

24. SLOVAKIA

Moderate growth ahead

First GDP contraction in modern history

In 2009, the Slovak economy contracted for the first time since its formation in 1993. Real GDP fell by 4.7%, mainly driven by a collapse of industrial production by over 15%. This large collapse came after several years of fast real convergence, with GDP per capita (in PPS) increasing from 47% to 65% of the EU-15 average over the period 2002-08. During the boom years, the prospect of joining the euro area had stimulated large inflows of foreign direct investment in Slovakia. These inflows played an important role in the convergence process. They contributed to strong productivity growth by allowing faster build-up of the capital stock and transfer of technology and know-how. At the same time, sound macroeconomic and structural policies allowed large macroeconomic imbalances to be avoided and strong external competitiveness to be maintained. The buoyant economic growth also led to a continuous fall of the unemployment rate, from 18.7% in 2002 to 9.5% in 2008.

Given its large degree of trade-openness, Slovakia was strongly exposed to the slump in global trade, with exports tumbling by some 25% in the first quarter of 2009 compared to the same period of 2008. In the subsequent quarters of 2009, exports stabilised and gradually recovered reflecting a pick up in foreign demand for electronic products and cars, the latter being sustained by the implementation of car-scrapping schemes in several EU countries. At the same time, the crisis triggered a large increase in savings of households and non-financial corporations and a sharp fall in their investments. Households' consumption fell by 0.7% and fixed total investment by 10.5% in 2009. Companies also reduced their inventories at an unprecedented pace which acted as an "accelerator" of the contraction.

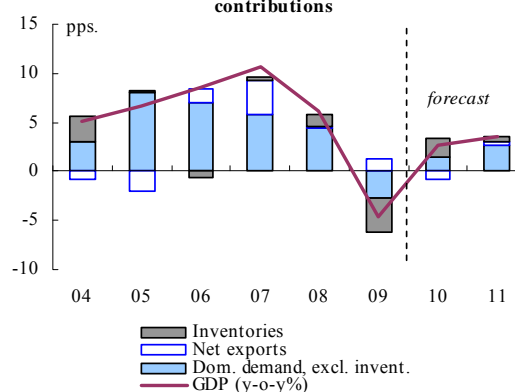
Despite government efforts to mitigate the impact of crisis on the labour market, the unemployment rate increased to 12% in 2009. The reaction of the labour market to the downturn was strong and almost immediate. This can be explained by the abruptness of the downturn and the flexibility of the labour market. However, employees' average compensation per head continued to increase, mainly as a result of application of pre-crisis wage agreements, an increase in severance payments and

dismissal of mainly low-paid workers. The resulting large increase in real unit labour costs, may have negatively affected Slovakia's competitiveness in 2009.

Despite the large shock to the real economy and severe stress in global financial markets, the Slovak banking sector has remained strong. This reflects the good liquidity situation of credit institutions and low dependence on cross-border lending. A tightening of lending conditions was observed for households and businesses, but this was primarily due to an expected increase in non-performing loans and more uncertain growth prospects, rather than to liquidity constraints on banks.

In response to the slump in external demand, the Slovak government implemented a policy strategy to support domestic demand. On the fiscal side, the authorities allowed the automatic stabilisers to operate fully and adopted anti-crisis measures totalling roughly ½% of GDP for both 2009 and 2010. The measures targeted specific sectors of the economy (car-scrapping scheme) and disadvantaged groups (increased tax credit for low earners), and aimed at supporting employment (contributions for retention of employees) and R&D activities.

Graph II.24.1: Slovakia - GDP growth and contributions



An externally-driven recovery

Real GDP is projected to increase by 2.7% in 2010 and 3.6% in 2011. While positive, these figures are much lower than those during the boom phase.

The ongoing recovery is mainly driven by rising demand for exports and a gradual re-building of inventories. Exports volumes grew by 8.6% in the second half of 2009 compared to the first half of the year, and business confidence indicators in the tradable sector have continued to improve in the first few months of 2010. Moreover, the recovery in exports is observable in all sectors, and is not limited to the car industry, which benefited in 2009 from exceptional one-off subsidies in several EU countries. Despite existing spare capacities in the manufacturing sector, investment is expected to rise by 3.7% in 2010. The main drivers should be the implementation of public-private partnership (PPP) projects focused on highways construction (2.4% of GDP), the rebuilding of the production facilities of the Volkswagen plant and green-field investment of the electronics producer AU Optronics. As the recovery in exports and inventories is also likely to result in a hike of imports, the overall contribution of net export to growth is projected to turn negative in 2010.

Households' consumption is projected to pick up only in 2011 after virtually no growth in 2010. This reflects still fragile, although recovering, consumer confidence and a further deterioration of the labour market. Employment is expected to fall further in 2010 and to rebound only in 2011. The unemployment rate is likely to peak in 2010, reaching 14%. Moreover, persistent structural problems in the labour market, such as professional-skill mismatches, which led to significant labour shortages at the end of the previous boom, could slow down the adjustment. Despite a minimum wage increase of over 4%, average wages are expected to record moderate growth in 2010, thus weighing on growth of real disposable income. The latter should, however, be supported by only modestly increasing inflation, which was pushed down significantly by the downturn. In 2010, inflation is projected to remain low at 1.3% due to envisaged developments in energy prices and household demand, as well as a decrease in excise duties on diesel fuels. In 2011, prices are expected to pick up in view of accelerating economic activity.

Slovakia's high reliance on exports exposes this forecast to some uncertainties. The continuation of the export-led recovery is conditioned on a rebound of the EU economy in 2010-11. A faster economic recovery is possible should exports demand and total investment benefit from ongoing PPP projects for motorways construction and

further foreign direct investment prove higher than expected. At the same time the withdrawal of fiscal stimulus measures in 2010-11 in most EU countries (in particular the car-scrapping schemes) may affect the external demand for cars by more than expected in this forecast. Overall, the risks to the baseline scenario of macroeconomic forecast appear to be balanced.

Strengthening potential growth and competitiveness

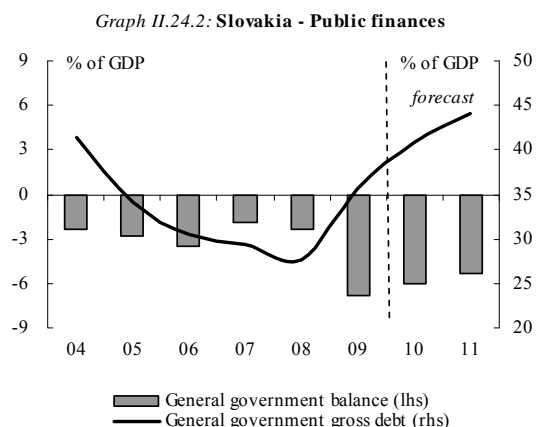
The crisis led to a sizeable reduction of potential growth in Slovakia. Current estimates suggest that potential growth will drop from an average of 5% in 2004-2008 to 3% in 2009-13. This decline is driven by a fall in labour utilisation, a much slower accumulation of productive capital and sluggish productivity growth.

Slovakia's specialisation in automotive industry has proved to be an asset to the economy. Car-scrapping schemes in several EU countries limited the fall of the Slovak car production to about 20% in 2009. Moreover, announced large foreign investments for 2010 are largely linked to car production. This supports the argument that the adoption of the euro, a favourable location and lower labour costs compared to regional peers continue to make Slovakia an attractive destination for foreign capital. However, the resulting increase in the already high specialisation of Slovakia in the car industry will make it even more vulnerable to swings in foreign demand for this specific type of good. A priority should accordingly be to develop new areas of specialisation, in particular by attracting foreign capital through skills upgrading and improvements of the education system.

Slovakia's competitiveness position is expected to remain strong. Depreciating exchange rates of neighbouring countries' currencies vis-à-vis the euro in the first half of 2009 and strong growth of real unit labour costs in Slovakia resulted in a sizeable deterioration of Slovakia's external price competitiveness in 2009. However, the ongoing appreciation of exchange rates in Slovakia's neighbours since the spring of 2009, the projected slowdown in wages and the rebound of productivity in 2010 should largely offset last year's developments. Ensuring moderate developments in domestic prices and costs, as well as improvements in non-price competitiveness, will be crucial for retaining and further enhancing Slovakia's competitiveness and attractiveness.

Stabilization of public finances

Years of procyclical policies during the boom – the structural deficit deteriorated from 1.8% of GDP to 4.8% of GDP over the period 2005-08, when growth averaged 8% per year – had left Slovakia's government finances in a vulnerable position at the onset of the crisis. The recession unmasked these looming imbalances. The headline deficit soared from 2.3% in 2008 to 6.8% of GDP in 2009.



The full operation of automatic stabilisers triggered a sizeable increase in social spending and a marked decline in revenue. The stimulus measures announced in the context of the EERP package were broadly neutral for the deficit.

Announced consolidation efforts to cut expenditure on goods and services and capital, together with the recovery of the economy in 2010-11, are expected to contribute to a reduction of the headline deficit to 6.0% of GDP in 2010 and 5.4% of GDP in 2011. The higher projection of the 2010 general government deficit compared to the most recent update of the stability programme (5.5% of GDP) reflects primarily a base effect given an upward revision of the headline deficit for 2009 notified in April and lower revenue expectations. The largest part of the improvement in the deficit would reflect a decline of the structural deficit. This forecast is, however, subject to risks. In particular, spending pressure may intensify ahead of and after the general elections in June 2010, and the projected balanced fiscal position of local governments seems optimistic in view of the impact of the crisis on the revenues of these entities. The high deficits and capital injections in two state-owned banks will cause general government gross debt to rise from 35.7% of GDP in 2009 to 40.8% of GDP in 2010. Under the no-policy-change assumption, government debt is expected to reach 44% of GDP in 2011.

Table II.24.1:

Main features of country forecast - SLOVAKIA

	2008			92-05	Annual percentage change					
	bn EUR	Curr. prices	% GDP		2006	2007	2008	2009	2010	2011
GDP	67.2		100.0	-	8.5	10.6	6.2	-4.7	2.7	3.6
Private consumption	38.2		56.8	-	5.9	6.9	6.0	-0.7	0.1	2.1
Public consumption	11.7		17.4	-	9.7	0.1	5.3	2.8	2.5	2.2
Gross fixed capital formation	16.7		24.9	-	9.3	9.1	1.8	-10.5	3.6	3.9
of which : equipment	7.1		10.5	-	-6.3	4.3	15.4	4.0	3.5	3.5
Exports (goods and services)	55.8		83.0	-	21.0	14.3	3.2	-16.5	5.7	5.9
Imports (goods and services)	57.3		85.3	-	17.8	9.2	3.1	-17.6	6.8	5.2
GNI (GDP deflator)	65.4		97.3	-	8.2	11.1	6.1	-3.2	2.3	3.4
Contribution to GDP growth :										
Domestic demand				-	7.6	6.4	4.8	-2.5	1.4	2.6
Inventories				-	-0.7	0.3	1.3	-3.4	2.0	0.6
Net exports				-	1.6	3.9	0.1	1.3	-0.7	0.4
Employment				-	2.3	2.1	2.8	-2.4	-1.9	1.2
Unemployment rate (a)				-	13.4	11.1	9.5	12.0	14.1	13.3
Compensation of employees/head				-	7.7	8.4	5.9	4.7	3.5	4.2
Unit labour costs whole economy				-	1.5	0.1	2.5	7.2	-1.1	1.7
Real unit labour costs				-	-1.4	-1.0	-0.3	8.5	-2.3	-1.2
Savings rate of households (b)				-	-	-	-	-	-	-
GDP deflator				-	2.9	1.1	2.9	-1.2	1.3	3.0
Harmonised index of consumer prices				-	4.3	1.9	3.9	0.9	1.3	2.8
Terms of trade of goods				-	-1.8	-1.1	-1.9	0.8	-1.8	0.2
Trade balance (c)				-	-5.4	-1.8	-1.5	1.6	-0.2	0.3
Current account balance (c)				-	-8.2	-5.1	-6.7	-3.1	-4.5	-4.1
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-7.8	-4.7	-5.8	-2.4	-3.7	-3.2
General government balance (c)				-	-3.5	-1.9	-2.3	-6.8	-6.0	-5.4
Cyclically-adjusted budget balance (c)				-	-3.9	-3.7	-4.5	-6.4	-5.4	-4.7
Structural budget balance (c)				-	-3.6	-3.7	-4.7	-6.6	-5.4	-4.7
General government gross debt (c)				-	30.5	29.3	27.7	35.7	40.8	44.0

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.