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## **Overview of Current Economic Conditions in the Slovak Republic (April 2007)**

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## **Overview of Current Economic Conditions in the Slovak Republic**

**(by Michal Olexa and Ján Haluška)**

The Slovak Republic (SR) is a little country with 5.4 million inhabitants (in 2006). It arose in 1993 after the division of former federation (CSFR) with the Czech Republic (CR). Since May 1, 2004 Slovakia is a member country of the European Union (EU-25) and its population is comparable to Denmark or Finland. Approximately one tenth of the total population of the SR lives in Bratislava – the capital of Slovakia.

Slovakia had a very open economy before entering the EU – the total nominal value of exports and imports of goods and services was higher approximately by 53% than GDP at current prices in year 2004. But over the last two years the Slovak economy has become even more open – the rate of its openness increased to 60% in 2005 and up to 76% in 2006. The main business partners of the SR are the EU countries, where approximately 85% of exports of goods were directed to in 2005 or 2006, and where approximately 70% of imports of goods came from. According to the shares in exports and imports of goods, the largest individual trade partner of the SR was Germany also in 2006 (24% vs. 21%), before the Czech Republic (14% vs. 12%). Italy had the third biggest share in exports of goods from the SR (7%); the Russian federation had it in imports to the SR (11%).

The Slovak Republic has been acting as an independent state only from 1993 (before it was a part of the former CSFR). In 1991-1993 there was a transition recession<sup>1</sup> and a permanent growth has been achieving since 1994. It follows from the revised data (see the table below) that the real GDP was higher by 60% in 2006 compared to 1995, which means that it was increasing by 4.4% yearly on average.

However, the macroeconomic efficiency of the Slovak economy was not growing proportionally. There were typical features of overheating in 1996-1998, i.e. a relatively high economic growth accompanied by a deepening external and internal imbalance. It recorded so-called soft landing in 1999 (the real GDP growth slowed down markedly, but remained a positive one), which was a result of the macroeconomic stabilization policy. Since 2000 the dynamics of its growth has been increasing gradually. According to preliminary data the real GDP increased by 6.0% in 2005 and by 8.3% in 2006. As a result of this the SR counted among the countries with the highest economic growth within the EU in last two years.

With respect to the growth of macroeconomic efficiency of the Slovak economy in last years the decisive influence is generally being ascribed to the effects of economic reforms realized after 2002. Those are the reform of tax system (since 1.1.2004), reform of social system and labour market (2003-2004), pension reform (since 1.1.2005),

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<sup>1</sup> The transformation recession was connected with the process of transformation of its system from a centrally planned to market economy, which started with price and foreign trade liberalization and privatization in 1991.

reform of public administration with fiscal decentralization (2003-2004), and the reform of public finance administration (2003-2005), which led inter alia to introduction of hard budget constraint and the establishment of State treasury.

Mainly due to the tax reform the SR is seen as a country, which has currently one of the most favourable business environment in the Central and Eastern Europe. The reform simplified the tax system radically and the so-called flat tax of 19% has become crucial, which decreased taxation of companies and employers markedly. The same rate (19%) was set also for VAT. The improvement of business conditions is being reflected in the inflow of FDI, which increased from 1.5% of GDP in 2005 to 3.5% of GDP in 2006. The FDI that have no privatization character are directed mainly to automobile industry (Volkswagen, Peugeot, KIA) and electronics industry (Sony, Samsung) and are participating in creation of new jobs significantly. In this connection the total employment recorded untraditionally high increases in last two years (by 2.1% in 2005 or by 3.8% in 2006) accompanied by an abrupt decrease in unemployment. The unemployment rate, which has been a chronic problem of the Slovak economy, decreased from 18.1% in 2004 to 16.2% in 2005 or to 13.3% in 2006, while it fell down to 12.0% in the 4<sup>th</sup> quarter of 2006.

All the mentioned reforms have contributed to a consolidation of public finance and resulted in the lessening of internal imbalance. While the public finance deficit was 7.2% of GDP in 2002, it fell to 2.5% of GDP in 2005 or to 3.1% of GDP (with its influence). Thanks to the high growth of the Slovak economy in 2006 the favourable trend of public finance was managed to sustain. According to the projection of the Ministry of Finance of the SR from January 2007 the deficit of public finance should reach 2.5% of GDP (without the influence of the 2<sup>nd</sup> pillar of pension reform) or 3.6% of GDP in 2006.

In June 2006 premature parliamentary elections were held in the SR. Their winner was the biggest former opposition party SMER-SD (Social Democracy), which together with other two parties (before opposition ones as well) have formed a new coalition government. The victory was based on a very sharp criticism of impacts of reforms (in particular the establishment of flat VAT of 19%) on living standard mainly of socially weaker population. All the parties of former coalition government, which had been carrying out economic reforms since 2002, have become the opposition ones. So Slovakia has got a government that has – for the first time since 1993 – an ambition to implement social democratic policy during the next four years.

However, the new government has reserved the flat tax despite pre-election promises to tax above-standard incomes higher and changed only the VAT for medicaments (from 19% to 10%). But they have stopped the privatization of state property, try to restrict the growth of energy prices, cancelled the charges for health service, and want to change the Labour Code markedly (strengthen the position of unions and collective negotiation, increase the minimal wage, limit after hours etc.). They confirmed the intention as well – adopted by the former government – to meet the Maastricht criteria in order to implement euro since January 1<sup>st</sup> of 2009 in Slovakia.

The Slovak crown (SKK) was admitted into the ERM II system in October 2005 in connection with the SR's ambition to enter the EMU (Euro zone) in January 1, 2009, and the central parity against euro was fixed at the level of 38.455 SKK/EUR. However, significant structural changes and high economic growth of the SR have caused that a high differential of labour productivity arose towards the Euro zone, which has resulted in a significant strengthening of balanced real exchange rate. In conditions with a relatively low inflation – 4.5% on average in 2006 – it has been reflected also in the level of nominal exchange rate. Therefore the central parity was revaluated in March 2007 (almost by 8%) and its new level is 35.4424 SKK/EUR against euro, from which it may diverge by 15% maximally to both sides. Apart from the criterion of exchange rate stability the SR currently meets also the criterion concerning the public debt (it comprised 34.5% of GDP at the end of 2005), and the criterion of interest rates as well. It is supposed that the SR will fulfill all the Maastricht criteria necessary for entering the EMU in 2008.

**Output, population and employment growth in Slovakia, 1996-2006  
(2000 prices, % change)**

	<b>Real GDP growth</b>	<b>Population growth rate</b>	<b>Real GDP growth per capita</b>	<b>Employment growth rate</b>
<b>1996</b>	6.9	0.2	6.7	3.6
<b>1997</b>	5.7	0.2	5.5	-0.9
<b>1998</b>	3.7	0.1	3.6	-0.3
<b>1999</b>	0.3	0.1	0.2	-3.0
<b>2000</b>	0.7	0.1	0.6	-1.4
<b>2001</b>	3.2	-0.4	3.6	1.0
<b>2002</b>	4.1	0.0	4.1	0.2
<b>2003</b>	4.2	0.0	4.2	1.8
<b>2004</b>	5.4	0.1	5.3	0.3
<b>2005</b>	6.0	0.1	5.9	2.1
<b>2006</b>	8.3	0.1	8.2	3.8
<b>2006q1</b>	6.7	n.a.	n.a.	3.7
<b>2006q2</b>	6.7	n.a.	n.a.	4.5
<b>2006q3</b>	9.8	n.a.	n.a.	3.8
<b>2006q4</b>	9.6	n.a.	n.a.	3.5

Last year the growth of efficiency of economy was the fastest in the history of Slovakia. In compliance with an expectation the growth of domestic and also external demands (total exports) contributed to it. While the former increased by 6.4% against 2005, the latter even by 20.7%. But the growth of domestic demand decelerated by above 2 percentage points compared to 2005, because the consumer and investment demands were increasing slower (they increased by 6.3% or by 7.3%). Only the final consumption of government was increasing faster than in 2005, which is apparently connected with the fact that the last year was the election one. It increased even by 7.2% in the 1<sup>st</sup> half

of and by 1.8% in the 2<sup>nd</sup> half. In spite of this it was the most slowly growing component of domestic demand.

Due to the growth of external demand the increase in total exports was almost by 3 percentage points higher than the increase in total imports last year. In this connection one radical change came that is crucial from the viewpoint of long-term sustainability of the Slovak economy growth and refers to the impact of net export on the real GDP growth. Because for the first time in the history of independent SR the net export contributed to the real GDP growth at a relatively significant rate, and in the conditions of high domestic demand growth.

It is a qualitatively new form of the Slovak economy growth. In the previous years the net export had usually a braking influence on GDP growth, rarely a neutral one. In 1999 or 2003 it contributed to real GDP growth significantly as well, but it was in conditions of real decrease in domestic demand.

The fall of domestic demand in 2003 was connected with the increase of (average) inflation – from 3.3% in 2002 to 8.5% in 2003 – caused mainly by increasing (still) regulated prices of housing, water, electricity, and gas, but also by adjustments of VAT rates and excise taxes.

Slovakia belongs to the countries with the highest dynamics of economic growth within the EU – the economic growth was even 3 times higher compared to the EU average last year. However, its level of economic development is left behind the countries of the former EU-15 (before its enlargement in 2004) markedly. According to the data from the Eurostat, GDP per capita in the SR (in PPS) achieved 48.3% of the EU-15 average in 2003, it was 52.8% against the EU-25 average (without Bulgaria and Romania). Thanks to the high economic growth GDP per capita increased to 57.1% of the EU-25 average in the SR in 2005 and to 60.3% in 2006 (estimation).

### Basic indicators of labour market in Slovakia, 1994-2006<sup>2</sup>

	<b>Economically active population by LFS</b> (thousands of persons)	<b>Economic activity rate by LFS</b> (%)	<b>Employment rate of persons (15-64)</b> (%)
<b>1994</b>	2443.7	59.9	59.9
<b>1995</b>	2470.5	59.8	60.2
<b>1996</b>	2509.1	60.1	61.8
<b>1997</b>	2521.9	59.9	60.8
<b>1998</b>	2544.8	59.9	60.1
<b>1999</b>	2573.0	60.0	57.8
<b>2000</b>	2608.2	60.3	56.5
<b>2001</b>	2652.5	60.7	56.5
<b>2002</b>	2628.2	60.2	56.7
<b>2003</b>	2634.3	60.3	57.6
<b>2004</b>	2658.6	60.2	56.9
<b>2005</b>	2645.7	59.5	57.7
<b>2006</b>	2654.8	59.1	59.3
<b>2006q1</b>	2653.3	59.0	58.1
<b>2006q2</b>	2651.7	59.0	59.2
<b>2006q3</b>	2662.3	59.2	59.9
<b>2006q4</b>	2651.7	59.0	59.9

But there are considerable regional differences in the level of economic development in Slovakia. While in the neighbourhood of capital Bratislava GDP level per capita reached even 129.3% of the EU-27 (including Bulgaria and Romania) average in 2004, western Slovakia reached only 52.7%, central Slovakia 46.7%, and eastern Slovakia only 42.3% (based on NUTS2 classification).

The labour market of the SR is – considering the number of inhabitants – a small one and within the EU its size is comparable to the labour market in Finland. The number of economically active population has not been changed markedly in last six years (oscillating around 2 650 thousand persons), but there was a growing trend before.

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<sup>2</sup>All the presented indicators of labour market were created on the basis of the ILO methodology (LFS - Labour Force Survey) and so they are comparable internationally.

The economic activity rate in the SR is very near to 60% in the long run<sup>3</sup>. The employment rate had also been reaching about 60% (67% for men and 54% for women) up to the year 1998, but due to employment drop in 1999 and 2000 (by over 4% cumulatively) it decreased to approximately 57% (about 63% for men, 51% for women). It has been growing very slightly since then, which is connected with the renewal of employment growth. It increased to above 59% in 2006, and it achieved almost 60% in the 4<sup>th</sup> quarter.

In 2005 the employment rate of the SR was comparable to the employment rate in Hungary or in Italy, but was lower by about 6 percentage points compared to the EU-25 employment rate.

<b>Unemployment rates in Slovakia, 1993-2006</b>				
	<b>Overall</b>	<b>Men</b>	<b>Women</b>	<b>Long-term unemployment (% of unemployed)</b>
<b>1993</b>	12.2	n.a.	n.a.	n.a.
<b>1994</b>	13.7	13.3	14.1	41.7
<b>1995</b>	13.1	12.6	13.8	53.2
<b>1996</b>	11.3	10.2	12.7	51.6
<b>1997</b>	11.8	10.9	12.8	50.3
<b>1998</b>	12.5	11.9	13.2	50.7
<b>1999</b>	16.2	16.0	16.4	46.9
<b>2000</b>	18.6	18.6	18.6	53.9
<b>2001</b>	19.2	19.5	18.8	55.6
<b>2002</b>	18.5	18.4	18.7	59.8
<b>2003</b>	17.4	17.2	17.7	61.2
<b>2004</b>	18.1	17.3	19.1	60.6
<b>2005</b>	16.2	15.3	17.2	68.1
<b>2006</b>	13.3	12.2	14.7	73.1
<b>2006q1</b>	14.9	14.0	16.1	72.0
<b>2006q2</b>	13.5	12.2	15.0	74.4
<b>2006q3</b>	12.8	11.7	14.2	72.3
<b>2006q4</b>	12.0	10.9	13.4	73.7

An accompaniment of the Slovak economy development, which, however, arose in time when it was a part of the former CSFR, yet is a high unemployment rate. First of all it is a consequence of the transition recession of the Slovak economy in 1991-1993 that was characterized inter alia also by a high fall of total employment. The highest drop of

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<sup>3</sup> Men aged 15-59 years comprised till 2003 the population at productive age and women aged 15-54 years in the SR. As a result of the ongoing pension reform the age of taking retirement is raising gradually to 62 years both for men and for women.

employment – almost by 15% - was recorded in the 1st year of the economic transformation (1991).

In 1991 the massive fall of employment was caused due to many factors, the most significant of which was the decrease of demand - domestic and foreign one as well. While the decrease of domestic demand was connected mainly with a considerable inflation growth as a result of price liberalization, the decrease of external demand was conditioned by the markets disintegration of the former Council of Mutual Economic Assistance (CMEA), where the substantial part of the Slovak exports was oriented till then. But also some administrative measures (the conversion of arms production) and the beginning of privatization process contributed to the employment decrease. The registered unemployment rate increased rapidly due to the fast drop of employment – from 2.4% in January 1991 (about 60 thousand persons) to 11.8% in December 1991 (about 300 thousand persons). In 1992 the situation at labour market stabilized (temporarily).

The increase of unemployment rate in 1993 and 1994 can be regarded as a negative consequence of the disintegration of the former CSFR, which was subsequently overcome though, but only at the cost of overheating the Slovak economy (1996-1998). Due to both a necessary stabilization macroeconomic policy and the intensification of restructuring process of the Slovak economy the unemployment rate started increasing again since 1999. Its growth culminated in the 1st quarter of 2001, when it increased up to 19.7%. The unemployment rate has been decreasing gradually since then, but preconditions for its more lasting decrease were created by radical economic reforms that have been realized from year 2002. In connection with the increasing inflow of FDI, which generates a creation of new jobs, the unemployment rate decreased to 13.3% in 2006 (on average). But it fell even to 12.0% in the 4<sup>th</sup> quarter, ergo to the lowest level since 1997. But there are still considerable regional differences in unemployment rate. While in the neighbourhood of the capital Bratislava (i.e. in the western part of the SR) the registered unemployment rate reached less than 3% at the end of last year, there exist regions in the south-eastern part of the SR where it exceeded 25%.

The specific problem of the Slovak labour market is a long-term unemployment, which is unfortunately still deepening. The share of long-term unemployed in the total number of unemployed persons was high in the SR already at the beginning of its independent existence (1993), when it achieved about 40%. But it has been still increasing since then, and it increased rapidly especially in last two years – to more than 68% in 2005 and it exceeded 73% in 2006.

So the SR has by far the highest share of long-term unemployed within the EU-25, considerably exceeding the average of EU-25, which was 45.0% in 2005.

**Average gross (nominal) hourly wage of employees in the economy of the SR (for the enterprises with 20 and more employees - calculated per person)**

	in overall economy		in manufacturing		Inflation
	SKK	% chg	SKK	% chg	%
<b>2000</b>	81.26	8.5	86.31	10.8	12.0
<b>2001</b>	88.37	8.7	94.41	9.4	7.1
<b>2002</b>	100.51	13.7	105.24	11.5	3.3
<b>2003</b>	111.94	11.4	114.35	8.7	8.5
<b>2004</b>	121.44	8.5	122.44	7.1	7.5
<b>2005</b>	131.85	8.6	132.08	7.9	2.7
<b>2006</b>	144.07	9.3	142.00	7.5	4.5

	in overall economy		in manufacturing	Exchange rate
	USD	USD	USD	SKK/USD
<b>2000</b>	1.76	1.87	1.87	46.2
<b>2001</b>	1.83	1.95	1.95	48.3
<b>2002</b>	2.22	2.32	2.32	45.3
<b>2003</b>	3.04	3.11	3.11	36.8
<b>2004</b>	3.77	3.80	3.80	32.2
<b>2005</b>	4.25	4.26	4.26	31.0
<b>2006</b>	4.85	4.78	4.78	29.7

The growth of average gross (nominal) hourly wage of employee in the whole economy of the SR was relatively high during last six years (2001-2006). Considering that it was higher than inflation every year the real wage was increasing too. The real wage achieved the highest growth in 2002 (by 10.1%), which was the election year. However, the real wage achieved a high growth at a macro level also in 2005 (by 5.7%), in which the inflation fell to the historical minimum.

During last five years, the average gross (nominal) hourly wage of employee in the whole economy of the SR was increasing substantially faster in USD than in the domestic currency (SKK). It is a result of appreciation of the nominal exchange rate of SKK to USD, which has been going on since 2002.

The level of wage differentiation is still relatively low. It results from the comparison of average gross (nominal) wage at a macro level and in industry.

## Survey on income and living conditions EU SILC 2005

EU SILC is a state statistical survey, the aim of which is to obtain information on the distribution of income, the level and structure of poverty and the social exclusion. The survey is being done in accordance to the Regulation No. 1177/2003 of the European Parliament and the Council of Europe on the Community statistics on income and living conditions. It is a harmonised survey, which has been carried out from 2005 in all 25 EU member countries.

The survey on income and living conditions (EU SILC) treats the poverty as a multi-dimensional phenomenon. It traces the poverty in relation to work, education and health; it notes the subjective opinions of households and individuals and relates the poverty to the social exclusion. Thus, for the purposes of the survey of basic dimensions of social exclusion, the data on primary and secondary needs of households, on housing and expenditures of households have been inquired. These serve for the calculation of indicators on the non-monetary poverty.

The first survey on income and living conditions (EU SILC) for 2004 was carried out in Slovakia from 16 May until 16 June 2005.

The EU SILC 2005 survey in Slovakia is the first survey, which fully complies with the comparable international methodology and thus develops the basic data to which the results for next years can be compared. The EU SILC survey is planned for several years and currently the data collection for 2005 is being done.

### Preliminary data

#### Median of the equivalent disposable income

Currency	Value (annual)	Value (monthly)
National (SKK)	113 270	9 439
EUR	2 828	
PPS	5 407	

#### Risk of poverty rate – 60% of national median

Currency	Absolute value	Relative value
National (SKK)	5 663	13,3%

According to the preliminary data from EU SILC 2005, the share of people being threatened by poverty is 13.3%. It means that they are living in household where the equivalent disposable income is lower than 60% of median of the equivalent income (i.e. lower than 5 663 SKK monthly).

Regarding the gender, no significant differences in the risk of poverty rate were identified (13.2% in case of men and 13.5% for women).

### **Risk of poverty rate after social transfers by gender and age groups in %**

<b>Age</b>	<b>Male</b>	<b>Female</b>	<b>Total</b>
SR	13.2	13.5	13.3
0-15	.	.	18.4
16-24	17.1	16.6	16.8
25-49	13.4	14.7	14.1
50-64	8.3	8.3	8.3

From the viewpoint of age children under 15 are the most endangered, 18.4% of them are below the poverty limit. The share of persons endangered by poverty has been falling with an increasing age in particular age groups.

Gini coefficient expresses the inequality of the income distribution. It can reach the values in scope of 0% (total equality) up to 100% (total inequality). In accordance to the EU SILC data, it achieves 26.2%.

(Note: The second survey EU-SILC was conducted in 2006. Preliminary results will be available at the beginning of May this year.)

### **Income distribution**

As only selected preliminary EU SILC 2005 survey results are available, the income distribution in Slovakia is presented based on the results obtained from household surveys. The table contains the gross and net income per head and monthly averages in the years under observation. The first two rows contain the average values for the total population. In particular quintiles, the average (not threshold) values are presented.

From the income development for the presented 10 years, two basic conclusions can be made:

- The average values in the entire horizon exceed the level of the 3rd quintile, while their ratio is stable (the income of approximately 65% of Slovak population is lower than the average one).
- The income of rich people (5<sup>th</sup> quintile) was growing faster than the income of poor people (1<sup>st</sup> quintile) in the 90s of last century. While in 1994 the ratio of average income of the fifth quintile against the first quintile had been 2.9, in 2003

it was already 3.6. The incomes of poor people and rich people as well were growing approximately at the same rate after 2000.

### Per Capita Household Income distribution by quintile (fifth), SKK

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Average value	gross	5171	5748	6574	6718	7293	8292	8766	9178	9607	10053
	net	4490	5010	5611	5752	6379	7247	7654	8026	8399	8774
first quintile	gross	2975	3696	3629	3824	4077	4508	4743	4994	5234	5459
	net	2624	3241	3141	3293	3571	3936	4143	4340	4529	4706
second quintile	gross	4082	4973	4984	5296	5777	6374	6751	7076	7413	7760
	net	3542	4426	4236	4516	5033	5557	5861	6189	6488	6753
third quintile	gross	4853	6079	6112	6419	6952	7772	8204	8602	9086	9667
	net	4206	5330	5206	5531	6144	6839	7243	7612	8062	8604
fourth quintile	gross	5957	7492	7612	8063	8760	9746	10548	11022	11631	12394
	net	5134	6416	6474	6866	7678	8563	9240	9596	10119	10834
fifth quintile	gross	10075	12005	12900	12666	13873	16565	17337	17754	18358	19173
	net	8739	10266	11002	10841	12071	14414	15041	15520	16166	17002
exchange rate	SKK/USD	30,6	33,6	35,2	41,4	46,2	48,3	45,3	36,8	32,3	31,0
	SKK/EUR	38,4	38,0	39,6	44,1	42,6	45,3	42,7	41,5	40,0	38,6

### Minimum wage

Since 2000, each year a new threshold for the minimum wage has been declared in Slovakia entering into force as of 1 October. The relevant government regulation states both, the minimum hourly and the monthly wage. The minimum wage for each hour being worked out is declared for employees, whose weekly working time has been determined for 40 hours.

### Minimum Wage (SKK)

From	Hourly	Monthly
1. 1. 2000	21.60	4 000
1. 10. 2000	23.80	4 400
3. 10. 2001	26.60	4 920
1. 10. 2002	32.00	5 570
1. 10. 2003	35.00	6 080
1. 10. 2004	37.40	6 500
1. 10. 2005	39.70	6 900
1. 10. 2006	43.70	7 600

The elections in 2006 represented the end of the government of right-wing coalition. The winner of elections was the party SMER-SD oriented social-democratically and also

the new government has been enforcing a policy like this. Its social-democratic character has been reflected in various measures. One of them has been also a more considerable increase in minimal wage since October 1, 2006 compared to previous two years.