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Slovakia: an eager reformist, yet distinctly unpopular government

In order to make up for time lost prior to 1998, Slovakia is now ramming through a series of the most radical reforms in the EU – albeit in concert with social hardship. Whereas foreign investors heap the government with praise, most Slovaks cannot conceal their disillusionment. In the second round of the presidential election on 17 April, Ivan Gasparovič, the former nationalist speaker of parliament, beat his former political friend Vladimír Mečiar; while the candidate of the governing coalition lost. Despite his primarily ceremonial position, the Slovak president has the right to veto bills, acts and amendments thereto, whereafter parliament has to decide whether to pursue or drop the issue. Based on the experience of the term of the former president, Rudolf Schuster, also a strict opponent of the current government, presidential vetoes can be seen as a means of delaying reforms rather than stopping them completely. In any event, the government has already forced through the bulk of its comprehensive economic reform programme. The programme is primarily targeted towards sustaining economic growth and reducing the budget deficit. Sustainability is to be achieved mostly by attracting foreign investors. As an appropriate tool to that end, the government has adopted a 19% tax rate for corporate profits, personal income and all other types of income: an extremely low tax rate compared to other EU countries. It came into effect on 1 January 2004. The expected decline in related revenues should be offset by a standard value-added tax rate of 19% on all goods (including staples) and services; this replaces the previous two-tier VAT scheme. Those in favour of this wide-ranging tax reform are banking on more effective tax collection, more FDI, stronger economic growth and a stabilization of budgetary revenues. However, those opposing it underscore the unfairness inherent in any flat-tax system, with the rich reaping most of the benefits of lower taxation, while the low- and medium-income groups have to bear the brunt, primarily in the form of more indirect taxes.

As for the stabilization and the ultimate reduction of the budget deficit, the administration has initiated a radical reform of the welfare state: the criteria governing qualification for the receipt of full social benefits and maximum allowances have been tightened. The funding and management of the health system, encompassing public hospitals and private pharmacies, has been reorganized. As for the pension system, the Slovak parliament approved a new bill in 2003 that provided for a gradual increase in the statutory retirement age (up to 62) and the establishment of privately managed personal pension schemes, into which workers will pay half of their compulsory social security contributions. As of January 2005, the new pension scheme will be mandatory for new entrants to the labour market, whereas current workers will be given the choice.

Earlier this year the administration reduced basic social benefits to long-term jobless with the declared aim of lowering budgetary expenditures. It lowered the ceiling for transfer payments to families: for example, by introducing family allowances degressive with the number of children. As was to be expected, this reform led to a huge uproar among the Roma living in slum quarters, some 300,000 persons located predominantly in the eastern part of the country. Most of them are trapped in a vicious circle of low education and extremely low job opportunities. Major efforts will be called for to change this situation, including EU funding, for example, in the context of rural development initiatives; such a move, however, requires co-financing from national sources. In fact, pronounced social disparities are coming to the fore in general and may well scupper the current government's fragile political mandate.

The Slovak export-oriented economy has forged ahead over the past three years, despite only slight economic expansion in the EU-15 and rising unit labour costs (in euro terms) in Slovakia. As a matter of fact, the improved competitiveness of the country's industry, based as it is on a healthy shift towards higher value-added products, has opened the door to international markets. Foreign sales are still increasing at double-digit rates; they are in fact the main driving force behind the country's economic expansion. The bulk of this economic growth relates to car exports (VW Bratislava is producing an increasing number of cars in the upper price bracket); they soared by 45% and accounted for 29% of total exports in 2003. The result is a slightly positive foreign trade balance overall and a negligible current account deficit as well. Slovak GDP rose by 5.5% in the first quarter of 2004. Exports (goods and services) rose by 16% (GDP concept). Following a pronounced increase in 2001 and 2002, total domestic demand (dominated by private consumption) dropped in 2003, mostly on account of lower real household incomes. Despite hikes in both regulated prices and taxes, real incomes rose moderately in the first quarter of 2004, yielding private consumption growth of 3%. Gross fixed capital formation stagnated.

Based on increased production in the automotive sector, gross industrial production in the first four months of 2004 expanded by 6.2%. Labour productivity rose by more than 7% and real wages by 1.5%. Nevertheless, unit labour costs in euro terms are rising as appreciation of the Slovak koruna (in both nominal and real terms) has eroded a part of productivity gains. The major contributor to the country's industrial expansion was the transport equipment industry (VW Bratislava); the sector expanded by 31% and already accounts for 22% of total manufacturing. In contrast, output in the mining and energy sector declined. In the wake of the building boom, output in the construction sector rose by 2.4%.

Following an upward trend over a period of more than three years, employment stagnated in the first quarter of 2004. As a result, the registered unemployment rate has remained high, amounting to 15.3% at the end of April 2004. The labour act has been revised several times. The new bill should enhance labour market flexibility and ultimately bring the unemployment rate down. Furthermore, the rise in foreign greenfield investments will create more new jobs over time. The French carmakers PSA Peugeot-Citroën plan to invest EUR 0.7 billion by 2006 in a new plant in Trnava (western Slovakia) employing nearly 4000 workers and producing 300,000 cars a year. In March 2004 KIA, the Hyundai associate, decided to locate its first European plant in Žilina (north-western Slovakia). The investment target is some EUR 0.7 billion for a production facility employing close on 3000 workers and manufacturing at least 200,000 cars a year after 2006. If both projects materialize, their potential production capacity combined with that of VW Bratislava would be more than 900,000 cars a year. Slovakia would thus become the world's largest carmaker in per capita terms. After reaching a record level of EUR 4 billion in 2002, FDI inflows dropped to some EUR 0.5 billion in 2003. A recovery, however, is expected both this year and in future years on account of the above large-scale projects and other greenfield investment plans attracted by the low corporate tax rate. Unfortunately, investors are mainly focusing their attention on the richer western regions which dispose of a well-developed infrastructure, disregarding the poorer regions where unemployment is high. As a result, the massive regional disparities are heightened still more. In order to combat this asymmetrical development, the government intends to speed up construction of a motorway link between Bratislava and Košice, the country's second largest city located to the east. The entire motorway programme is scheduled for completion by 2012; total costs are estimated at EUR 6 billion, part of which will be covered by the EU structural or cohesion funds.

As a result of the ongoing price deregulation and higher indirect taxation, consumer prices rose by 8.3% in the first four months of the year. The inflationary impact of external factors has been relatively neutral as the stronger Slovak koruna (which reached a new high of less than SKK 40/EUR at the beginning of June) has come into play, partly offsetting the rise in dollar-based prices for imported fuels and reducing the prices of certain imported consumer goods. As yet, the central government's budget deficit has dropped appreciably and accounted for less than 1% of GDP in the first five months of 2004. Budgetary expenditures even declined in nominal terms, while revenues mainly from VAT and corporate income tax rose more sharply than expected. Apparently, some of the improvements stem from radical cutbacks in the welfare system in terms of expenditures and from the flat-tax scheme in terms of revenues. Whether both trends can be sustained remains to be seen.

In 2004 in particular, export performance and, to a gradual degree, domestic demand will be the main engines of economic growth; GDP will increase by about 4.5%. In 2005, GDP growth may accelerate to 5%, supported by exports and greater (pre-election) domestic demand. Price and tax adjustments will keep the inflation rate high: 8% this year and 5% in 2005. After an historic low in 2003, the current account deficit will rise slightly in the coming years as export growth decelerates and foreign-owned companies gradually repatriate more profits. Furthermore, the envisaged real appreciation of the Slovak koruna will support imports. After joining the EU, the Slovak economy's greatest challenge will be coping with accession to the European Monetary Union. Slovakia intends to: (a) stay in the ERM II for as brief a period as possible (i.e. two years only); and (b) meet the Maastricht criteria by 2007. Thus, the introduction of the euro will fall due in 2009. The main obstacles to achieving this ambitious target will be the need to reduce in time the general government budget deficit to 3% of GDP.

Table SK

Slovak Republic: Selected Economic Indicators

	1999	2000	2001	2002	2003 1)	2003	2004	2004	2005
						1st quarter		forecast	
Population, th pers., mid-year	5395.3	5400.7	5379.8	5378.6	5378.8	.	.	.	.
Gross domestic product, SKK bn, nom.	844.1	934.1	1009.8	1096.4	1195.8	272.2	308.2	1330	1460
annual change in % (real)	1.5	2.0	3.8	4.4	4.2	4.1	5.5	4.5	5
GDP/capita (EUR at exchange rate)	3546	4061	4334	4774	5358	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	9160	9910	10480	11330	11730	.	.	.	.
Gross industrial production									
annual change in % (real)	-2.7	8.6	6.9	6.5	5.3	10.7	6.6	6	7
Construction industry									
annual change in % (real)	-25.8	-0.4	0.8	4.1	6.0	3.0	2.9	.	.
Consumption of households, SKK bn, nom.	473.0	519.6	577.5	623.1	667.5	159.6	176.3	.	.
annual change in % (real)	2.7	-0.9	4.9	5.3	-0.6	2.6	3.0	2	5
Gross fixed capital form., SKK bn, nom.	249.8	242.3	291.0	300.6	308.4	65.7	68.2	.	.
annual change in % (real)	-19.6	-7.2	13.9	-0.9	-1.2	-2.0	0.9	4	7
LFS - employed persons, th, avg.	2132.1	2101.7	2123.7	2127.0	2164.6	2130.8	2128.8	.	.
annual change in %	-3.0	-1.4	1.0	0.2	1.8	1.2	-0.1	.	.
LFS - employed pers. in industry, th, avg.	630.3	615.3	628.8	640.9	634.1	637.2	626.8	.	.
annual change in %	-4.9	-2.4	2.2	1.9	-1.1	-0.6	-1.6	.	.
LFS - unemployed persons, average	416.8	485.2	508.0	486.9	459.2	482.7	511.5	.	.
LFS - unemployment rate in %, average	16.2	18.6	19.2	18.5	17.4	18.4	19.3	17	16
Reg. unemployment rate in %, end of period	19.2	17.9	18.6	17.5	14.0	16.5	16.0	14	13
Average gross monthly wages, SKK	10728	11430	12365	13511	14365	13082	14541	.	.
annual change in % (real, gross)	-2.8	-4.5	0.8	5.8	-2.0	-1.0	2.7	.	.
Consumer prices, % p.a.	10.6	12.0	7.1	3.3	8.5	7.6	8.3	8	5
Producer prices in industry, % p.a.	4.3	10.8	6.5	2.1	8.3	8.5	3.0	5	4
General governm.budget, EU-def., % GDP 2)									
Revenues	49.8	47.6	45.5	45.2	49.1	.	.	42	43.1
Expenditures	56.9	59.9	51.5	50.9	52.7	.	.	46.1	47
Deficit (-) / surplus (+)	-7.1	-12.3	-6.0	-5.7	-3.6	.	.	-4.1	-3.9
Public debt in % of GDP 2)	43.8	49.9	48.7	43.3	42.8	.	.	45.1	46.1
Discount rate, % p.a., end of period	8.8	8.8	8.8	6.5	6.0	6.5	5.5	.	.
Current account, EUR mn	-920	-761	-1950	-2043	-248	-91	108	-300	-500
Current account in % of GDP	-4.8	-3.5	-8.4	-8.0	-0.9	.	.	-0.9	-1.4
Gross reserves of NB incl. gold, EUR mn 3)	3410	4391	4748	8824	9717	9099	10019	.	.
Gross external debt, EUR mn 4)	10470	11637	12516	12655	14654	12877	14673 Feb	.	.
FDI inflow, EUR mn	366	2089	1768	4378	506	314	276 Feb	.	.
FDI outflow, EUR mn	-348	23	39	5	20	12	1 Feb	.	.
Exports of goods, BOP, EUR mn	9603	12879	14115	15270	19355	4219.1	5011.3	22800	26200
annual growth rate in %	0.7	34.1	9.6	8.2	26.7	24.0	18.8	18	15
Imports of goods, BOP, EUR mn	10628	13860	16488	17517	19923	4358.9	4996.5	22900	26300
annual growth rate in %	-8.6	30.4	19.0	6.2	13.7	12.9	14.6	15	15
Exports of services, BOP, EUR mn	1937	2436	2779	2958	2912	691.9	458 Feb	.	.
annual growth rate in %	-10.7	25.8	14.1	6.4	-1.5	3.5	.	.	.
Imports of services, BOP, EUR mn	1732	1961	2244	2474	2703	676.9	437 Feb	.	.
annual growth rate in %	-14.5	13.2	14.5	10.3	9.2	24.1	.	.	.
Average exchange rate SKK/USD	41.42	46.20	48.35	45.34	36.77	38.96	32.43	.	.
Average exchange rate SKK/EUR (ECU)	44.12	42.59	43.31	42.70	41.49	41.80	40.58	40	39.5
Purchasing power parity SKK/USD, wiiw	15.63	16.23	16.51	16.63	17.22	.	.	.	.
Purchasing power parity SKK/EUR, wiiw	17.08	17.45	17.91	17.99	18.95	.	.	.	.

Notes: 1) Preliminary. - 2) According to ESA 95, excessive deficit procedure. - 3) From January 2002 new valuation of gold. - 4) Up to 2002 wiiw calculated from USD, in 2003 original data in EUR.

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