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Slovakia's economic success and the global crisis

Tomasz Dąborowski

Slovakia, which for many years was seen as lagging behind the other European countries, is currently considered to be a model of successful economic transformation. On 1 January 2009, Slovakia was the first Central European state to join the Eurozone, and is currently the fastest developing country in the European Union. These achievements have been possible thanks to a consistent economic policy, and in particular the implementation of liberal economic reforms, investor-friendly legislation and effective measures towards adopting the euro.
Nevertheless, the current global economic crisis is putting Bratislava's success to the test. Due to the specific characteristics of the Slovak economy, namely its reliance on exports and the dominant position of the automotive industry in production, as well as the recent gas crisis, economic growth is losing momentum. It seems, however, that with the country's accession to the Eurozone and the government recovery plan announced on 27 January, the Slovak economy will manage the crisis better than any other of the Visegrad Group members.

Slovakia: a leader in regional transformation

Slovakia reported a major improvement in its macroeconomic situation in recent years, and has established itself as one of the Central Europe's leading economies (see Appendix 1). In 2002–2007, its GDP grew by 6% a year on average (and by as much as 10.4% in the record year of 2007). At the same time the two largest problems affecting the Slovak economy, inflation and unemployment, have been successfully addressed. Unemployment fell from 18% to 10%, and inflation from 12% to 3% between 2002 and 2007. Another success consisted in the very balanced budget policy, as a result of which the budget deficit was reduced from 3.5% of GDP in 2004 to 2.2% of GDP in 2008, while public debt decreased from 43% of GDP in 2004 to 30% of GDP in 2008.
Nevertheless, in spite of such dynamic economic development, it was only in 2007 that Slovakia's purchasing power parity reached the level of its neighbours, the Czech Republic and Hungary. The distance which still exists between Slovakia and the remaining countries of the region stems from the halting of economic transformation processes during Vladimir Meciar's rule in the 1990s.

Continuity of economic policy

Slovakia owes its economic success mainly to the centre-right government of PM Mikulas Dzurinda, which governed the country for two consecutive terms between 1998 and 2006. This long period in power enabled Dzurinda to carry out a number of structural reforms. The Dzurinda government also decided that Slovakia should quickly adopt the euro.

The economic policy assumptions formulated by the Dzurinda cabinet were taken over by the populist left-wing government of Robert Fico which came to power in 2006. The Fico government continued working towards rapid accession to the Eurozone. It also decided to make only minor corrections to the economic policy, such as abolishing the symbolic healthcare charges, increasing minimum wages and taxing the highest earners. These changes did not undermine the key principles of economic policy which the preceding cabinet had developed.

The sources of Slovakia's success: foreign investments and the adoption of the euro

The main objectives of Slovakia's economic policy were to carry out liberal economic reforms, open up the economy to foreign investors, and undertake measures to quickly introduce the euro.

The **structural economic reforms** implemented by the Dzurinda government, namely tax, pension and healthcare reforms, the introduction of more flexible labour legislation and the launching of a broad privatisation process, seem to have had the most significant impact. The introduction in 2004 of a flat 19% tax rate (for both personal and corporate income tax) has been particularly important, as it substantially reduced the tax burden in Slovakia, which are now among the lowest in the region[1].

Another important priority of Slovakia's economic policy concerned **attracting foreign investments**, one of the objectives for this being to reduce the unemployment rate. The Slovak authorities took active measures to improve the investment climate, and consequently Slovakia currently offers the most favourable conditions for economic activity among all of its neighbours, according to the World Bank[2]. The stimulus for substantial growth in foreign investments came from the very favourable conditions accorded to major foreign investors by the Slovak government. The tax cuts and reliefs were much deeper than in the neighbouring countries (including Poland and the Czech Republic). As a result, Slovakia became the country of choice for large global concerns, especially from the automotive sector, to invest and build new factories (see Appendix 2). The electronics industry also experienced dynamic growth owing to the new factories opened by Samsung and Sony, among others.

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Between 2002 and 2007, foreign direct investments accounted for 7.5% of the annual GDP on average, which was the best result in the region (see Appendix 1). The rapid influx of FDI was one of the main drivers of economic growth, and also had a positive impact on the trade balance (the investments were mainly channelled into export-oriented sectors).

Slovakia was also the first country in the Central European region to undertake **concrete measures with a view to entering the Eurozone**. Adoption of the euro was regarded as the most favourable solution, due to the small size of the Slovak economy and its close ties with the EU countries. In 2003 (still before accession to the EU) the Slovak government adopted a strategic plan for accession to the Eurozone in 2009, which was then consistently imple-

[1] According to Eurostat, the tax burden on the population is lower in Slovakia than in Poland, the Czech Republic or Hungary. Slovakia also reports the second lowest tax burden on businesses in Central Europe (after the Czech Republic).

[2] In the 'Doing Business 2009' World Bank report, which assess the conditions for, and legislation on business activity and foreign investments, Slovakia ranked 36th of the 181 states studied, compared to Hungary at 41st, the Czech Republic at 75th, Poland at 76th and Ukraine at 145. http://www.doingbusiness.org/economyrankings/?direction=Asc&sort=0

mented. It appears that Slovakia would not have been able to keep a balanced budget policy, if not for the requirement to meet the convergence criteria (the so-called Maastricht criteria)[3], as the obligations related to accession to the Eurozone were the main factor that prevented the Slovak government from increasing welfare spending and expanding the budget deficit. In mid-2008, the EU Council of Ministers decided that Slovakia had met all the Maastricht criteria, and the conversion rate of the Slovak crown was set at 30.126 Slovak crowns to the euro (the conversion rate was quite high, mainly as a result of the efforts undertaken by PM Fico. However, it appears that this may have created serious problems for the competitiveness of the Slovak economy. Slovakia entered the Eurozone as planned, on 1 January 2009.

Slovakia faces crisis

In spite of the excellent economic results so far, Slovakia is now involved in a major economic slowdown caused by recession in the European Union. Initially, Slovakia was not affected by the global financial crisis, unlike the other Central European economies (Hungary, the Czech Republic, Romania and Poland have reported deep declines in the stock exchange listings and national currency exchange rates). In the period in question, Slovakia managed to avoid the negative consequences of the crisis because it had adopted the convergence criteria and strongly tied the Slovak crown to the euro by keeping it within the ERM2 corridor[4] (the euro depreciated the least during the financial crisis).

According to the newest projections of the European Commission, Slovakia is among those EU economies which are tackling the crisis most effectively.

However, when the financial crisis triggered global recession in late 2008, it turned out that the Slovak economy was involved in a major slowdown, due to the decreasing demand for Slovakia's commodities in the country's main trade partners and the decline in Slovakia's exports, as confirmed by preliminary partial statistical data according to which Slovakia's industrial production decreased by 9,2% in the year to November 2008, experiencing the deepest decline in history, while exports decreased by 15.6%[5].

Nevertheless, according to the newest projections of the European Commission, Slovakia is among those EU (and Central European) economies which are tackling the crisis most effectively. The projected GDP growth in 2009 should amount to 2.7%. The much lower GDP growth in comparison to the previous years (the 2008 GDP growth will probably be around 7%) will be due to the lower dynamics of exports (exports are expected to grow by 0.7% in 2009, compared to 13.8% in 2007)[6]. This dramatic slump is connected with the crisis affecting the automotive industry, which accounts for as much as 30% of Slovakia's exports.

The economic slowdown may be even worse, as the analyses presented do not take into account the consequences of the Russian-Ukrainian gas crisis and the interrupted gas supplies in January 2009, when more than one thousand of the largest industrial gas consumers had no gas supplies, as a result of which some of them had to stop production. According to preliminary estimates, the losses may even reach €2 billion. **Preliminary assessments of the Slovak Finance Ministry indicate that the GDP may decrease as a consequence of the gas crisis by 1–1.5% of the GDP.**

Will the Fico government tackle the crisis?

The economic crisis will be the most serious test of the Fico government's efficacy. For a long time, the government took no action apart from amending the 2009 draft budget and reducing the GDP growth forecasts from 6 to 4.6% (which is still a very optimistic projection, as demonstrated by the European Commission's most recent assessments). The go-

[3] The convergence criteria (the so-called Maastricht criteria) are intended to ensure that the economies acceding to the Eurozone are similar to the economies of the other countries already in the zone. These criteria concern a) fiscal matters (budget deficit no higher than 3% of the GDP, public debt below 60% of the GDP); b) long-term percentage rates (not exceeding the average in the three countries with the lowest inflation rate in the EU by more than 2%); c) inflation (not exceeding the average in the three countries with the lowest inflation rate in the EU by more than 1.5%); d) stable currency rates (the ERM2 corridor – the currency rate should be maintained for two years within the margins of +/- 15% against the euro); e) formal issues: independence of the central bank.

[4] ERM2 (Exchange Rate Mechanism 2) – keeping the national currency exchange rate within the margins of +/- 15% against the euro.

[5] Figures from the Statistical Office of the Slovak Republic.

[6] Interim forecast, January 2009, European Commission, Directorate-General for Economic and Financial Affairs, p. 40.

vernment's general programme of measures to fight the economic crisis was announced only on 27 January 2009. The programme provides for €332 million (around 0.5% of the GDP) to be allocated to support businesses in Slovakia, and for more flexible labour legislation to be enacted. According to PM Fico, **the budget deficit will not be increased, which is a very positive signal for foreign investors.** The funds for the programme's implementation are to be raised by making cuts in spending on the administration. If Fico fulfils his pledge, Slovakia may be in a position to tackle the crisis better than any other country in the region.

Slovakia's accession to the Eurozone has been the key factor in mitigating the negative consequences of the crisis. **Adoption of the Euro will have a positive impact on Slovakia's economic results, because the Eurozone countries are perceived by investors and creditors as much more reliable** (the Euro being one of the most stable currencies). Consequently, the cuts in foreign investments may be relatively lower in Slovakia than in those other countries of the region that have not joined the Eurozone. At the same time, Slovakia will be able to obtain loan financing in global financial markets at a lower cost. The most serious threat to the Slovak economy seems to come from the relatively high crown-to-euro conversion rate. This will have a negative influence on the competitiveness of Slovakia's economy in comparison with the economies of the countries from outside the Eurozone. It seems, however, that the benefits from joining the Eurozone, such as improved credibility, lower currency risk and new investments, are much greater than the losses.

APPENDIX 1

Macroeconomic indexes of the Visegrad Group in 2008

	Poland	Slovakia	Czech Republic	Hungary
Average GDP growth (%)	5.0	7.1	4.2	0.9
Budget deficit (% of GDP)	-2.5	-2.2	-0.3	-6.0
Inflation	4.2	3.9	6.3	6.0
Unemployment	7.4	9.8	5.0	7.7
Per capita GDP as PPP at end of 2007 (US$)*	16316	20267	24229	19019

Source: Eurostat and IMF (*)

Macroeconomic indexes of the Visegrad Group in 2002–2007

	Average GDP growth(%)*	Budget deficit (% of GDP)*	FDI(% of GDP)*	Inflation*	Unemployment*/**
Hungary	4.0	-7.5	2.5	5.3	6.6
Slovakia	6.1	-3.7	7.5	4.7	12.7
Czech Republic	4.4	-4.1	5.4	1.8	7.3
Poland	4.5	-4.5	3.0	2.1	16.6

Source: Eurostat

* average annual figures in 2002–2007

** due to the different methodology employed by Eurostat, the figures differ from national figures

APPENDIX 2

Slovakia's automotive industry

Slovakia is Central Europe's third largest car producer, after the Czech Republic and Hungary. In 2008, more than 800,000 vehicles were produced there; this means that production increased by 140% over 2006. The automotive industry plays a key role in Slovakia's economy; in 2007 it accounted for over 35% of industrial production and over 30% of exports. Currently three car factories operate in Slovakia, Volkswagen in Bratislava, PSA Peugeot Citroen in Trnava and KIA Motors in Zilina.

Centre for Eastern Studies
Koszykowa 6A,
00-564 Warszawa
e-mail: info@osw.waw.pl

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