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Slovakia: accelerating GDP growth and rising self-confidence towards elections

On 26 November 2005, Slovakia was – quite unexpectedly – admitted into the ERM-II. The central exchange rate parity was set at SKK 38.455 to the euro, with a +/-15% fluctuation band. If Slovakia meets the Maastricht criteria, it could adopt the euro in 2008, or – more realistically – at the beginning of 2009. Although Slovakia is relatively successful on its way to meeting the criteria, the rapid entry into the EMR-II was probably driven by political rather than economical considerations. While the EMR-II restricts a country's sovereignty in national monetary, fiscal and exchange rate policies, the Slovak economy does not yet seem stabilized enough to give up some instruments of national economic policy. On the other hand, the political reasons for entering the ERM-II are well understandable given the approaching parliamentary elections (September). The opposition parties are leading in the opinion polls, therefore impressive news of any kind are highly valued by the government. Supported by the EMR-II entry and positive expectations for the future, the Slovak koruna has appreciated, reaching SKK 37.40 to the euro on 10 January 2006. Since then it has remained on the stronger side of the parity.

The economy continues to grow at a high rate in spite of just moderate growth in the old EU countries. Growth even accelerated in the third quarter of 2005 when GDP was up by 6.2% compared to 5.1% in the second quarter. Backed by rising wages, private consumption rose by 5.8%. Following three years of near-stagnation, gross fixed capital formation expanded by 11.4% mostly due to rising industrial investment. Exports are again gaining momentum and the contribution of foreign trade to GDP growth turned positive: the strong expansion of exports (goods and services) exceeded the rise in imports of consumer and investment goods. That occurred despite the real appreciation of the Slovak currency (by some 6% on annual average), which made imports cheaper. The real appreciation was compensated by shifting to high-value export products.

Following stagnation in the first quarter of 2005, industry has recovered. As a result, gross industrial output rose by 3.2% in the first eleven months of 2005. Up until 2003 industrial growth had been chiefly fuelled by car production by VW Bratislava, but in the past two years foreign investment companies, mostly operating in metallurgy, machinery & equipment, electrical & optical equipment and wood manufacturing, registered above-average growth rates. Wages expanded faster than labour productivity in all important sectors, resulting in rising unit labour costs.

The Russian-Ukrainian gas dispute temporarily affected supplies to Slovakia. By relying on own gas reserves, however, the gas supplies for domestic consumers did not suffer. Slovakia is a highly energy-intensive economy with an output structure dominated by the most energy-intensive industries such as steel and aluminium metallurgy.

The strong economic growth has been reflected in rising employment. Total employment (LFS) increased by 2% in the first three quarters of 2005. At the same time, the unemployment rate (LFS) dropped by 2.1 percentage points to 16%. Nevertheless Slovakia has the second highest unemployment rate in the EU, after Poland.

In recent years, Slovakia has gained a reputation as a reform pioneer. Because of comprehensive reforms and favourable macroeconomic developments, in December 2005 Standard & Poor’s Ratings services upgraded Slovakia’s long-term and short-term sovereign credit ratings.

The projected budget deficit of 3.8% of GDP in 2005 has most probably been met. Despite its minority position in parliament, the government managed to push through the draft budget for 2006. The projected general government budget deficit is to amount to 2.9% of the GDP, excluding pension reform costs.

Volkswagen (VW), still the largest carmaker in Slovakia, produced above 200 thousand cars in 2005. The projected output in 2006 is 220 thousand units (mostly Audi Q7). VW is generating about one fifth of Slovakia’s total exports, which is to expand to one quarter in 2006. Another carmaker, PSA Peugeot Citroen, confirmed its plan to invest about EUR 1 billion into a new plant in Trnava, instead of the originally stated EUR 0.7 billion. If fully realized, PSA will manufacture some 450 thousand cars per year by the end of the decade. In addition, KIA, the Hyundai associate, envisaged production of at least 200 thousand cars a year after 2006. Three big FDI projects[1] in a total value of some EUR 2 billion, announced in the past two years, are however still in delay. After FDI inflows of EUR 1 billion in 2004, the total inflow probably reached close to EUR 1.5 billion in 2005.

Significant confusion surrounded the privatization of a 66% stake in Slovakia's two largest airports just a few weeks ago. Some observers claimed that the TwoOne consortium (Vienna International Airport, Raiffeisen Zentralbank and Penta) favoured by the tender commission had presented the weakest business plan for the Bratislava and Košice airports among four bidders.[2] Following several weeks of heavy criticism led by the

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[1] The projects relate to KIA car manufacturing, the privatization of a 66% stake in the power utility Slovenské elektrárne by the Italian company Enel and tyre production by the Korean company Hankook Tyre. For details see *The Vienna Institute Monthly Report*, No. 10, 2005, p. 11.

[2] Apart from TwoOne, a consortium including the Spanish Abertis, the British TBI and the Slovak J&T financial group, Tepe Akfen Ventures and Independent Slovak Airport Partners (Köln-Bonn Airport, SNC-Lavalin International, and Airport Consulting Vienna) had bidden for the airports.

opposition parties, on 19 January the government ordered a second round in the airport tender. With EUR 300 million, TwoOne offered more than the closest bidder, a consortium led by Abertis. As a result, on 1 February the cabinet approved TwoOne as purchaser. In addition, the winner is obliged to invest some EUR 250 million in both airports (of which EUR 240 million in Bratislava) in the period 2006 to 2010. The contract is to be signed by 28 February.

Vigorous private demand, fuelled by rising real wages and pre-election populism, as well as strong investment growth coupled with growing export expansion will keep GDP growth at a high level, reaching close to 6% this year. Later on gradually rising industrial output, mainly in FDI-led car manufacturing, will contribute most to the GDP expansion. In the wake of increasing labour demand the unemployment rate may go down further. An increase in energy prices and in the excise tax on spirits will induce somewhat higher inflation. The budget deficit may fall below 3% already in 2006. Increasing repatriation of profits by FDI companies and expanding domestic demand as well as high prices for imported fuels will keep the current account deficit at a high level in the years to come. In addition, the strong domestic currency will encourage imports.

The government is satisfied with the approved EU budget for 2007 to 2013. For instance, according to the agreement, in this period Slovakia is to receive some EUR 1.35 billion annually from the EU budget for cohesion.[3] In addition, it is to obtain around EUR 370 million in support for decommissioning the V1 nuclear power plant in Jaslovske Bohunice. The total costs thereby incurred are estimated at about EUR 1.8 billion. The EU will also support the development of infrastructure and under-developed regions in Slovakia with a total amount of some EUR 390 million.

[3] If fully utilized, that would account for roughly 2.5% of real GNI annually in the period 2007 to 2013.

Table SK

Slovak Republic: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005 [1]	2006	2007
								forecast	
Population, th pers., mid-year	5395.3	5400.7	5379.8	5378.8	5379.0	5382.2	5386.7	.	.
Gross domestic product, SKK bn, nom.	844.1	934.1	1009.8	1098.7	1201.2	1325.5	1440	1570	1720
annual change in % (real)	1.5	2.0	3.8	4.6	4.5	5.5	5.6	6.0	6.5
GDP/capita (EUR at exchange rate)	3546	4061	4334	4784	5382	6149	6930	.	.
GDP/capita (EUR at PPP - wiiw)	8750	9470	10040	10860	11190	11750	12630	.	.
Gross industrial production									
annual change in % (real)	-2.6	8.4	7.6	6.7	5.3	4.2	3.1	7	8
Gross agricultural production									
annual change in % (real)	-2.5	-12.3	9.9	1.5	-2.4	1.1	.	.	.
Construction industry									
annual change in % (real)	-25.8	-0.4	0.8	4.1	6.0	5.7	16.4 I-X	.	.
Consumption of households, SKK bn, nom.	473.0	519.6	577.5	624.5	667.5	738.7	.	.	.
annual change in % (real)	2.7	-0.9	4.9	5.5	-0.8	3.5	6	7	4
Gross fixed capital form., SKK bn, nom.	249.8	242.3	291.0	303.5	308.4	327.2	.	.	.
annual change in % (real)	-19.6	-7.2	13.9	-0.6	-1.5	2.5	12	15	15
LFS - employed persons, th, avg.	2132.1	2101.7	2123.7	2127.0	2164.6	2170.4	2210	.	.
annual change in %	-3.0	-1.4	1.0	0.2	1.8	0.3	2	.	.
LFS - employed pers. in industry, th, avg.	630.3	615.3	628.8	640.9	634.1	641.3	647.9 I-IX	.	.
annual change in %	-4.9	-2.4	2.2	1.9	-1.1	1.1	1.4 I-IX	.	.
LFS - unemployed, th pers., average	416.8	485.2	508.0	486.9	459.2	480.7	430	.	.
LFS - unemployment rate in %, average	16.2	18.6	19.2	18.5	17.4	18.1	16	15	14
Reg. unemployment rate in %, end of period	19.2	17.9	18.6	17.5	15.6	13.1	11.4	10	9
Average gross monthly wages, SKK	10728	11430	12365	13511	14365	15825	17300	.	.
annual change in % (real, gross)	-2.8	-4.5	1.0	5.8	-2.0	2.5	6	.	.
Consumer prices, % p.a.	10.6	12.0	7.1	3.3	8.5	7.5	2.7	3	3
Producer prices in industry, % p.a.	4.3	10.8	6.5	2.1	8.3	3.4	4.5	4	3
General governm.budget, EU-def., % GDP [2]									
Revenues	49.8	47.6	37.1	36.0	35.9	37.3	37.0	.	.
Expenditures	56.9	59.9	43.6	43.7	39.7	40.5	40.8	.	.
Deficit (-) / surplus (+)	-7.1	-12.3	-6.6	-7.8	-3.8	-3.1	-3.8	-2.9	-3
Public debt in % of GDP [2]	47.2	49.9	49.2	43.7	43.1	42.5	36.7	38.2	38.5
Discount rate, % p.a., end of period	8.8	8.8	8.8	6.5	6.0	4.0	3.0	.	.
Current account, EUR mn [3]	-920	-761	-1950	-2043	-244	-1149	-2200	-2000	-2000
Current account in % of GDP	-4.8	-3.5	-8.4	-7.9	-0.8	-3.5	-5.9	-4.7	-4.2
Gross reserves of NB incl. gold, EUR mn [4]	3410	4391	4748	8824	9717	10954	13083	.	.
Gross external debt, EUR mn	10470	11637	12516	12655	14654	17421	21996 IX	.	.
FDI inflow, EUR mn	402	2089	1768	4397	593	1016	1500	.	.
FDI outflow, EUR mn	-348	23	39	5	20	-114	100	.	.
Exports of goods, BOP, EUR mn [3]	9603	12879	14115	15270	19359	22354	25000	28800	34600
annual growth rate in %	0.7	34.1	9.6	8.2	26.8	15.5	12	15	20
Imports of goods, BOP, EUR mn [3]	10628	13860	16488	17517	19924	23526	26500	30500	35400
annual growth rate in %	-8.6	30.4	19.0	6.2	13.7	18.1	13	15	16
Exports of services, BOP, EUR mn [3]	1937	2436	2779	2958	2912	3000	3500	.	.
annual growth rate in %	-10.7	25.8	14.1	6.4	-1.5	3.0	17	.	.
Imports of services, BOP, EUR mn [3]	1732	1961	2244	2474	2703	2785	3100	.	.
annual growth rate in %	-14.5	13.2	14.5	10.3	9.2	3.0	11	.	.
Average exchange rate SKK/USD	41.42	46.20	48.35	45.34	36.77	32.26	31.02	.	.
Average exchange rate SKK/EUR (ECU)	44.12	42.59	43.31	42.70	41.49	40.05	38.59	37.0	36.0
Purchasing power parity SKK/USD	15.65	16.08	16.30	16.21	17.03	17.91	17.93	.	.
Purchasing power parity SKK/EUR	17.87	18.26	18.70	18.80	19.96	20.97	21.17	.	.

Notes: 1) Preliminary. - 2) According to ESA'95, excessive deficit procedure. - 3) wiiw calculated from USD. - 4) From January 2002 new valuation of gold.

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