Project LINK
Country Report: Slovak Republic
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1. Recent trends

Due to the improvement of the economic climate at home (in SR) and in the relevant foreign environment (euro area) as well, the growth of the Slovak economy accelerated this year. While in the first half of 2013 the real GDP grew by 0.6%, in the first half of 2014 it increased by 2.5%. Despite the acceleration of economic growth, however, the overall price level in the economy (measured by the GDP deflator), dropped by 0.5% on the yearly basis. Indeed, any stimulus has been lacking that would generate pressure on its growth as export, import, producer, and consumer prices fell in the first half of 2014.

While export, import, and producer prices fell even in the past year, consumer prices have risen, but the dynamics of their growth slowed sharply. Total inflation reached 1.4% last year (on average), but in December 2013 it fell to 0.4%. However, since the beginning of this year the consumer prices index has been slightly decreasing due to the cost factors - deflation for the period of January to August reached 0.1% (on average).

The economic growth was boosted by a recovery of domestic demand and the acceleration of external demand. The domestic demand was higher by 4.9% (on the yearly basis), external demand increased by 6.3% in the first half of 2014. Given that the real GDP growth (i.e. domestic sources) was lower if compared to the aggregate demand growth, the growth of the total imports accelerated. Nevertheless, the trade balance registered a surplus, which reached 7.7% of nominal GDP. The export of cars and consumer goods was again the main source of a surplus. Thanks to the high surplus in the trade balance, the surplus in the current account was generated as well, which amounted to 2.8% of GDP in current prices in the first half of 2014.

All three main components contributed to the domestic demand recovery, but relatively most important was the contribution of investment demand that increased by 5.0%. Public sector demand was higher by 4.8%, consumer demand by 3.1%. The recovery in consumer demand, which was recorded after four years of its continuous decline, is linked to the growth of the purchasing power of population. The total employment increased by 0.9% and real wage growth in the economy accelerated (not only due to deflation) in the first half of this year.

The growth of total employment is related to the increasing demand for labor, which is being generated by both private and public sector. In the private sector its main source is industry, where employment increased by 1.6% in the first half of 2014. In construction, however, employment has continued to fall (for the fifth consecutive year). Growth in demand in the labor market has reduced labor market imbalances. The unemployment rate fell to 13.2% (LFS methodology) in the second quarter of this year, which represents a year on year decrease by 0.8 percentage points.

2. National Policy Assumptions and International Environment

Due to the consolidation of public finances, the government succeeded to reduce the public deficit to 2.77% of GDP in the past year. In this regard, the Slovak Republic was excluded from the excessive deficit procedure in the first half of this year, in which it was since 2009. The public debt reached the level of 55.4% of GDP at the end of 2013.

To ensure the sustainability of the general government deficit below 3% of GDP, the government approved the National Reform Program (NRP) in April this year that summarizes the consolidation measures to achieve sustainable growth, job creation and improved quality of life (in the context of goals and objectives of the Europe 2020 Strategy). In 2014, the NRP key theme is employment, because high unemployment is a chronic problem of the Slovak economy.

The main part of NRP is the Stability program for the years 2014 to 2017, which contains a mid-term outlook of fiscal policy. The government intends to continue in consolidation of public finances in order to reduce the structural deficit to about 0.5% of GDP in 2017. Achieving this goal should stop the increase of public debt (relatively to GDP) not to exceed 57% of GDP and it should be gradually reduced from 2016. The aim is to reduce the government deficit to 2.64% and 2.49% of GDP in 2014 and 2015 respectively.

Due to the military conflict in Ukraine the assumptions on the relevant external environment have deteriorated. While the economic growth in the euro area was flat in the second quarter, in Germany - the main trading partner of the SR, the economic performance surprisingly even declined. The uncertainty, related to the further development of the conflict in Ukraine, exacerbates also the expectations on further developments in the euro area.

3. Forecast Summary

Domestic demand as a whole should contribute to the growth of the Slovak economy also in the second half of this year. But the dynamics of its growth is very likely to slow down. Unlike the first half of the year, the major factor of growth in domestic demand should become the consumer demand whose growth should continue mainly because of almost zero inflation expected in the second half of this year. Growth in purchasing power of population, however, should not only stem from the growth of real wages in the economy (probably by more than 4%), but also from the decrease in the average unemployment rate from 14.2% in 2013 to 13.5% in 2014.

Dynamics of growth of other two main components of domestic demand should slow down in the second half of 2014. In the case of investment demand, it is indicated by economic sentiment indicator (it stopped growing in August 2014) and by still very low growth of investment credits for firms. On the other hand, due to a relatively high growth in demand of the public sector in the first half of this year, which contributed to the growth in domestic demand and thus also to the performance of the economy, the state budget got worsen. The state budget deficit deepened from 4.8% of GDP in the first half of 2013 to 5.6% of GDP in the first half of 2014. In respect of government's commitment to continue in consolidation of public finances and keep the deficit below 3% of GDP, the growth of public sector demand should significantly slow down.

The economic growth should be based solely on domestic demand in the second half of this year, while net exports will reduce the impact of domestic demand. This model of GDP growth worked already in the second quarter of this year. It should be maintained because new industrial orders from abroad in the second quarter indicate that the growth of exports of goods will not significantly accelerate in the short term horizon. Consequently, the braking effect of net exports to economic growth should not be changed. The real GDP should grow by 2.4% this year, the nominal GDP by 2.0%. Therefore the overall price level in the economy (measured by the GDP deflator) should fall by 0.4% against 2013.

In 2015 the real GDP should increase by 2.7%, which should be due to the contribution of domestic demand and net exports again. The expected acceleration in economic growth should increase the inflation to 1.2%, next year, the unemployment rate should drop to 13.4%.

4. Policy Issues and Uncertainties

The presented estimate of economic growth includes several double-sided risks. In accordance with expectations deterioration of so-called soft indicators, which began in Germany in the second quarter of this year, is being observed with a time lag in Slovakia as well. In fact, the growth of the economic sentiment indicator stopped in August. Thus the main negative risk is further development of domestic demand. Of course, in the context of potential impacts of reciprocal sanctions adopted by the EU and Russia due to the conflict in Ukraine, the negative risks are represented by further development of the external or the aggregate demand.

Also the very low inflation in the euro area stands for one of the risks. However, ECB monitors the risks to the outlook for price developments and take measures to keep the medium to long-term inflation expectations unchanged.