Zdenek Lukas

Slovakia: a new European citadel of car manufacturing?

One year ago the Social-Democratic Party Smer, led by Robert Fico and his allies, took power; it followed eight years of pro-reform centre-right coalition governments. Despite post-election fears that the social democrats would radically change the liberal economic policy that was backed by the booming economy, any changes have been of a largely cosmetic nature. As a result, the economic fundamentals established by the earlier policy makers have continued to shape the current economic events. Nevertheless, the ruling government has pursued a socially balanced policy that was coupled with increased budgetary expenditures focused on poor people, young families and pensioners. Likewise, budgetary spending on agriculture and on the Government Office were raised overproportionately. The rapidly expanding economy and hence high budgetary revenues make it easy to finance these items. However, spending on establishing a 'knowledge economy' – i.e. money on education and research & development – has so far increased less than total budgetary expenditures on average. Changes in the flat-tax system have been modest, focusing on lowering the VAT rate on medicines and on higher taxation of considerably above-average wages. Foreign direct investors have not been affected by the recent tax amendments. This is good news because foreign investment and its economic impact have been the main driving force behind the country's strong (and sustainable) economic expansion and its acceleration observed in the past few years.

On the supply side, the GDP expansion in the first quarter of 2007 followed mostly from growth in gross value-added in industry and in services (transport, post, telecommunications), both rising by 19%. Construction is also contributing to GDP growth: its output rose by 21% in the first quarter, mostly driven by new construction, modernization and reconstruction.

Slovakia has remained one of top growing economies in Europe. Growth even speeded up in the first quarter of 2007, when GDP rose by 9% as compared to 6.7% in the corresponding period of 2006. As a result of rising industrial investment, in particular FDI and stepped-up infrastructure investment, gross fixed capital formation increased by 7.7%. Rising real wages and credits to private households fuelled private consumption, up 6.5%. Since the second half of 2006 real exports have gained momentum, driven in particular by foreign demand for cars, steel, refinery products and electronics. Although the strong domestic demand was partly covered by rising imports, foreign trade contributed positively to overall GDP growth. Despite the appreciation of the domestic currency, the export goods manufactured by the new FDI-led companies have been sufficiently competitive to withstand the appreciation. With increasing repatriation of profits of FDI and a widening foreign trade deficit, the current account deficit deteriorated in 2006, accounting for 8.3% of the GDP. According to preliminary data, the current account for January to March 2007 ended in a modest surplus (EUR 20 million, or 0.2% of GDP).

As a result of the lively investment activity, gross industrial output expanded by 15.3% in the first four months of 2007. Industrial employment (LFS data) rose by some 5%, while industrial labour productivity was up by around 10%. At the same time nominal wages rose by some 8%, and unit labour costs (ULCs) dropped by about 2% in SKK terms. Taking into account the appreciation of the Slovak koruna by above 8% in the reference period, ULCs rose by some 6% in euro terms. Nevertheless, the competitiveness of Slovak tradable goods continues to rely on the wage rates, which in euro terms are relatively low: gross monthly wages averaged some EUR 540 in the first quarter of 2007, i.e. at least one fifth lower than in other Central European competitors (Czech Republic, Hungary, Poland). The National Bank of Slovakia (NBS) is fighting appreciation through foreign exchange intervention. The latest one (in April 2007) in the amount of EUR 700 million resulted in a marginal depreciation.

The foreign investment enterprises in the automotive industry (Volkswagen, PSA Peugeot Citroen and KIA in association with Hyundai) are the flagships of the Slovak economy and are important driving forces for other industrial sectors. Car production soared by 93% in the first four months of 2007 as compared to the same period a year earlier; in particular in the newcomer factories (PSA and KIA) production is rising more and more rapidly. Foreign investment enterprises operating in machinery & equipment and in electrical & optical equipment also registered high rates of production growth (15% and 19% respectively).

With an annual production of more than 1 million cars envisaged for the end of the current decade, Slovakia is becoming the world's biggest car producer per capita. Car production is expected to account for more than half of manufacturing output and over 60% of total exports in 2008.

FDI inflows doubled to EUR 3.3 billion in 2006, after a fall to EUR 1.7 billion in 2005. The highest number of investors has targeted the car, electro-technical and machinery industries as well as services. The largest projects, two new car factories (PSA Peugeot-Citroen and KIA Hyundai), are both located in western Slovakia and account for strong pro-employment effects. As foreign investors are focusing on the more developed western regions, the eastern parts of the country with high unemployment are falling behind. So far there are only two large foreign investment enterprises (with the concomitant employment effects) in eastern Slovakia, US Steel Košice (the largest flat-rolled steel producer in Central Europe) and the German automobile gear box manufacturer Getrag Ford Košice-Kechnec. As for the year 2007, we expect a substantial slowdown of the FDI inflow as compared to the record level of 2006.

Since 2006 the accelerating economic growth has supported growth in employment as the demand for labour has been on the rise. Total employment (LFS) increased by 3.1% in the first quarter of 2007, chiefly due to industrial employment rising by 5.2%. The unemployment rate (LFS) fell by 3.4 percentage points, to 11.5% in the first quarter of 2007. Whereas the standard of living is rising on the country average, the gap between rich and poor remains wide. At the end of March 2007, more than 7% of the Slovak population were living below the poverty line. The wealthiest region is Bratislava, followed by the Žilina district in the north-west. Purchasing power is lowest in southern-central Slovakia and in districts in the remote east (with the exception of Košice city). Infrastructure is unbalanced and links between the eastern and western parts of the country are underdeveloped. Therefore, the fast completion of the motorway system between the west (Bratislava) and the east (Košice) has been one of the government's priorities. The main bottlenecks in construction are the technical preparation of the project and the negotiations with owners of the land needed for the motorway. There is the risk that Slovakia may not be able to make full use of the more than EUR 3 billion granted by the EU up until 2013. Several deadlines having been postponed, a realistic target date for the completion of the motorway now seems to be 2015.

On the road to the euro, Slovakia was admitted into the ERM-II already on 26 November 2005. The central exchange rate parity was set at SKK 38.46 to the euro, with a +/-15% fluctuation band. Since joining the ERM-II the Slovak koruna has appreciated by 12%, reaching SKK 34.50 to the euro in February 2007. Based on economic fundamentals as well as on mutual agreements with the EU administration and the European Central Bank, on 19 March 2007 the NBS appreciated the central exchange rate parity of the Slovak koruna by 8.5% to SKK 35.44 to the euro. The standard fluctuation band of +/-15% around the central rate parity continues to be observed. So far the policy makers have been relatively successful on their way towards meeting the Maastricht criteria. Slovakia aims to keep its budget deficit below 3% of GDP (the maximum threshold for the euro adoption). There should be no problem in meeting the Maastricht criterion related to inflation, although developments on the world oil markets might represent some risks. The new government has repeatedly confirmed its ambitious target of adopting the euro by 2009.

The vigorous external and domestic demand, fuelled by accelerating export growth and rising real wages, will keep GDP growth at a high level, reaching above 8% this year. The strong (and sustainable) expansion of industrial output in the coming years, mainly in car manufacturing, will contribute most to the GDP growth. Consumer price inflation will most probably meet the Maastricht criterion. In the wake of rising labour demand the unemployment rate will go down further. Increasing budget tax revenues thanks to robust GDP growth will result in reducing the budget deficit to below 3% of GDP in 2007. The foreign trade balance will be in surplus owing to the strong expansion of industrial exports. By contrast, increasing repatriation of profits by FDI companies, expanding domestic demand partly covered by imports as well as high prices for imported fuels will slow down the improvement in the external position. In addition, the strong domestic currency will encourage imports. All in all, the current account deficit will slightly diminish in the years to come.

Table SK

Slovak Republic: Selected Economic Indicators

	2002	2003	2004	2005	2006 [1]	2006	2007	2007	2008
						1st quarter		forecast	
Population, th pers., mid-year	5378.8	5379.0	5382.2	5386.7	5390.0	.	.	.	.
Gross domestic product, SKK bn, nom. [2]	1111.5	1212.7	1355.3	1471.1	1636.3	368.8	414.6	1830	2020
annual change in % (real) [2]	4.1	4.2	5.4	6.0	8.3	6.7	9.0	8.5	8
GDP/capita (EUR at exchange rate) [2]	4839	5434	6288	7077	8150	.		.	.
GDP/capita (EUR at PPP - wiiw) [2]	10990	11500	12360	13410	15080	.		.	.
Gross industrial production									
annual change in % (real)	6.7	5.3	4.2	3.6	9.9	9.5	15.2	14	10
Gross agricultural production									
annual change in % (real)	1.5	-2.4	5.6	-6.0	.	.	.	.	.
Construction industry									
annual change in % (real)	4.1	6.0	5.7	14.7	14.8	14.3	21.4	.	.
Consumption of households, SKK bn, nom. [2]	634.3	676.9	754.4	829.8	927.2	221.5	241.9	.	.
annual change in % (real) [2]	5.2	0.1	3.8	7.2	6.3	6.6	6.5	7	5
Gross fixed capital form., SKK bn, nom. [2]	303.5	302.8	327.1	394.6	432.1	89.1	98.6	.	.
annual change in % (real) [2]	0.3	-2.3	5.0	17.5	7.3	13.8	7.7	8	7
LFS - employed persons, th, avg.	2127.0	2164.6	2170.4	2216.2	2301.4	2257.5	2326.6	.	.
annual change in %	0.2	1.8	0.3	2.1	3.8	3.7	3.1	.	.
LFS - employed pers. in industry, th, avg.	640.9	634.1	641.3	649.1	666.4	653.4	687.1	.	.
annual change in %	1.9	-1.1	1.1	1.2	2.7	1.8	5.2	.	.
LFS - unemployed, th pers., average	486.9	459.2	480.7	427.5	353.4	395.8	303.0	.	.
LFS - unemployment rate in %, average	18.5	17.4	18.1	16.2	13.3	14.9	11.5	11	10
Reg. unemployment rate in %, end of period	17.5	15.6	13.1	11.4	9.4	11.4	8.9	8	7
Average gross monthly wages, SKK [3]	13511	14365	15825	17274	18761	17315	18511	.	.
annual change in % (real, gross)	5.8	-2.0	2.5	6.3	3.3	2.7	4.2	4	3
Consumer prices, % p.a.	3.3	8.5	7.5	2.7	4.5	4.3	2.8	3	2
Producer prices in industry, % p.a.	2.1	8.3	3.4	4.7	8.4	9.5	3.4	5	4
General governm.budget, EU-def., % GDP [4]									
Revenues	35.7	37.5	35.4	35.2	33.9	.	.	.	.
Expenditures	43.3	40.3	37.8	38.0	37.3	.	.	.	.
Deficit (-) / surplus (+)	-7.7	-2.8	-2.4	-2.8	-3.4	.	.	-3.0	-2.8
Public debt, EU-def., in % of GDP [4]	43.3	42.4	41.5	34.5	30.7	.	.	.	.
Discount rate, % p.a., end of period	6.5	6.0	4.0	3.0	4.8	3.5	4.5	.	.
Current account, EUR mn [5]	-2043	-1747	-2656	-3288	-3640	-622	20	-2500	-2500
Current account in % of GDP	-7.8	-6.0	-7.8	-8.6	-8.3	-6.3	0.2	-4.7	-4.1
Gross reserves of NB incl. gold, EUR mn	8824	9717	10954	13067	10145	13657	12437	.	.
Gross external debt, EUR mn	12655	14654	17421	22705	24449	23580	24317 II	.	.
FDI inflow, EUR mn	4397	1914	2441	1694	3324	316 I-II	241 I-II	.	.
FDI outflow, EUR mn	12	219	-17	126	294	40 I-II	33 I-II	.	.
Exports of goods, BOP, EUR mn [5]	15270	19359	22248	25743	33273	7145	9825	46000	57000
annual growth rate in %	8.2	26.8	14.9	15.7	29.2	28.5	37.5	38	24
Imports of goods, BOP, EUR mn [5]	17517	19924	23485	27713	35733	7771	9876	45000	55500
annual growth rate in %	6.2	13.7	17.9	18.0	28.9	31.3	27.1	26	23
Exports of services, BOP, EUR mn [5]	2958	2912	3000	3542	4313	596 I-II	666 I-II	4800	5300
annual growth rate in %	6.4	-1.5	3.0	18.1	21.7	13.4	11.7	11	10
Imports of services, BOP, EUR mn [5]	2474	2703	2785	3285	3783	526 I-II	661 I-II	4700	5600
annual growth rate in %	10.3	9.2	3.0	18.0	15.2	10.5	25.7	24	19
Average exchange rate SKK/USD	45.34	36.77	32.26	31.02	29.72	31.17	26.24	.	.
Average exchange rate SKK/EUR (ECU)	42.70	41.49	40.05	38.59	37.25	37.46	34.37	34.5	33.5
Purchasing power parity SKK/USD	16.21	16.59	17.19	17.09	17.24	.	.	.	.
Purchasing power parity SKK/EUR	18.80	19.60	20.38	20.37	20.13	.	.	.	.

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

1) Preliminary. - 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.