

24. SLOVAKIA

Resuming real convergence following a deep recession

The crisis and policy response in 2009

With an average real GDP growth rate of over 7% during the period 2003-08, Slovakia was one of the best-performing EU countries. At the same time, overall sound macroeconomic and structural policies kept the key macroeconomic balances in check. The external position remained strong, government finances were kept under control and, while a few signs of overheating emerged by mid-2008, inflation hovered in a range from 2 to 5%. These achievements enabled Slovakia to adopt the euro in January 2009, which helped to shield the country from potential exchange rate pressure and supported confidence during the crisis.

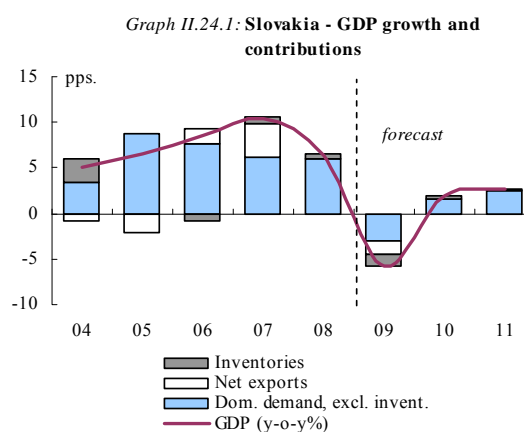
Given its high degree of trade openness, the Slovak economy has been particularly exposed to the crisis. It has been affected primarily through the trade channel, as demand from trading partners has plummeted, triggering a plunge in exports by some 25% in the first half of 2009 compared to the same period of 2008. This was followed by an even larger fall in imports, as uncertainties related to the crisis led to a massive increase of savings by both households and the corporate sector. Private investment and consumption fell respectively by 4.6% and 4.8% in the year to the first quarter of 2009. As a result, real GDP slowed markedly in late 2008 and tumbled by 11% (non annualised) in the first quarter of 2009. Despite the large shock to the real sector of the economy and intense stress in global financial markets, the Slovak banking sector has been relatively resilient, due to the good liquidity situation of credit institutions and low dependence on cross-border lending. Consequently, apart from capital injections in two small state-owned banks, no major rescue operations have been necessary.

The policy response of the Slovak government to the crisis has aimed to contain the economic downturn by supporting domestic demand in order to partly offset the slump in external demand. Fiscal policy has allowed the full operation of automatic stabilisers. The authorities adopted anti-crisis packages in November 2008 and February 2009, which amount to roughly 0.5% of GDP for both 2009 and 2010. But these measures have mainly been financed through a reallocation of resources within the budget, and therefore do not have a negative impact on public accounts. They

are targeted at specific sectors of the economy (car-scrapping scheme) and disadvantaged groups (increase in tax credit for low earners), and aim at supporting employment (contributions for retention of employment) and R&D activities.

Gradual recovery expected in 2010-11

The Slovak economy is projected to recover progressively in 2010 and 2011, against the backdrop of a gradual pick-up in private consumption and investment. After a decline by 5.8% in 2009, real GDP is projected to increase by around 1.9% in 2010 and 2.6% in 2011. While positive, these figures are much lower than those recorded during the boom phase. This reflects the influence of several factors playing in various directions. On the positive side, recent high-frequency indicators have provided some signs of stabilisation in economic activity. Business confidence appears to be recovering slowly, while exports have stopped falling and the inventories cycle is gradually turning around. With an increase of about 2% in the second quarter of 2009 (non-annualised), real GDP recorded a technical rebound after the sharp fall in the first three months of the year, and growth is expected to remain in positive territory over the forecast horizon.



However, powerful headwinds are likely to slow the recovery. The adjustment of the labour market will come with a lag – in 2010 employment growth is projected to remain negative and unemployment is set to approach 13%, one of the highest levels among central and eastern European countries. This will weigh on real disposable income and

contribute to maintaining the households saving rate at a high level, thus explaining the projected sluggishness of private consumption in 2010-11. Similarly, the underutilisation of production capacities and the sharp decline of new orders in the automotive and electronics sectors, combined with a significant reduction in profits and uncertain economic outlook, seem likely to prevent a sizeable rebound of investment in the short run, following the contraction by 12.4% in 2009. Inflation, which has been pushed down significantly by the contraction in economic activity, is projected to remain low over the forecast period. A faster economic recovery would be possible if export demand were to prove higher than expected and total investment were to benefit from ongoing public-private partnership projects for motorway construction and further foreign direct investment. By contrast, a larger deterioration in consumer confidence, driven by a bleak labour market outlook, could weigh on the recovery.

Key challenges are to limit the medium-term consequences of the crisis on the economy...

Following the large loss of output during the crisis, one main challenge will be to ensure that the downturn does not durably affect the potential growth of the Slovak economy. While subject to considerable uncertainties in the current circumstances, available estimates suggest that Slovak potential growth will be, at least temporarily, impacted by the crisis, mainly due to a slower accumulation of productive capital. If not appropriately managed, the restructuring of the automotive sector, currently characterised by ample – and perhaps in part structural – overcapacity, could also weigh on growth in the coming years. Finally, a further rise in the already high structural rate of unemployment cannot be excluded. Against this background, it would appear to be important to prevent the increase in unemployment from having permanent effects and to facilitate the transition to new types of economic activity.

...and to preserve competitiveness in the post-crisis environment

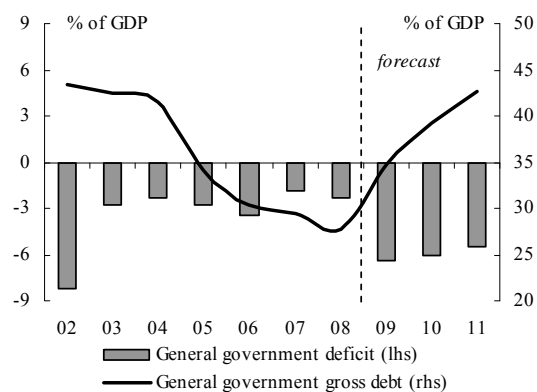
Following accession to the euro area, Slovakia's external imbalances can only be tackled through adjustments in domestic prices and costs vis-à-vis competitors and through improvements in non-price competitiveness. Since 2000, Slovakia had

had one of the fastest appreciating currencies in the EU – the currency appreciated by more than 40% in effective real terms. The appreciation has continued during the crisis, mainly reflecting nominal exchange rate movements in neighbouring countries. Although it is difficult to draw firm conclusions on the magnitude of a possible deterioration in Slovakia's external price competitiveness during the crisis, the evolution of relative prices and cost developments and developments in non-price factors are crucial for enhancing competitiveness.

Rapid deterioration of public finances

Several years of expansionary policies during the economic boom phase – with a deterioration in the structural deficit from 1.8% of GDP to 4.7% of GDP over the period 2005-08 – left Slovakia's government finances in a vulnerable position at the onset of the crisis. The sharp swing in the output gap from very positive to mildly negative territory between 2008 and 2009 has unmasked looming fiscal imbalances, and the general government deficit widened by 4 percentage points of GDP to 6.3% of GDP in 2009. In line with the European Economic Recovery Plan, the government decided to let automatic stabilisers operate freely in 2009. In view of shallow recovery expectations in 2010, the announced consolidation efforts are expected to lead to a narrowing of the general government deficit, which is projected to decline to 6% of GDP in 2010. Government debt is projected to rise from 28% of GDP in 2008 to about 39% of GDP in 2010 and, under the no-policy-change assumption, to roughly 43% of GDP in 2011.

Graph II.24.2: Slovakia - Public finances



Slovakia is a small and very open economy, implying low fiscal multipliers even in normal times. At the current high levels of deficit and in

the context of a global crisis, the size and even sign of fiscal multipliers are even more uncertain, implying that fiscal consolidation may not be harmful for growth. Reversing current negative trends in public finances will however be more difficult than in the past. Previous strategies, based on the partial allocation of revenue windfalls to deficit reduction in the context of exceptional economic performance, are not likely to be effective given the mixed economic outlook for Slovakia in the medium term.

Table II.24.1:

Main features of country forecast - SLOVAKIA

| | 2008 | | | 92-05 | Annual percentage change | | | | | |
|--|---------|--------------|-------|-------|--------------------------|------|------|-------|------|------|
| | bn Euro | Curr. prices | % GDP | | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| GDP | 67.3 | 100.0 | - | - | 8.5 | 10.4 | 6.4 | -5.8 | 1.9 | 2.6 |
| Private consumption | 38.0 | 56.5 | - | - | 5.8 | 7.0 | 6.1 | -1.2 | 0.5 | 2.2 |
| Public consumption | 11.7 | 17.4 | - | - | 10.2 | -1.3 | 4.3 | 4.6 | 3.5 | 2.8 |
| Gross fixed capital formation | 17.5 | 25.9 | - | - | 9.3 | 8.7 | 6.8 | -12.4 | 2.5 | 3.3 |
| of which : equipment | 7.3 | 10.8 | - | - | -6.3 | 4.2 | 19.6 | -12.5 | 2.7 | 3.5 |
| Exports (goods and services) | 55.6 | 82.6 | - | - | 21.0 | 13.8 | 3.2 | -15.7 | 2.4 | 5.0 |
| Imports (goods and services) | 57.2 | 85.0 | - | - | 17.7 | 8.9 | 3.3 | -13.5 | 2.4 | 4.9 |
| GNI (GDP deflator) | 65.7 | 97.5 | - | - | 9.0 | 10.0 | 6.7 | -6.0 | 1.7 | 2.5 |
| Contribution to GDP growth : | | | | | | | | | | |
| Domestic demand | | | - | - | 7.6 | 6.1 | 6.0 | -3.1 | 1.5 | 2.6 |
| Stockbuilding | | | - | - | -0.9 | 0.6 | 0.5 | -1.3 | 0.3 | 0.0 |
| Foreign balance | | | - | - | 1.7 | 3.8 | -0.2 | -1.5 | 0.0 | 0.1 |
| Employment | | | - | - | 2.3 | 2.1 | 2.9 | -2.0 | 0.0 | 0.6 |
| Unemployment rate (a) | | | - | - | 13.4 | 11.1 | 9.5 | 12.3 | 12.8 | 12.6 |
| Compensation of employees/head | | | - | - | 7.6 | 8.8 | 8.7 | 3.6 | 3.9 | 4.3 |
| Unit labour costs whole economy | | | - | - | 1.5 | 0.6 | 5.2 | 7.8 | 2.0 | 2.3 |
| Real unit labour costs | | | - | - | -1.4 | -0.5 | 2.2 | 3.1 | -1.0 | -0.6 |
| Savings rate of households (b) | | | - | - | - | - | - | - | - | - |
| GDP deflator | | | - | - | 2.9 | 1.1 | 2.9 | 4.5 | 3.0 | 2.9 |
| Harmonised index of consumer prices | | | - | - | 4.3 | 1.9 | 3.9 | 1.1 | 1.9 | 2.5 |
| Terms of trade of goods | | | - | - | -1.8 | -1.1 | -1.9 | 3.6 | 0.7 | 0.6 |
| Trade balance (c) | | | - | - | -5.2 | -1.7 | -1.7 | -1.0 | -0.5 | -0.1 |
| Current account balance (c) | | | - | - | -7.4 | -5.1 | -6.8 | -5.8 | -5.3 | -5.0 |
| Net lending(+) or borrowing(-) vis-à-vis ROW (c) | | | - | - | -7.0 | -4.7 | -5.6 | -4.8 | -4.3 | -4.2 |
| General government balance (c) | | | - | - | -3.5 | -1.9 | -2.3 | -6.3 | -6.0 | -5.5 |
| Cyclically-adjusted budget balance (c) | | | - | - | -4.2 | -4.0 | -5.0 | -6.0 | -5.4 | -4.6 |
| Structural budget balance (c) | | | - | - | -3.9 | -4.0 | -5.2 | -6.2 | -5.4 | -4.6 |
| General government gross debt (c) | | | - | - | 30.5 | 29.3 | 27.7 | 34.6 | 39.2 | 42.7 |

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