Zdenek Lukas

Slovakia: comprehensive reforms and export-led growth

The coalition government, in power since October 2002, is pushing through an economic programme that is first of all targeted at the stabilization of public sector expenditures. In a first step towards reforming the healthcare scheme, the rules for qualification for full social benefits and the maximum amount of allowance were tightened. Further (impending) reform steps are to reorganize the financing and management of the health system such (public hospitals and private pharmacies). As for the pension system, in 2003 the Slovak parliament approved a new act to increase the statutory retirement age and create privately managed personal-pension accounts, into which workers will pay half of their compulsory contributions. The resulting shortfall in the pay-as-you-go state pension system is to be covered, over a transition period, by privatization revenues. Securing the latter, however, is uncertain given that the privatization of the big companies in Slovakia has been completed.

To step up budgetary revenues, the government further deregulated (i.e. raised) prices of housing, energy, water and public transport at the beginning of 2003. In August taxes on fuels, beer and tobacco were raised as well. At the beginning of 2004 Slovakia introduced a single 19% tax rate for personal income, corporate profits, and all other types of income. The flat tax for personal income coupled with the higher tax-free income replaced the progressive five-rate system ranging from 10% to 38%. In the entrepreneurial sector, the 19% tax rate on corporate profits replaced the earlier rate of 25%. The expected decline in revenues is to be compensated by unifying the earlier two-tier value added tax at a rate of 19% on all goods (also staples) and services. The supporters of this wide-ranging tax reform expect more effective tax collection, more FDI, stronger economic growth and a stabilization of budgetary revenues. However, opponents emphasize the unfairness inherent in any flat-tax system, with most of the benefits of lower taxation going to the rich, while the low- and medium-income groups are asked to pay actually higher taxes. Thus corporations located in Slovakia will benefit from both the lower tax rate and cost savings related to book-keeping and administration. On the other hand, the flat VAT rate will raise prices for consumers mostly in retail trade, restaurants and other services.

Despite slow growth in the EU, the Slovak economy has been growing strongly for the past two years: rising competitiveness, based on decreasing unit labour costs in industry and a shift towards higher value-added products, has opened the door to international markets. Foreign sales are increasing continuously; they are in fact the sole driving force behind the economic expansion. Car exports (VW Bratislava), soaring by around 70% and accounting for 30% of total exports, dominate this development. The Slovak GDP grew by 4% in the first nine months of 2003. Exports (goods and services) rose by 22% (GDP concept).

Following a strong expansion in 2002, total domestic demand (dominated by private consumption) stagnated in 2003; hikes in regulated prices and in some excise taxes fuelled inflation and eroded real household incomes. Gross fixed capital formation and government consumption stagnated.

On the supply side, gross industrial production expanded by 5.3% in 2003; labour productivity rose by more than 6%, real wages fell by 3%. As a result, unit labour costs were declining. Import prices stagnated; at the same time exporters were able to sell larger quantities at higher prices. The major contributors to the industrial expansion were the transport equipment industry (VW Bratislava) with a production growth of 30%, followed by rubber & plastic products (18%) and electrical and optical equipment (11%). On the other hand, output of the mining and energy sector declined. Mostly due to maintenance and activities abroad, output of the construction sector rose by more than 5% in 2003. The construction of new buildings however has increased only marginally as investors remain hesitant.

Demand for labour is rising and consequently unemployment is on the decline. The registered unemployment rate fell to 15.6% at year-end compared to 17.5% at the end of 2002. At least part of the decline went on account of more rigorous registration rules. In order to comply with the EU *acquis,* the labour act was first revised in April 2002 and several amendments came into force in July 2003. The new legislation should improve the flexibility on the labour market and finally result in a further lowering of the unemployment rate. Besides, the government hopes that the rising foreign green-field investments will gradually create more new jobs. Unfortunately, investors are mainly targeting the rich western regions and disregarding the poor regions with high unemployment in the rest of the country. As a result, the anyhow massive regional disparities are even increasing.

The higher inflation in 2003 (consumer prices rose by 8.5%) was home-made as the administrative measures accounted for more than 75% of the total price increase. Another domestic factor was the acceleration of the food price dynamics. External factors dampened the price level as the strengthening of the Slovak koruna, in particular vis-à-vis the US dollar, pushed down prices of imported fuels and some consumer goods. The central government's deficit fell slightly (by 0.3 percentage points) and accounted for 4.5% of GDP in 2003 as the growth of budgetary expenditures decelerated and revenues rose due to increases in regulated prices and taxes.

After a record level of EUR 4 billion in 2002, the FDI inflow dropped to about EUR 0.5 billion in 2003. It is however anticipated to recover in the years to come because of the envisaged green-field investment by the French carmaker PSA Peugeot Citroen (EUR 0.7 billion by 2006) and other projects expected due to the low corporate flat-tax. As a result of the export expansion and depressed domestic demand, the current account deficit fell strongly, to less than 2% of GDP, as compared to 8% in the year 2002.

In 2004 the export performance will again be the main driving force of economic growth; GDP will grow by about 4.5%. In 2005 GDP growth may accelerate to 5%, supported by exports and recovering domestic demand driven by pre-election demand stimulation. The price and tax adjustments will keep the inflation rate high, at 8% this year and 5% in 2005. After a historical low in 2003, the current account deficit will be rising slightly in the coming years as export growth will decelerate and the repatriation of profits of FDI companies will gradually increase. Besides, the expected real appreciation of the Slovak koruna will support imports.

After joining the EU, the greatest challenge for the Slovak economy will be to master the accession to the European Monetary Union. The Slovak Central Bank and the government envisage to enter the ERM II as soon as conditions have been created to introduce the euro. This implies that Slovakia intends to stay in the ERM II for as brief a period as possible, i.e. just two years. In order to achieve this goal, the Maastricht criteria will have to be met already at the beginning of joining the ERM II. The Slovak administration believes that it will be able to fulfil these criteria by 2006. Thus, Slovakia intends to introduce the euro in 2008. However, there are some serious obstacles on the way to this ambitious target. Reducing the public budget deficit (currently at 5% of GDP) by 2 percentage points already in 2006 will be a tough challenge, in particular in view of the envisaged reforms. Assuming less revenue from the low corporate taxes coupled with less revenue from the reformed pension system, the budget deficit may even increase in the future. In addition, fiscal stability in the coming years may be undermined by liabilities (mostly state guaranties), altogether accounting for some 10% of GDP. Last but not least, the target of significantly cutting the inflation rate will be confronted with considerable upward adjustments in various relative prices, which were delayed in the election year 2002. Despite the progress in price deregulation in 2003, further adjustment steps are needed and the election year 2006 is approaching.

Table SK

Slovak Republic: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002	2003 [1]		2004	2005
									forecast	
Population, th pers., mid-year	5383.2	5390.7	5395.3	5400.7	5379.8	5378.6	5378.8		.	.
Gross domestic product, SKK bn, nom.	712.7	781.4	844.1	934.1	1009.8	1096.4	1235		1390	1525
annual change in % (real)	4.6	4.2	1.5	2.0	3.8	4.4	4.0		4.5	5
GDP/capita (EUR at exchange rate)	3483	3661	3546	4061	4334	4774	5530		.	.
GDP/capita (EUR at PPP - wiiw)	8350	8830	9160	9910	10480	11330	12100		.	.
Gross industrial production										
annual change in % (real) [2]	2.7	5.0	-2.7	8.6	6.9	6.5	5.3		6	7
Gross agricultural production										
annual change in % (real)	-1.0	-5.9	-2.5	-12.3	8.2	5.5	.		.	.
Goods transport, mn t-kms	17672	17808	19996	19829	18501	18182	12723	I-IX	.	.
annual change in %	-5.9	0.8	12.3	-0.8	-6.7	-1.7	-5.3	I-IX	.	.
Gross fixed capital form., SKK bn, nom.	243.5	281.8	249.8	242.3	291.0	300.6	.		.	.
annual change in % (real)	15.0	11.0	-19.6	-7.2	13.9	-0.9	-0.5		2	5
Construction industry										
annual change in % (real)	9.2	-3.5	-25.8	-0.4	0.8	4.1	5.4	I-X	.	.
Dwellings completed, units	7172	8234	10745	12931	10321	14213	8261	I-IX	.	.
annual change in %	14.6	14.8	30.5	20.3	-20.2	37.7	-3.0	I-IX	.	.
Employed persons total - LFS, th, avg	2205.9	2198.6	2132.1	2101.7	2123.7	2127.0	2162.5	I-IX	.	.
annual change in %	-0.9	-0.3	-3.0	-1.4	1.0	0.2	2.0	I-IX	.	.
Employed pers. in industry - LFS, th, avg	665.8	662.5	630.3	615.3	628.8	640.9	634.6	I-IX	.	.
annual change in %	-3.5	-0.5	-4.9	-2.4	2.2	1.9	-0.8	I-IX	.	.
Reg. unemployed, th pers, end of period	347.8	428.2	535.2	506.5	533.7	504.1	452.2		.	.
Reg. unemployment rate in %, end of period	12.5	15.6	19.2	17.9	18.6	17.5	15.6		14	13
LFS - unemployment rate in %, average	11.8	12.5	16.2	18.6	19.2	18.5	18.0		16	15
Average gross monthly wages, SKK	9226	10003	10728	11430	12365	13511	13757	I-IX	.	.
annual change in % (real, gross)	6.5	1.7	-2.8	-4.5	0.8	5.8	-1.7	I-IX	.	.
Retail trade turnover, SKK bn [3]	328.8	379.4	442.1	481.1	301.1	328.0	287.1	I-XI	.	.
annual change in % (real)	4.8	8.6	9.8	2.3	4.5	5.8	-5.8	I-XI	.	.
Consumer prices, % p.a.	6.1	6.7	10.6	12.0	7.1	3.3	8.5		8	5
Producer prices in industry, % p.a.	4.5	3.3	4.3	10.8	6.5	2.1	8.1		7	4
Central government budget, SKK bn										
Revenues	180.8	177.8	216.7	213.5	205.4	220.4	233.1		.	.
Expenditures	217.8	197.0	231.5	241.1	249.7	272.0	289.0		.	.
Deficit (-) / surplus (+)	-37.0	-19.2	-14.8	-27.6	-44.4	-51.6	-56.0		.	.
Deficit (-) / surplus (+), % GDP	-5.2	-2.5	-1.8	-3.0	-4.5	-4.8	-4.5		.	.
Money supply, SKK bn, end of period										
M1, Money	166.1	147.2	153.9	187.2	228.5	246.8	264.2	Nov	.	.
M2, Money + quasi money	453.5	466.1	523.6	601.5	680.3	713.8	740.3	Nov	.	.
Discount rate, % p.a., end of period	8.8	8.8	8.8	8.8	8.8	6.5	6.0		.	.
Current account, EUR mn	-1596	-1764	-920	-761	-1950	-2059	-400		-500	-800
Current account in % of GDP	-8.5	-8.9	-4.8	-3.5	-8.4	-8.0	-1.3		-1.5	-2.1
Gross reserves of NB incl. gold, EUR mn [4]	2978	2493	3410	4391	4748	8824	9717		.	.
Gross external debt, EUR mn [5]	9699	10146	10470	11637	12516	12655	13474	Sep	.	.
Exports total, fob, EUR mn [6]	7299.0	9540.6	9602.2	12879.5	14115.4	15270.1	19440		22200	25800
annual growth rate in %	3.6	11.9	0.6	34.1	9.6	8.2	27		14	16
Imports total, fob, EUR mn [6]	9119.0	11634.7	10627.7	13859.8	16487.8	17517.4	19730		22900	26800
annual growth rate in %	2.7	12.3	-8.7	30.4	19.0	6.2	13		16	17
Average exchange rate SKK/USD	33.62	35.24	41.42	46.20	48.35	45.34	36.77		.	.
Average exchange rate SKK/EUR (ECU)	38.01	39.60	44.12	42.59	43.31	42.70	41.49		40.5	40.0
Purchasing power parity SKK/USD, wiiw	14.23	14.79	15.63	16.23	16.51	16.63	17.78		.	.
Purchasing power parity SKK/EUR, wiiw	15.86	16.41	17.08	17.45	17.91	17.99	18.98		.	.

Notes: 1) Preliminary. - 2) From 1999 according to EU methodology. - 3) From 2001 according to NACE, excluding VAT. - 4) From January 2002 new valuation of gold. - 5) In 2003 original data in EUR. - 6) Converted from the national currency to EUR at the official exchange rate; from 1998 new methodology.

Source: wiiw Database incorporating national statistics; wiiw forecasts.