west/east divide

Despite the appreciation of the domestic currency, the robustly expanding industrial exports remain competitive on the international markets. Unit labour costs in industry declined by about 4% in SKK terms (they grew by about 6% in EUR terms). At comparable productivity, wages in Slovakia are still lower than those in the Czech Republic, Hungary and Poland (and unit labour costs are thus lower as well). The strong economic expansion is supporting employment growth. However, labour market improvements have been selective and focused on the more prosperous western regions; the eastern and southeastern districts are still struggling with high unemployment as the bulk of FDI has been concentrated in the Bratislava region. The western part of the country is facing increasing bottlenecks concerning skilled industrial workers, partly because of the low labour mobility within Slovakia.

The left-oriented government, in power since summer 2006, is continuing with the pro-business agenda initiated by the previous centre-right coalition cabinet. As a result, Slovakia remains an attractive target for FDI, particularly in the automotive, electronics and steel industries. Because of labour shortages in the west, some big foreign investors are heading east. But, as for the two largest eastern urban regions (Košice and Prešov), the municipal heads there, with strong political ambivalence, have so far been unable to offer suitable industrial zones because of local land disputes. By contrast, some small municipalities, more ready for political compromise, are more successful. The best example is the Kechnec Industrial Park, near a small village located on the southeast border with Hungary, where the local authorities were able to attract a number of FDI enterprises (first of all the German automobile gear box manufacturer Getrag Ford). So far, the firms have invested some EUR 400 million in Kechnec. Economic development in eastern Slovakia is also hindered by the poor transport infrastructure.[1] The construction of a motorway connecting Bratislava and Košice should be completed within the next three years. Part of the highway construction is to be financed by the public-private partnership model, and the recently adopted legislation facilitates easier access to the required land plots.

Despite some risks, good prospects for GDP growth and euro adoption

Slovakia is the most enthusiastic country regarding an early adoption of the euro. Already on 26 September 2007, the cabinet approved a new law related to a smooth transition from the Slovak koruna to the euro. Fiscal discipline is crucial for meeting the Maastricht criteria and alleviating the risks of rising inflation after the planned accession to the eurozone in 2009. The general government deficit was at about 2.5% of GDP in 2007, after 3.7% recorded in 2006. Despite an expected upward correction, the country will very likely meet the 3% Maastricht limit as it is benefiting from the highest economic growth in its history that also boosts state revenues. The main challenge on the way to euro adoption is posed by inflation risks, related to rising energy and food prices, apart from demand-pull factors. The appreciating Slovak koruna is however working against strong inflationary pressures.

Economic growth will decelerate in the years to come, because the pre-year base value for further GDP expansion is very high and the high rate of industrial growth – mostly driven by the spectacular expansion of car and electro-technical manufacturing – will most likely slow down as well. However, pro-growth effects of large foreign direct investments will continue to support economic growth. Falling unemployment and rising incomes (both wages and social transfers) will stimulate domestic demand (both private consumption and investment). Although FDI-led investment growth may decelerate after three years of robust growth, investment will still support the economic expansion thanks to EU transfers financing ambitious infrastructure projects. Despite some risks related to weaker foreign demand, we believe that FDI-led companies will be able to find outlets for their products. As a result, foreign trade will contribute positively to GDP growth in the coming years as well. Increasing labour demand will help to reduce the unemployment rate further. However, the structure of unemployment (mostly long term and among the Roma minority) is unfavourable and may prevent a more radical fall in unemployment. Despite the expected foreign trade surpluses in the coming years, the current account deficit will probably stabilize at roughly 4% of GDP, largely due to increasing repatriation of profits by FDI companies.

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[1] At the end of 2007, the European Commission approved all of the eleven operational programmes for Slovakia, totalling EUR 11.3 billion, for the period 2007 to 2013. More than one third of the funds is to flow to the eastern regions Košice and Prešov.

Table SK

Slovak Republic: Selected economic indicators

	2002	2003	2004	2005	2006	2007 [1)]	2008	2009	2010
								Forecast	
Population, th pers., mid-year	5,379	5,379	5,383	5,387	5,391	5,399	.	.	.
Gross domestic product, SKK bn, nom. [2)]	1,108	1,222	1,362	1,485	1,660	1,850	2,050	2,250	2,440
annual change in % (real) [2)]	4.8	4.8	5.2	6.6	8.5	9	8	7	6
GDP/capita (EUR at exchange rate)	4,825	5,478	6,317	7,144	8,264	10,147	.	.	.
GDP/capita (EUR at PPP - wiiw)	11,070	11,490	12,360	13,560	14,990	16,720	.	.	.
Gross industrial production									
annual change in % (real)	6.3	5.0	4.1	3.8	9.9	13.0	12	10	7
Gross agricultural production									
annual change in % (real)	1.5	-2.4	5.6	-6.3	0.0	.	.	.	.
Construction industry									
annual change in % (real)	4.1	6.0	5.7	14.7	14.9	5.7	.	.	.
Consumption of households, SKK bn, nom. [2)]	631.4	683.5	764.9	836.1	928.5	1,020	.	.	.
annual change in % (real) [2)]	5.5	1.6	4.2	6.5	5.9	7.8	7	5	7
Gross fixed capital form., SKK bn, nom. [2)]	303.5	302.8	326.4	394.3	436.2	480	.		
annual change in % (real) [2)]	0.2	-2.7	4.8	17.6	8.4	7.5	7	7	7
LFS - employed persons, th, avg.	2,127	2,165	2,170	2,216	2,301	2,350	.	.	.
annual change in %	0.2	1.8	0.3	2.1	3.8	2.1	.	.	.
LFS - employed pers. in industry, th, avg.	640.9	634.1	641.3	649.1	666.4	.	.	.	.
annual change in %	1.9	-1.1	1.1	1.2	2.7	.	.	.	.
LFS - unemployed, th pers., average	486.9	459.2	480.7	427.5	353.4	292	.	.	.
LFS - unemployment rate in %, average	18.5	17.4	18.1	16.2	13.3	11	10	9	8.5
Reg. unemployment rate in %, end of period	17.5	15.6	13.1	11.4	9.4	8.0	7	6	6
Average gross monthly wages, SKK [3)]	13,511	14,365	15,825	17,274	18,761	20,154	.	.	.
annual change in % (real, gross)	5.8	-2.0	2.5	6.3	3.3	4.5	3	.	.
Consumer prices, % p.a.	3.3	8.5	7.5	2.7	4.5	2.8	2.8	3	2.5
Producer prices in industry, % p.a.	2.1	8.3	3.4	4.7	8.4	2.0	4	.	.
General governm.budget, EU-def., % GDP [4)]									
Revenues	36.6	37.7	35.6	35.6	33.9	33.2	.	.	.
Expenditures	44.8	40.5	38.0	38.4	37.7	35.9	.	.	.
Net lending (+) / net borrowing (-)	-8.2	-2.8	-2.4	-2.8	-3.7	-2.7	-2.8	-2.8	-3.0
Public debt, EU-def., in % of GDP [4)]	43.4	42.4	41.4	34.2	30.4	.	.	.	.
Discount rate, % p.a., end of period	6.5	6.0	4.0	3.0	4.8	4.3	.	.	.
Current account, EUR mn [5)]	-2,043	-1,747	-2,656	-3,268	-3,127	-2,600	-2,500	-2,750	-3,700
Current account in % of GDP	-7.9	-5.9	-7.8	-8.5	-7.0	-4.7	-4.0	-4.0	-5.0
Gross reserves of NB incl. gold, EUR mn	8,824	9,717	10,954	13,067	10,145	12,930	.	.	.
Gross external debt, EUR mn	12,655	14,654	17,421	22,705	24,449	29,000	.	.	.
Gross external debt in % of GDP	47.6	49.3	49.6	57.9	50.9	52.7			
FDI inflow, EUR mn	4,397	1,914	2,441	1,952	3,324	2,300	2,000	.	.
FDI outflow, EUR mn	12	219	-17	120	294	100	200	.	.
Exports of goods, BOP, EUR mn [5)]	15,270	19,359	22,248	25,654	33,099	43,000	52,000	60,000	70,000
annual growth rate in %	8.2	26.8	14.9	15.3	29.0	29	22	15	17
Imports of goods, BOP, EUR mn [5)]	17,517	19,924	23,485	27,571	35,120	43,000	51,000	58,000	69,000
annual growth rate in %	6.2	13.7	17.9	17.4	27.4	23	18	14	19
Exports of services, BOP, EUR mn [5)]	2,958	2,912	3,000	3,542	4,313	5,300	6,300	6,900	7,600
annual growth rate in %	6.4	-1.5	3.0	18.1	21.7	22	19	10	10
Imports of services, BOP, EUR mn [5)]	2,474	2,703	2,785	3,285	3,710	4,700	5,600	6,100	6,800
annual growth rate in %	10.3	9.2	3.0	18.0	12.9	26	19	9	11
Average exchange rate SKK/USD	45.34	36.77	32.26	31.02	29.72	24.69	.	.	.
Average exchange rate SKK/EUR (ECU)	42.70	41.49	40.05	38.59	37.25	33.77	33.0	32.9	32.9
Purchasing power parity SKK/USD	15.90	16.71	17.23	17.20	17.13	17.11	.	.	.
Purchasing power parity SKK/EUR	18.61	19.78	20.47	20.33	20.53	20.49	.	.	.

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

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (FISIM adjusted). - 3) From 2006 including wages of armed forces. - 4) According to ESA'95, excessive deficit procedure. - 5) Calculated from USD.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.