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Slovakia:
Export-driven growth, but rising unemployment

With surprising strength and earlier than expected, the Slovak economy is recovering and returning on the path of economic growth, the highest among the NMS. The economic expansion has been largely the result of the revival in external demand supported by improved competitiveness. GDP was up by 4.8% in the first quarter of 2010 as the external sector improved. The volume of exports and imports (goods and services) expanded by 16.8% and 9.9% respectively. Gross capital formation declined by 2.2%, gross fixed capital formation almost stagnated (-0.4%). As a result, inventories declined moderately – but the speed of contraction decelerated substantially. Companies may not have been able to reactivate production in the export-oriented sectors early enough in order to meet the strong demand from abroad and thus may have partly resorted to their stocks instead of increasing production. Real wages rose modestly (by 1.6%) and unemployment increased strongly; the purchasing power declined and consumers' caution was rising. As a result, private consumption stagnated.

The main reason behind the economic expansion has been improved competitiveness. As in other eurozone countries, the weakening of the euro is having a positive impact on the economy in particular as compared to its non-euro neighbours. Among those, the Czech Republic is Slovakia's second most important trading partner after Germany, with a share of about 13% in total Slovak exports. Poland accounts for 8% of total Slovak exports. In the first quarter of 2010 the Slovak currency (i.e. the euro) depreciated by 7% year-on-year against the Czech koruna and even by 13% against the Polish zloty. Apart from the depreciation, the export expansion has been facilitated by a strong fall in unit labour costs (ULCs) coupled with rising labour productivity and falling producer prices. The outcome of this mix is boosting the country's competitiveness on non-euro markets and also, to a lesser extent, in the eurozone. However, increasing unemployment is the shadow side of rising export competitiveness. In this respect the foreign firms' behaviour contrasts strongly with that in their home countries – Germany, Italy, Austria – where various employment support schemes helped to maintain employment.

The rising competitiveness coupled with recovering external demand has stimulated growth in industry. Gross industrial output rose by 20% in the first quarter of 2010, whereas industrial employment (LFS data) dropped by 12% (about 20% of industrial jobs were shed within one year). As a result, industrial labour productivity increased by about 30%. With nominal wages up by some 8% (partly due to structural effects as less skilled and less paid jobs were cut), ULCs declined by some 20%. In addition, the mentioned euro depreciation against a basket of currencies has boosted the competitiveness of Slovak tradable goods outside the euro area (one-half of exports) even more. Total exports rose faster than imports and the foreign trade surplus amounted to EUR 302 million in the first quarter of 2010, as compared to a deficit of EUR 240 million in the corresponding period of 2009. Notably, while total exports rose by 18%, exports to Poland and the Czech Republic expanded by 33% and 22% respectively (in euro terms).

As in the pre-crisis period, foreign investment enterprises in the automotive industry are the most important driving force of the economy. Expanding by 53% in the first four months of 2010, car output recovered significantly faster and more strongly than expected. That growth was exclusively export-driven: car sales in Slovakia dropped by more than 40% year-on-year in spring 2010. Similar to the experience of other EU countries, the car-scrapping scheme fuelled demand in Slovakia only in the first half of 2009. Robust growth in the first four months of 2010 was also observed for machinery (53%), chemical products (36%), electrical equipment (33%) and steel production (25%). However, despite the optimistic mood prevailing in manufacturing, the reported year-on-year growth has to be seen against the background of the low statistical base in the corresponding period 2009 when the sector collapsed. As opposed to industry, construction output continued to fall (by 10%) in the first four months of the year. Nevertheless, prospects are encouraging as highway construction (supported by EU transfers) could provide an important impetus to the construction industry.

Although in the course of 2009 the government had adopted several anti-crisis measures chiefly targeted at the support of household consumption and employment, the recent revival has been solely export-led. In addition, the Slovak labour market has significantly deteriorated, with the unemployment rate (LFS) rising by 4.6 percentage points year-on-year to an average level of 15% in the first quarter of 2010. In particular industry, being foreign-owned to a high degree, has been affected. The country's eastern and southeastern districts are still struggling with the highest unemployment. However, also Bratislava – where the bulk of prosperous FDI companies is located and which so far has been an 'island' of high employment – is now facing rising unemployment as these companies have started laying off staff.

The average harmonized inflation rate amounted to 0.9% in 2009 and came to a complete halt in the first quarter of 2010. That also reflects the depressed state of the economy, of consumption and retail trade. In the first five months of the year the budgetary revenues stagnated, whereas the expenditures – before the elections – rose by 26% year-on-year. If the budgetary deficit were to rise at the same rate, the general government deficit would amount to more than 7% of GDP in 2010. In the light of recent developments, the envisaged reduction of the general government deficit from 6.8% to 5.5% pf GDP in 2010 and eventually to 3% in 2012 is far from certain. Apart from the current dynamics of the rising budget deficit there are other concerns such as the absence of binding limits on budgetary expenditures, the long-term sustainability of the pension system (due to the ageing population and cuts in the second, i.e. private, pillar of the pension system) and rising unemployment benefits. Past experience has shown that only several years of strong GDP growth have an effect on employment. The need for public spending will therefore remain for some time to come.

Following FDI inflows of EUR 2.4 billion in 2008, foreign direct investment came to a standstill in 2009 as some investors left the country, curbed investment or postponed planned investment. Although the economy is recovering, there is still not much room for a revival of FDI due to unused production capacities. Starting in 2011, VW will produce its New Small Family models in Slovakia and invest here EUR 300 million. Besides, the Slovak electric utility company Slovenské elektrárne (66% of shares owned by the Italian energy company Enel) will complete the third and fourth units of the Mochovce nuclear power station. This – the biggest – private investment (EUR 2.7 billion) is to be spent up until 2013.

The economic sentiment indicator is still lower than the long-term average (by 8 percentage points), but it increased by 24 points in May 2010 year-on-year. In addition, new orders received in industry show signs of recovery. In manufacturing new orders increased by 30% year-on-year in the first quarter of 2010. It seems that there is sustained optimism in the recovery. Backed by the current expansion, industrial output may grow by more than 15% this year. That should be boosted by a recovery in FDI inflows in 2010 to about EUR 1 billion with further FDI growth in the following years.

As for sustainable economic growth in the future, the crucial point is to avoid any measures that would threaten Slovakia's regained competitiveness and thus might undermine its competitive position particularly within the EU. If the euro remains weak and ULCs low, GDP growth may expand by above 3% in 2010. Later on, provided a strong recovery of the economies of Slovakia's main trading partners, GDP growth may even accelerate.

However, economic growth powered by massive consumption appetite will not return to the high rates seen a few years ago, as the purchasing power will rise only moderately. The trade surplus and an improving income balance may diminish the current account deficit to below 3% of GDP in 2010. The main challenges for the new government relate to rising unemployment and an escalating budget deficit.

Although the ruling party Smer-SD, led by Robert Fico, won (with nearly 35%) the parliamentary elections held on 12 June, it was not able to form the next government. Its previous ally, the LS-HZDS party headed by Vladimir Mečiar, did not pass the 5% threshold required to enter parliament, and its second ally, the extreme-nationalist Slovak National Party (SNS), surpassed the threshold only by a close vote. On the other side, the entire opposition centre-right block – led by the Slovak Democratic and Christian Union – Democratic Party (SDKU-DS), together with the new liberal party Freedom and Solidarity (SaS) and the Christian Democrat Movement (KDH), and with the moderate ethnic Hungarian party called the Bridge (MOST-HID) – has a majority with 79 seats in the 150-seat parliament. This block formed the new government, as the four parties' leaders rejected to cooperate with Smer-SD.

The elections being over, the most important challenge for the new cabinet is to prepare, in due time, a plausible austerity budget for 2011 and a credible programme of medium-term fiscal stabilization. Failing that, Slovakia's international rating would decline and interest rates along with costs of debt service would rise – and the growth of public debt (currently at some 40% of GDP) and of gross external debt (about 70% of GDP) would accelerate. In all likelihood the new government will be forced to cut public expenditures or increase the tax burden or both. With the centre-right oriented government the willingness to reform and to prepare a credible stabilization programme can be expected to be high.

Table SK

Slovakia: Selected Economic Indicators

	2006	2007	2008	2009 [1]	2009	2010	2010	2011	2012
					1st quarter			Forecast	
Population, th pers., average	5391.4	5397.3	5406.6	5418.2	.	.	5420	5430	5440
Gross domestic product, EUR mn, nom.	55045.5	61547.1	67221.0	63331.6	14656.0	15072.0	64600	68500	73400
annual change in % (real)	8.5	10.6	6.2	-4.7	-5.7	4.8	3	4	4
GDP/capita (EUR at exchange rate)	8300	10200	12000	11700	.	.	11900	12600	13500
GDP/capita (EUR at PPP)	15000	16900	18100	17000	.	.	.	.	.
Consumption of househ., EUR mn, nom.	30815.7	33860.3	37554.9	37674.1	9249.0	9184.0	.	.	.
annual change in % (real)	5.9	7.1	6.1	-0.7	-0.9	0.4	1	2	3
Gross fixed capital form., EUR mn, nom.	14588.8	16096.5	16715.6	14943.2	3405.0	3312.8	.	.	.
annual change in % (real)	9.3	9.1	1.8	-10.5	-3.9	-0.4	1	4	5
Gross industrial production									
annual change in % (real)	15.0	17.2	2.3	-14.5	-22.6	20.2	15	5	7
Gross agricultural production									
annual change in % (real)	-2.9	-4.5	10.6	-5.9	.	.	.	.	.
Construction industry									
annual change in % (real)	14.9	5.7	11.9	-11.3	-13.6	-13.9	.	.	.
Employed persons - LFS, th, average	2302.3	2357.7	2433.7	2366.3	2388.2	2283.1	2310	2310	2330
annual change in %	3.9	2.4	3.2	-2.8	-0.1	-4.4	-3	0	1
Unemployed persons - LFS, th, average	355.4	295.7	255.7	323.5	281.0	407.1	.	.	.
Unemployment rate - LFS, in %, average	13.4	11.1	9.5	12.0	10.5	15.1	15	14	13
Reg. unemployment rate, in %, end of period	9.4	8.0	8.4	12.7	10.3	12.9	14	13	12
Average gross monthly wages, EUR [2]	623	669	723	745	711.0	725	.	.	.
annual change in % (real, gross)	3.3	4.3	3.3	1.4	1.7	1.6	.	.	.
Consumer prices (HICP), % p.a.	4.3	1.9	3.9	0.9	2.3	0.0	1	2	2
Producer prices in industry, % p.a.	3.0	-1.4	2.5	-6.6	-5.1	-3.4	-2	2	2
General governm.budget, EU-def., % GDP									
Revenues	33.5	32.5	32.5	34.0	.	.	.	.	.
Expenditures	36.9	34.4	34.8	40.8	.	.	.	.	.
Net lending (+) / net borrowing (-)	-3.5	-1.9	-2.3	-6.8	.	.	-7	-6.5	-6
Public debt, EU-def., in % of GDP	30.5	29.3	27.7	35.7	.	.	42	45	45
Discount rate of NB, % p.a., end of period [3]	4.8	4.3	2.5	1.0	1.5	1.0	.	.	.
Current account, EUR mn	-3636	-3141	-4279	-2023	-576	-247	-1800	-3000	-3500
Current account in % of GDP	-8.2	-5.7	-6.6	-3.2	-3.9	-1.6	-2.8	-4.4	-4.8
Exports of goods, BOP, EUR mn	33349	42171	47722	39715	9125	10564	44000	45000	47000
annual growth rate in %	30.0	26.5	13.2	-16.8	-21.2	15.8	10	3	5
Imports of goods, BOP, EUR mn	35817	43009	48435	38528	9172	10255	42000	43000	45000
annual growth rate in %	29.9	20.1	12.6	-20.5	-19.4	11.8	8	2	5
Exports of services, BOP, EUR mn	4322	5140	5796	4522	1027	984	4700	4800	5000
annual growth rate in %	22.0	18.9	12.8	-22.0	-18.8	-4.2	4	3	4
Imports of services, BOP, EUR mn	3790	4752	6269	5768	1422	1259	6100	6400	6800
annual growth rate in %	15.4	25.4	31.9	-8.0	5.3	-11.5	5	5	6
FDI inflow, EUR mn	3311	2108	2395	-35	394	309	1000	1500	2000
FDI outflow, EUR mn	292	149	177	311	217	-10	300	400	500
Gross reserves of NB excl. gold, EUR mn [4]	9639	12280	12674	481	182	516	.	.	.
Gross external debt, EUR mn	24449	30156	37286	45328	40257	46290	.	.	.
Gross external debt in % of GDP	50.8	54.6	55.5	71.6	63.6	71.7	.	.	.
Average exchange rate EUR/EUR	1.236	1.121	1.038	1.000	1.00	1.00	1.00	1.00	1.00
Purchasing power parity EUR/EUR	0.681	0.677	0.687	0.689	.	.	.	.	.

Note: Slovakia introduced the euro on 1 January 2009. Up to and including 2008 all time series in SKK as well as exchange rates and PPP rates have been divided for statistical purposes by the conversion factor 30.126 (SKK per EUR) to a kind of statistical EUR (euro-fixed).

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) From 2006 including wages of armed forces. - 3) 2-week limit rate of NB for REPO tenders, from 2009 official refinancing operation rates for euro area (ECB). - 4) From January 2009 (euro introduction) only foreign currency reserves denominated in non-euro currencies.

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