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Economic development of Slovakia in 2004

(A study prepared on behalf of the United Nations Economic Commission for Europe)

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1. A general overview of economic development in 2004

The foreign policy position of Slovakia was strengthened when the country achieved full membership of NATO (April 2004) and of the EU (May 2004). Its domestic political stability, in combination with a sufficiently strong position of the centre-right Government, was manifested especially in the negative outcome of the referendum on early parliamentary elections. In this situation, the Government – formally a minority one – with the support of some independent MPs was able to continue pursuing its reform agenda. In particular, it achieved the passage of pension and healthcare system reforms. Among important steps taken by the Government was the last major deregulation of the prices of energy, fuel and water, and the continuation in the reform of public finance management.

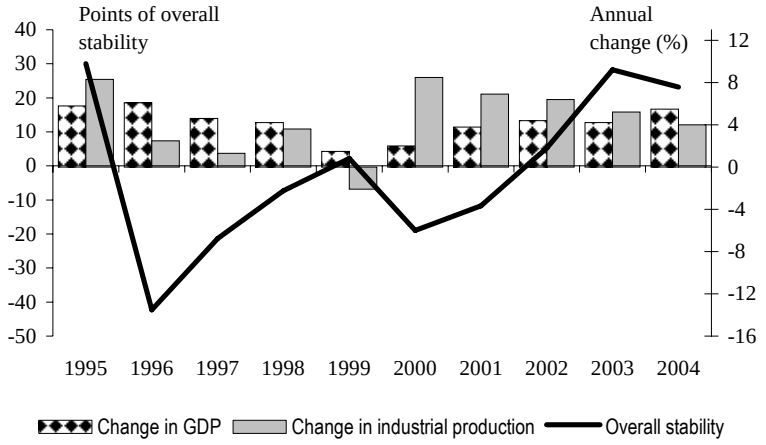
Reform measures implemented in 2004 that had an immediate impact on the economy included especially price deregulations which resulted in the decline of all the components of final demand, especially the population demand, and in increased costs on the supply side. However, an opposite – i.e. stimulating – effect was initiated already in 2004 by the tax reform introduced the year before (which reduced the tax burden by introducing a flat-rate tax) and by other reforms that significantly enhanced the flexibility of the labour market. These reforms, in combination with the continued political stability, increased the attractiveness of Slovakia as the locality with favourable conditions for the inflow of foreign direct investments. This situation was reflected in the promotion of Slovakia by rating agencies to the level of an investment-grade country, which e.g. the Standard and Poor Agency awarded to the Czech Republic already in 1999 and to Hungary in 2002.

Main features of economic development in the Slovak Republic in 2004 were: firstly, further strengthening of growth dynamics that had been relatively robust already in the previous years and, secondly, preservation of macroeconomic stability above the average level attained throughout the

entire period of transformation of the Slovak economy. The position of the year 2004 in the above development trends is illustrated in Graphs 1 and 2.

Graph 1

The development of the performance and stability of the Slovak economy in the 1997 – 2004 period[1]



[1] Overall stability values attained in individual years have been derived from the values of partial indicators (components) of stability, namely the values of year-on-year inflation rate, ratio of public finance balance to the GDP in percentage terms, ratio of net exports to the GDP in %, and the difference between labour productivity improvements and real wage growth in the national economy. Overall stability (S) values in the period *t* are calculated as:

$$St = \left(\sum_1^n \left[\left(at - sat \right) : \left| \frac{\max a - \min a}{2} \right| \right] \cdot 100 \right) \cdot \frac{1}{n}$$

Where:

S_t = overall stability in the year *t*

[ ] . 100 = value of the element (component) of partial stability comparable with the values of other elements in the year *t* in points

a = value of the element of partial stability in the year *t*

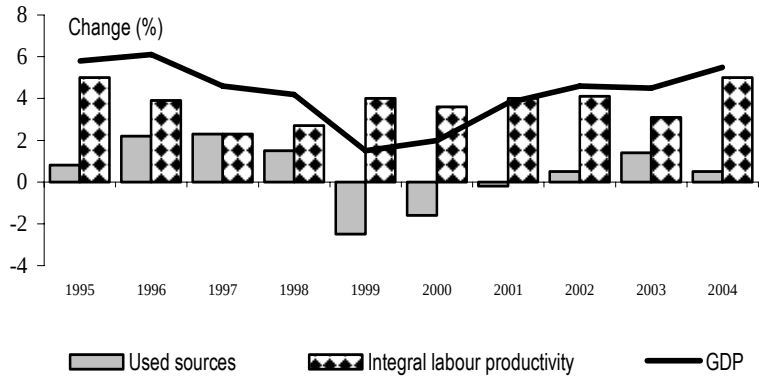
sa = mean value of the element of partial stability in the relevant period

|*max a – min a*| = absolute value of the interval between maximum and minimum value of the element of partial stability in the relevant period.

Graph 1 illustrates a clear correlation between positive economic growth from 2001 onwards, which culminated in 2004, and the strengthening of macroeconomic stability during several years. A stable macroeconomic environment is an important factor encouraging the activities of foreign and local entrepreneurs. The implementation of stabilisation policy and improved macroeconomic equilibrium help translate the results of their endeavours into speeding up the improvement of economic results. Positive parameters of economic growth and macroeconomic stability attained in 2004 create a favourable climate for further positive development of the Slovak economy in the forthcoming years.

Graph 2

Annual changes in the GDP and its factors



[1] Established on the basis of the production function $Y = L^{\alpha} + K^{1-\alpha} + \Delta$, converted into the growth rate form: $\Delta Y/Y = \alpha\,(\Delta L/L) + (1 - \alpha)\,(\Delta K/K) + \Delta A/A$,
Where:

ΔL/L - the rate of growth in the number of employees (employment) in the national economy according to statistical data

ΔK/K - the rate of growth of the residual value of fixed assets at constant prices (using own calculation of the investment price index)

ΔA/A - integral labour productivity growth rate

α, or $1 - \alpha$ - share of household consumption and/or gross fixed capital formation on the sum of both mentioned variables.

Graph 2 illustrates mainly the fact that in 2004 the acceleration of economic growth went hand in hand with improvements in its quality, as seen from the aspect of factors affecting the generation of GDP. Thus, growth quality improvements reflected in the combination of a better use of resources (labour and tangible capital) and a faster growth rate of integral labour productivity from 3.1 % in 2003 to 5 % in 2004 increased the GDP growth rate from 4.5 % in 2003 to 5.5 % in 2004.

Graph 2 shows that during the last decade the trends in economic growth and its quality have changed several times and in several ways.

The quality of economic growth in the 1995 – 1998 period was characterised by massive and incessantly growing expenditures of resources and their increasingly lower effects expressed in terms of integral labour productivity. The combined influence of these two factors led to a slowdown in GDP growth already in 1997 and 1998.

From 1999 onwards, the trends of economic growth quality went through significant changes. The Slovak economy started to function with a diminishing volume of resources (both in terms of employment and tangible capital), accompanied by simultaneous improvements in integral productivity. Both trends were taking place against the backdrop of corporate restructuring, which also included increasingly tighter budgetary restrictions for the corporate sector, and brought about an increase in the number of bankruptcy proceedings. However, because the higher growth of integral productivity in 1999 and 2000 failed to offset fully the effects of the reduced deployment of resources, the GDP growth rate of that period was lower than in the previous years.

Graph 2 shows that the volume of growth-generating resources started to increase already in 2001, accompanied by a relatively high growth of integral productivity. In this manner, both aggregate GDP factors were mutually reinforcing one another and helped improve the quality of economic growth, until its parameters reached the 2004 level.

Information given in Table 1 completes the picture of the changes in the trends of the quality of economic growth displayed in Graph 2.

The development of economic growth shown in Table 1 is broken down according to its different characteristics into individual periods, which coincide with the duration of political cycles. It proves that both the growth rate of the economy and its quality were influenced by economic policies of individual government formations. However, because of the continuity and inertia of economic processes, the results observed in individual periods are affected, to a certain extent, by the situation in the preceding period.

Table 1

Average annual changes in the GDP and its factors

	1995 – 1998	1999 – 2002	2003 – 2004
GDP changes in % [1]			
Of which (in points):	5.2	3.0	5.0
employment	1.1	-0.8	1.1
labour productivity [2]	4.1	3.8	3.9
tangible capital	2.4	-1.6	0.8
productivity of tangible capital[3]	2.8	4.6	4.2
used resources – total	1.7	-0.9	1.0
integral labour productivity[4]	3.5	3.9	4.0

[1] At constant prices.
[2] GDP change per 1 worker in %.
[3] GDP change/unit of the residual value of fixed assets at constant prices in %.
[4] The mode of calculation is described in the note to Graph 2.

One characteristic feature of the growth attained during the 1995 – 1998 political cycle was a relatively high growth rate resulting from massive deployment of tangible capital assets, with the lowest productivity improvements of the entire relevant decade. During the two subsequent political cycles (1999 – 2002 and 2003 – 2004), government policies and/or policy

framework for entrepreneurial activities were largely oriented towards accelerating the growth of capital and integral labour productivity.[1]

Characteristics of the main sides of economic development of Slovakia in 2004 are shown within their development trends in Table 2. They are supplemented by depicting selected connections in the Graph 3.

On basis of data in Table 2 it can be said that the results of the Slovak economic development in 2004 were outbalanced by positive tendencies. Labour productivity growth in national economy proves raising of its competitiveness. The values of partial stability indicators (core inflation rate, balance of public finance, differences between productivity change and real wages change) characterize the process of the solution of nominal convergence tasks or (in case of inflation rate increased by price deregulation) express creating conditions for their realization in the near future.

It is obvious even from the very limited number of indicators used for characterization of social development in Slovakia that its trends continued also in 2004. Despite certain positive developments in part c. of graph 3 we cannot say that the labour market situation (employment development and unemployment rate) recorded any principal and lasting positive turn already in 2004.

In 2004, though the real household consumption/inhabit. exceeded the pre-reform level by 15 %, however, its index was markedly behind the value of GDP index. Not even in 2004 the real wages could achieve the 1989 level.

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[1] When evaluating economic growth in 2004 it must be taken into consideration that one percentage point of GDP growth (at constant prices) represented the statistical difference between GDP generated and GDP used. After the correction of the growth rate attained in 2004 and of the above point, the contribution of integral productivity to GDP growth in the 2003 – 2004 period falls to its level in 1995 – 1998. The effect attained per one unit of used resources (the ratio of integral productivity contribution to used resources contribution), identified in the 2003 – 2004 period is, however, still higher (3.5 : 1.0) than the integral effect of used resources in the 1995 – 1998 period (3.5 : 1.7).

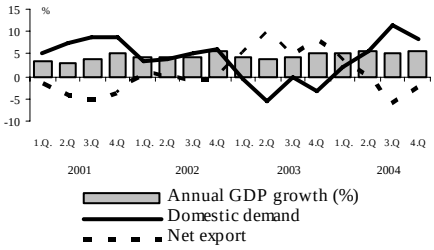
Table 2
Social-economic development in 1995 – 2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
	A. Economy performance development									
GDP Index[1] Previous year = 100	105.8	106.1	104.6	104.2	101.5	102.0	103.8	104.6	104.5	105.5
1989 = 100	89.2	94.7	99.0	103.2	104.7	106.8	110.9	116.0	121.2	127.9
Labour productivity index 1989 = 100[2]	103.7	107.6	114.0	119.3	124.4	129.3	133.4	140.3	144.0	152.4
Cost profitability in non-fin. org. in %	4.2	2.8	2.5	0.4	1.4	2.7	4.5	4.5	6.0	7.0
	B. Stability indicators									
Inflation rate in %[3]	9.9	5.8	6.1	6,7	10.6	12.0	7.1	3.3	8.5	7.5
of which: core inflation rate in %	.	.	.	6,1	6.0	5.7	4.3	2.1	2.6	2.6
Average interest rate on credits in %[4]	13.3	13.3	18.4	19,4	16.9	11.8	9.3	9.1	7.6	7.9
Balance of public finance/GDP in %[5]	.	-7.4	-6.2	-3,7	-7.0	-12.3	-6.0	-5.7	-3.7	-3.3
Annual Δ in productivity[3] – annual Δ in real wages in national economy in points	2.6	-6.6	-0.7	3,0	7.4	8.8	2.2	-0.6	4.6	3.4
Net export of goods and services/GDP in %[1]	2.5	-8.6	-7.6	-10,7	-2.2	-0.3	-3.8	-3.8	2.6	1.7
	C. Social development									
Year-on-year employment index[6]	101.7	103.6	99.1	99.7	97.0	98.6	101.0	100.2	101.8	100.3
Average unemployment rate in %[6]	13.1	11.3	11.8	12.5	16.2	18.6	19.2	18.5	17.4	18.1
Annual change in real wages in %	4,3	10.3	6.6	1.7	-3.1	-4.9	1.0	5.8	-2.0	2.5
Index of real wages in national economy 1989 = 100	78.2	86.3	92.0	93.6	91.0	86.9	87.8	92.8	91.3	93.6
Index of real household consumption/inhab. 1989 = 100	82.4	89.0	94.0	99.5	102.1	101.1	106.4	112.3	111.4	115.4
Share of social benefits in household consumption in %	24.4	23.6	23.3	22.8	23.3	22.5	21.3	21.2	21.6	20.2

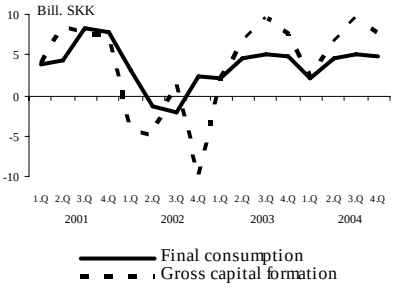
[1] At constant prices. [2] According to GDP at constant prices per worker. [3] According to consumer prices, in average per year. [4] From credits drawn from commercial banks, in average per year. [5] According to WIIW Research Reports 314. March 2005. [6] According to Labour force survey, in average per year.

Graph 3
The development of macroeconomic indicators in 2001 – 2004

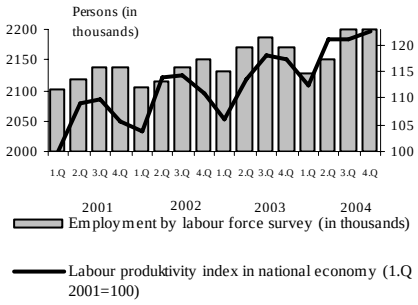
a. The share of domestic demand and net exports in GDP generation, in points



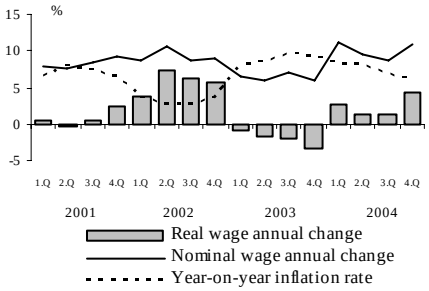
b. Consumption and investment



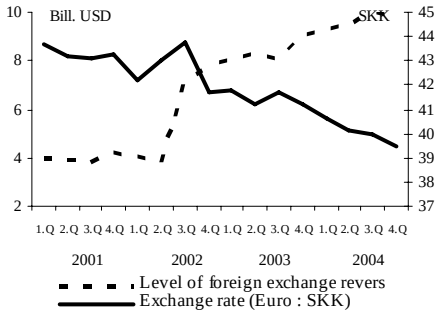
c. Employment and labour productivity



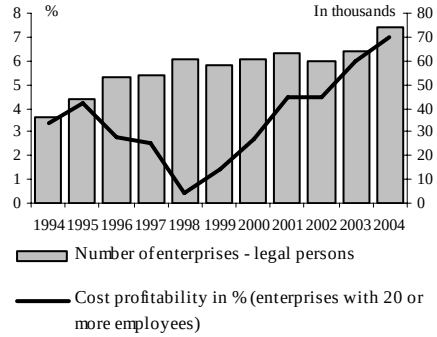
d. Prices and wages



e. Foreign exchange reserves and SKK exchange rate



f. Number of enterprises and profitability



A considerable difference between the values of real wages index and values of household consumption/inhabit. index has been caused by growth in income of self-employed, or by growth of their impact on household consumption. Data in the last line of Table 2 signify quite fast decline in relative volume of social benefits. Social benefits are constantly falling, not only in relation to household consumption (over the last 10 years almost by a fifth), but also in relation to the GDP used (from 12.6 % in 1995 to 11.2 % in 2004).

Part a. of the graph shows that, as regards the structure of demand, the year 2004 brought a change in the forces driving economic growth. The 2003 economic growth was driven exclusively by an increase in net exports. Net exports contributed to the 4.5 % growth of GDP with 6.6 points, while the effect of domestic demand was - 2.1 points. The above mentioned increase in net exports was directly attributable to an exceptionally high increase (22.5 % at constant prices) in the volume of exports and, indirectly, to the reduction of domestic demand caused by the faster price deregulation pace.

In 2004, the Slovak economy came again into a situation where the GDP growth was generated by – or primarily generated by – the growth in domestic demand. The contribution of changes in domestic demand and net exports to the 4.5 % GDP growth (without statistical difference) was 5.3 and - 0.8 points, respectively.

The positive influence of domestic demand on the GDP development in 2004 was caused by the growing total final consumption as well as growing gross capital formation, i.e. by an expansion of investment activities. (See part b. of Graph 3). The data on total final consumption show an increase in household consumption in real terms by 3.5 % and in general government consumption by 1.2 %. After a 0.6 % decline in gross fixed capital real formation in 2002 and its 1.5 % decrease in 2003, the year 2004 brought an increase by 2.5 %. However, the overall volume of gross capital formation (at constant prices) in 2004 exceeded the 2003 level by 13.1 %, mainly due to exceptionally big change in inventories, which accounted for

up to 2.2 percentage points of the 5.5 % GDP growth recorded in 2004. It is highly probable that inventory change will be substantially reduced in 2005 and will, on the one hand, contribute to slowing down the GDP growth rate while, on the other hand, increasing the rate of gross fixed capital formation due to the finalisation of investments previously reported as inventories.
Also in 2004, growth in gross fixed capital formation continued to include the internal changes characterised in Table 3.

Table 3
Structure of gross fixed capital formation in %[1]

	1996	1997	1998	1999	2000	2001	2002	2003	2004
GFCF – total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
of which: machinery and transport equipments	49.9	51.1	53.0	54.7	55.6	54.1	57.7	59.3	61.2
buildings and construc-tions	46.3	42.8	41.6	40.2	38.3	40.0	35.2	33.7	32.0
Other	3.8	6.1	5.4	5.1	6.1	5.9	7.1	7.0	6.8

[1] According to data at current prices. Until 1999 inclusive, the data in the table express the structure of tangible investments.

The share of machinery and equipments in gross fixed capital formation has kept steadily increasing course throughout the entire relevant period. The acceleration of this trend from 2002 onwards is matched by improvements in the quality of economic growth as presented in Graph 2.

Part c. of Graph 3 illustrates the correlation between economic growth combined with labour productivity improvements and employment trends. It graphically illustrates that although the decisive factor behind GDP growth in the 2001 – 2004 period was labour productivity, moderate increase in employment also played a certain positive role.

Parts d. and e. of Graph 3 illustrate certain characteristics of the processes that contribute to the overall macroeconomic stability. They show that (especially considering that price increases did not have the character of core inflation – see the section on price development) both internal and external factors played a role in the continued positive overall stability situation. Part f. of Graph 3 shows the situation in the corporate sector over a longer period of years 1994 to 2004. The trends of the development of both indicators (i.e. the number of operational companies and their economic performance) clearly indicate that the key characteristics of macroeconomic development in Slovakia throughout the entire transfor-mation period were essentially in conformity with the processes that were taking place in the corporate sector. Profitability improvements of non-financial organisations in 2004 reflected a positive impact of increasing incomes of agricultural companies from the funds of the European Union. But even if the entire change in the profit/loss results of agricultural companies in the relevant period (that represented SKK 2.9 billion) was deducted from the profit/loss results of non-financial organisations in 2004, cost profitability of these organisations in 2004 would have been 6.9 % compared with 6.0 % in 2003.

The evaluation of the performance of Slovak economy in 2004 should emphasise positive results attained in the area of stability and economic growth. Graph 3 shows that this has been achieved thanks to the successful solution of various problems in a number of areas of economic life. Most development trends that have been identified, and will be examined in details in the next sections, show that Slovakia was well prepared for entering and functioning in the European Union.

2. Production development

The growth of gross domestic product (GDP) was achieved in 2004 in a situation where the value added was increasing at a considerably faster rate (5.8 %) than gross production (3.1 %) and intermediate consumption

(1.5 %). As a result, the share of value added in gross production grew from 37.8 % in 2003 to 38.7 % in 2004. The value-added growth contributed to the GDP growth with 5.2 percentage points (p. p.), compared with other components of the GDP that contributed 0.3 p. p.

As regards individual sectors, a higher value added growth in 2004 than in the previous year was achieved in industry (especially manufacturing), construction, and agriculture. Like in 2003, the growth of value added in the service sector continued to slow down.

Industry was the largest contributor to the GDP growth in 2004 with 3.0 p. p., while the share of the service sector fell to the value of 1.7 p. p., mainly because of the decline in value added achieved in the sector of mostly public services (by 11.8 %). Overall development trends are characterised in Table 4.

T a b l e 4
GDP generation development in 2001 − 2004 (at constant prices)

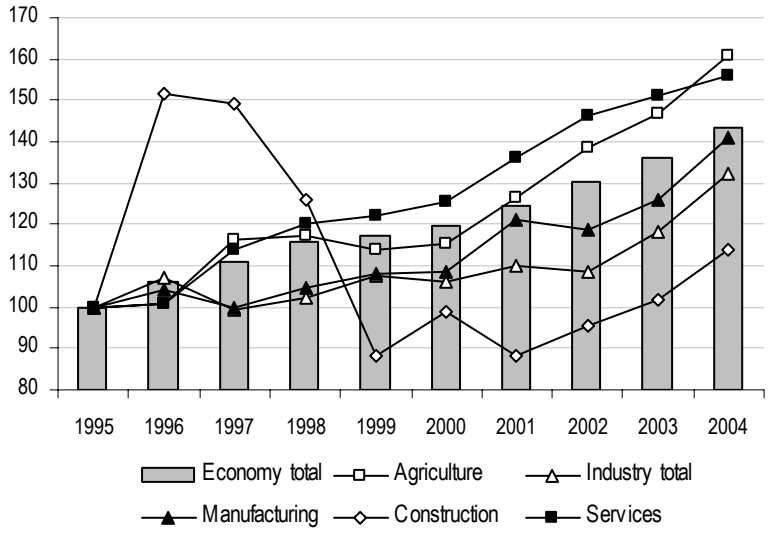
	2001	2002	2003	2004	2001	2002	2003	2004
	year-on-year changes in %				contribution to GDP growth in p. p.			
GDP	3.8	4.6	4.5	5.5	.	.	.	.
of which:								
agriculture	9.6	9.5	5.8	9.7	0.4	0.4	0.3	0.4
industry – total	3.8	-1.3	9.1	11.5	1.0	-0.3	2.3	3.0
manufacturing	11.3	-2.0	6.1	11.9	2.6	-0.5	1.4	2.7
construction	-11.0	8.4	6.8	11.8	-0.4	0.3	0.2	0.4
services – total	8.2	7.4	3.6	3.0	4.4	4.1	2.1	1.7

In spite of certain year-on-year variations in real value added increases, value added has shown a steady pattern of development in recent years in practically all sectors of national economy. A general overview of the value added growth by sectors is given in Graph 4.

The share of individual sectors in the GDP (at current prices) in the 1995 − 2004 period recorded significant changes: while the share of

services went up (from 51 % to 59 %), a decline was observed in the shares of agriculture (from 4 % to 3.6 %), industry (from 30.3 % to 24.5 %) and manufacturing (from 24.8 % to 19.4 %). Significant fluctuations that characterised the construction sector in the relevant period were reflected also in its varying GDP shares − its 2004 share of 5.2 % exceeds that of 1995 by more than 0.5 p. p., but is 1.6 p. p. below its 1996 value when the growth of construction reached its peak.

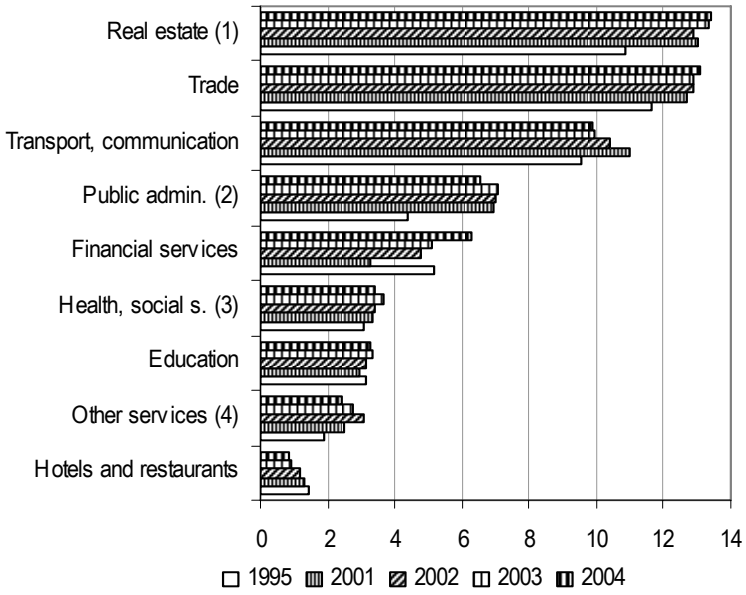
G r a p h 4
Value added development in key sectors of the Slovak economy, in %
1995 = 100, at constant prices



The following branches made the greatest contribution to the growing proportion of the service sector in the GDP: real estate, renting and commercial activities (increase by 2.6 p. p.), trade (increase by 1.5 p. p.), public administration, defence and compulsory social security (increase by 2.1 p. p.), and financial services (increase by 1.1 p. p.). The hotels and restaurants sector recorded negative developments when its GDP share fell from 1.4 %

in 1995 to 0.9 % in 2004; in real terms value added in this sector in 2004 dropped by almost 30 % in comparison with 1995. (For more details see Graph 5.)

Graph 5
The development of the shares of individual service segments in the GDP, in %
1995, 2001 − 2004, at current prices

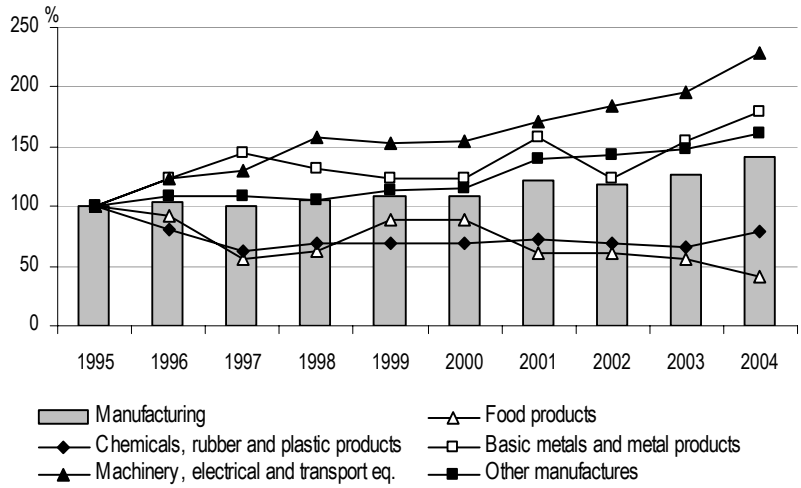


(1) Activities in the area of real estate, renting, and the entire range of commercial activities (computer and related services, research and development, legal, accounting, technical, advertising, security services, etc.)
(2) Public administration, defence, and compulsory social security
(3) Healthcare and social assistance
(4) Other community, social and personal services

In 2004, value added in *manufacturing* increased by 11.9 % relative to 2003, mainly due to its growth in chemicals, crude oil and rubber products

by 20 %, in the manufacture of machinery, electrical equipment and transport equipment by 17.1 %, in the manufacture of basic metals and metal products by 15 %, and in other manufacturing activities (excluding food products) by 8.5 %. Value added in food products manufacture posted a significant decline (by 25.7 %).

Graph 6
The development of value added in the manufacturing sectors
1995 = 100, at constant prices



As shown in Graph 6, long-term development of value added in manufacturing is characterised by its above-than-average growth in the manufacture of machinery, electrical equipment and transport equipment, of basic metals and metal products, and in other manufacturing activities; it stagnates or falls in the manufacture of food products and in the chemical industries.

The 4.0 % increase in the *industrial* production reported in 2004[2] reflected an increase in the manufacturing production by 4.6 %, and in the electricity, gas and water supply by 3.7 %; while in the mining and quarrying sector production fell by 10.6 %. The highest growth in the manufacturing sector was observed in the manufacture of machinery and equipment n. e. c. (15.9 %), and in the manufacture of electrical equipment (13.4 %). The growth of industrial production was thus achieved both thanks to a 0.4 % increase in the number of employed persons and a 3.6 % increase in productivity.

The growth of the receipts of own performances and goods of industrial companies slowed down in real terms in 2004 relative to 2003 from 11.8 % to 6.9 %, and in manufacturing from 14.1 % to 8.4 %. The high growth of the receipts of industrial companies in 2003 was mainly due to a steep rise in the sales in the manufacture of transport equipment (by 70 %) – it accounted for more than 60 % of the increase in sales of the manufacturing sector (at current prices). The 2004 growth of sales in the manufacture of transport equipment slowed down to 3 %. The majority (83 %) – but compared with the lower sales increase in manufacturing in the previous year – was in 2004 provided by the manufacture of basic metals and metal products (15.2 % growth), manufacture of electrical and optical equipment (28.8 % growth), of machinery n. e. c. (12.6 % growth), and of petroleum products (10.6 % growth).

The development of sales in individual branches of the manufacturing industry was clearly affected by their success on the international market. Most of the 2004 increase in exports (SKK 85 billion for the manufacturing as a whole) was reached in those sectors that also made the strongest contribution to the growth of sales.

The manufacture of transport equipment continued to hold the highest share in total exports in the *manufacturing* also in 2004 (26 %), although its

[2] In the course of the year, the growth rate recorded a gradual decline – from 6.2 % in the 1st quarter to 1.2 % in the 4th quarter

export fell by SKK 11 billion. It was followed by metals and metal products (16 %), electrical and optical equipment (14 %), and machinery n. e. c. (9 %).

The structure of manufacturing exports changed significantly during the last two years; compared to 2002, when the share of primary products and investment goods was identical (41 %), the share of investment goods in the years 2003 and 2004 exceeded that of primary products by 14 % and 11 %, respectively. Moreover, a trade balance surplus was obtained during the above two years in the trade in investment goods.

Positive developments were noted also in the breakdown of Slovak exports ranked by technology intensiveness. For the second consecutive year, the export of goods in the high tech segment continued to significantly grow also in 2004 (by 10 billion in 2003 and almost 22 billion in 2004).[3] On the whole, there has been an evident upward trend in the field of exports, where the growth rate of exports exceeds that of imports in more technology-intensive segments of the manufacturing sector (see Graph 7).

Admittedly, the exports of goods in the high-tech category still represent a weak point in our foreign trade. In spite of their increased share in manufacturing exports that grew from 5.7 % in 2003 to 7.6 % in 2004, they still fall significantly behind the EU average (23.5 % share in 2001). The trade balance deficit in the high tech segment continues to represent a particular problem: although it stopped growing in the 2002 − 2004 period, it is still exceptionally high (around SKK 59 billion).

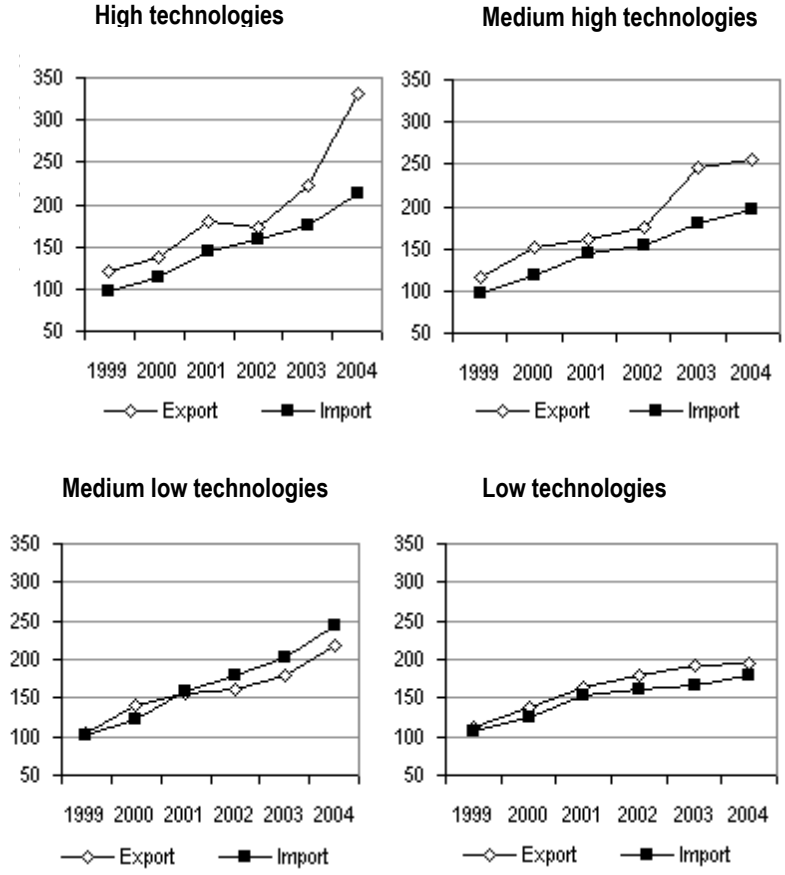
A much more favourable development was observed during the last two years in the balance of trade in medium-high technology goods which recorded a significant surplus. This primarily applies to the production of motor vehicles that made the most significant contribution to positive trade

[3] Exports are growing in the production of computers and other data processing equipment, and in the production of TV and radio sets, audio recording and reproduction equipment; both types of production recorded a positive trade balance in 2004.

balance developments, but also to other branches of this manufacturing sector segment.[4]

Graph 7

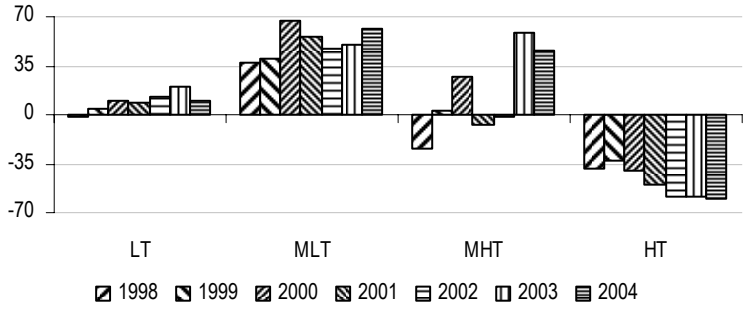
The development of exports and imports in manufacturing (1998 =100), in %



[4] E. g., in 2004, while the high surplus recorded in the trade in motor vehicles in 2003 fell by SKK 24 billion, the overall trade balance surplus in the segment of medium high technologies fell only by SKK 13 billion.

The development of trade balance in individual segments of the manufacturing that are characterised by varying technological intensity is shown in Graph 8.

Graph 8
The development of trade balance in the manufacturing segments, by technology intensity (in SKK billion)



Explanations: HT − high technologies, MHT − medium high technologies, MLT − medium low technologies, LT − low technologies.

Construction production increased in 2004 by 5.7 %, employment by 2.7 %, and labour productivity by 2.9 %. In contrast to the previous year, the growth in production was influenced mainly by new construction, modernisation and restructuring inside the country; on the other hand, a decline was recorded in the construction activities connected with repairs and maintenance and with construction work abroad. The receipts of construction companies' own performances and goods rose by 7.2 % (1.3 p. p. less than in 2003).

The receipts for own products in *agriculture* decreased in real terms by 1.1 %, when receipts for crop production increased by 1.5 % and the receipts for livestock products by 3.7 %.

Following a period of stagnation in 2001–2003, the year 2004 brought a significant improvement in *overall financial performance of corporations* –

their overall financial position improved by as much as SKK 42 billion compared with 2003 (see Table 5).

Table 5
The development of the financial position of corporations in 2000 − 2004

	2000	2001	2002	2003	2004
	Profit/loss in SKK billion				
Non-financial and financial corporations – total	88.0	134.8	133.7	138.0	180.0
Financial corporations	8.8	12.8	–5.5	−15.1	−12.3
Non-financial corporations	79.2	122.0	139.1	153.1	192.3
of which:					
Agriculture	–0.3	1.2	1.9	−1.9	1.0
Manufacturing	26.3	44.7	42.6	53.2	70.0
Construction	3.3	4.9	8.9	8.4	10.2
Services – total	36.2	55.0	56.0	55.4	67.4
Profitable and unprofitable non-financial corporations with 20 or more employees	49.4	86.2	95.3	115.2	149.3
of them: profitable	81.3	112.3	127.4	146.6	173.0
unprofitable	–32.0	–26.0	–32.2	−31.3	−23.7
	Cost profitability in %				
Non-financial corporations	3.5	5.2	5.7	6.0	7.0
Agriculture	–0.5	1.7	2.7	−3.1	1.6
Manufacturing	3.4	5.2	4.7	5.0	6.2
Construction	3.2	4.8	8.6	7.8	8.6
Services – total	3.3	5.2	5.0	5.1	5.6

The largest profit increase was recorded by corporations in the non-financial sector – by SKK 39.2 billion relative to 2003; the sector of financial corporations continued to make a loss – however, its total loss was reduced by SKK 2.8 billion.

All segments of the non-financial corporation sector posted positive aggregate profit/loss results. The largest profit increase was recorded

in industry (of almost SKK 22 billion), of which a profit of approx. SKK 17 billion was reached in the manufacturing and more than SKK 5 billion in the electricity, gas and water supply. Positive results were obtained in agriculture (profits of SKK 1 billion compared with a SKK 1.9 billion loss in 2003), and in construction (profits rose by SKK 1.8 billion). After three years of stagnation, total profits of the service sector grew by SKK 12 billion, of which almost SKK 7 billion were generated in the trade and close to SKK 3 billion in real estate, renting and commercial activities.

Approx. 30 % of all non-financial corporations with 20 or more employees reported a loss in 2004, just like in the two previous years. However, the total volume of their loss fell by almost SKK 8 billion. The relationship between the profits in profitable and the losses in unprofitable corporations display a steadily improving trend: while, for instance, the loss in 1998 was as high as 90 hellers per one Slovak crown of profit, the proportion of loss per one Slovak crown of profit plummeted to 25 or 21 hellers during the last two years, and to as low as 14 hellers in 2004.

The largest profit among non-financial corporations (55.2 %) was generated by large corporations; medium-sized enterprises contributed with 14.5 % and small enterprises with 30.3 %. In contrast to 2003, when small and medium-sized enterprises reported lower profits, in 2004 all three groups of enterprises surpassed the 2003 level.

3. Price development

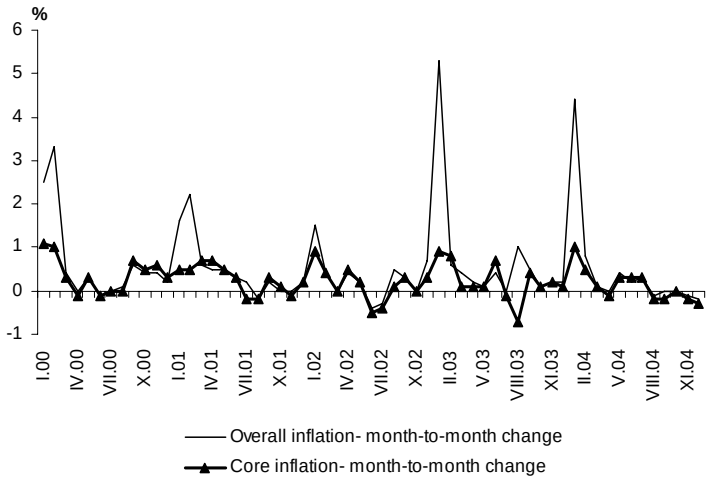
Rather than being a sign of internal instability of the economy, the relatively high average unemployment rate measured by the consumer price index reflected recent massive price deregulations and changes in indirect taxes (the time pattern and scope of these administrative inflationary influences are well discernible in the form of noticeable fluctuations of relevant

[5] Of this, the manufacture of coke, refined petroleum products and nuclear fuels represents close to SKK 9 billion, and metal production SKK 5 billion.

curves in Graph 9). Inflation rates of 8.5 % in 2003 and 7.5 % in 2004 seem to be relatively high only relative to the year 2002 (3.3 %), where the inflation figure reflected the absence of regular deregulations, mostly for political reasons. When viewing the 2003 and 2004 inflation rates from a longer-term perspective, they can be characterised not as high, but as adequate to the existing circumstances. They do not present a risk for the fulfilment of the relevant convergence criterion for the introduction of euro, and do not reflect the influence of longer-term inflationary pressures.

Graph 9

Month-to-month changes in overall and core inflation



It is a fact that the inflation rate in Slovakia was, especially in the summer months of 2004, significantly higher than in other V4 states.[6] Ho-wever, the inflation rate recorded in the summer months of 2004

[6] The July value of year-on-year inflation rate, which represented the annual maximum at the level of 8.5 %, was much higher than the rate of inflation in the Czech Republic (3.2 %) and Poland (4.6 %), and slightly higher than in Hungary (7.2 %).

represented the culmination that had been expected and that was followed by a sustained and long-term slowdown in price level growth. Starting in August 2004, no month-to-month increase has been reported in the level of consumer prices; the month-on-month price level reduction during the last two months of the year fulfilled even the most optimistic predictions about the slowdown of inflation in the second half of 2004. A certain role in this regard was played by the change in the comparison base that was introduced in the preceding year. The increase in indirect tax rates in August 2003 prompted an increase in the price level. Starting in August 2004, current price levels were therefore compared with higher price levels introduced in August 2003; this resulted in smaller year-on-year differences. Moreover, intensity of competition on the retail trade market, which increased again in the second half of 2004, also contributed to disinflation tendencies.

The character of key inflationary factors in 2004 reveals that core inflation contributed by a relatively small share to overall inflation. Core inflation contributed to year-on-year overall inflation in 2004 with 1.89 percentage points, i.e. only one fourth of the overall inflation rate.[7]

Prices in the production sphere were growing at a much slower rate than consumer prices (Graph 10).

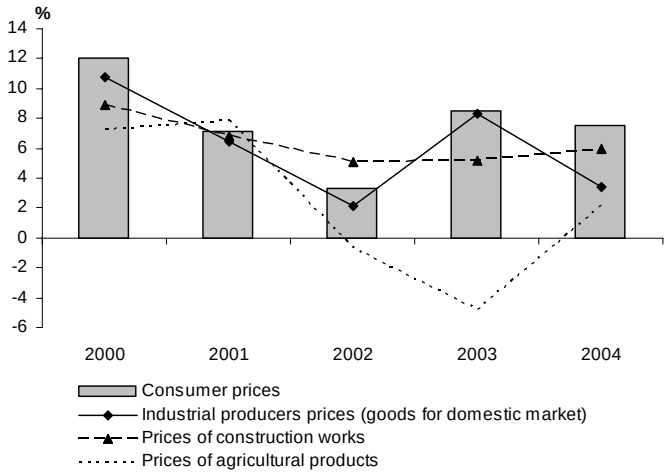
The most rapid growth among the prices in production sector was reported in construction work prices (by 6.0 % on the average). Prices of industrial producers (average year-on-year increase by 3.4 %, i.e. a significant slowdown in comparison with 8.3 % of the preceding year), and prices of agricultural products (2.1 %) rose only moderately. The logical explanation for considerable differences between the rates of growth of production and consumer prices is that the key inflationary factors that were in operation in 2004 had a direct effect on consumer prices (adjustments of VAT, consumption taxes, regulated prices for households). Also the GDP

[7] Total average inflation rate in 2004 can be broken down as follows:
Overall inflation rate 7.5% = contribution of changes in regulated prices at the level of 3.73 p. p. + contribution of changes in indirect taxes at the level of 1.94 p. p. + contribution of core inflation at the level of 1.89 p. p.

deflator, which is the broadest measure of price changes, achieved the value of 4.6 %, i.e. a much lower value than the average growth of consumer prices.

G r a p h 10

Year-on-year changes in consumer prices and producer prices



The assumption that the accession of Slovakia to the common market of the EU (EU accession) does not entail any price shock was thus confirmed. More significant price changes affected only a narrow range of agri-food commodities and did not exert a more pronounced influence on the overall price level. Exchange rate developments also had anti-inflationary effects: the appreciation of Slovak currency prevented a so-called imported inflation. The appreciation of local currency was the decisive factor behind the fall in the prices of imports and exports of goods and services, as shown by the deflator of exports at the level of 97.9 and the deflator of imports at the level of 98.3 (the same period of the previous year = 100).

Outlooks for 2005

It is important to note that, starting in 2005, price level movements in Slovakia became more predictable. Price level dynamics ceased to be a risk factor. The reasons for this conclusion include, on the one hand, the completion of the process of the elimination of price deformations and, on the other hand, the need to fulfil the Government's convergence programme in the area of inflation. The rate of overall inflation will be getting substantially closer to that of core inflation, which did not show greater fluctuations even in the preceding period. If administrative price interventions (price regulation, changes in indirect taxes) are minimised from 2005 onwards, the value of overall inflation will be gradually approaching that of core inflation. The sustained low core inflation also indicates that there are no uncontrolled inflationary pressures in Slovakia.

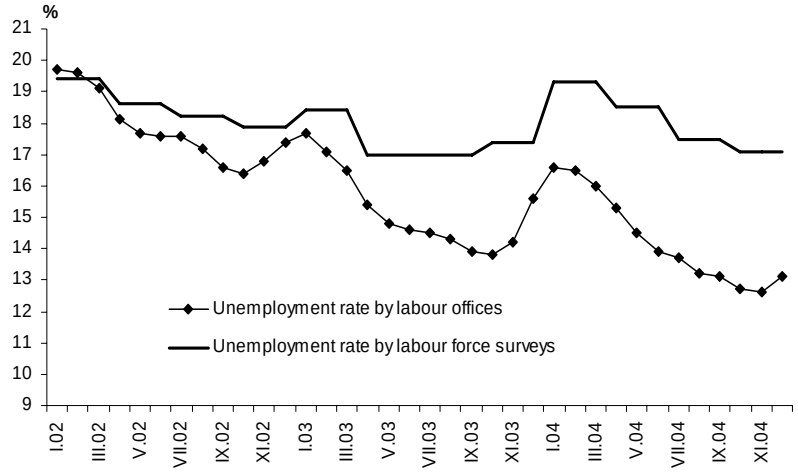
In 2005, the inflation rate is likely to achieve a record low level (the lowest in the existence of Slovakia to date). The government forecast expressed in its Updated Convergence Programme envisages the inflation rate of 3.4 %, i.e. less than one half of its 2004 value. Although this goal seemed to be overly ambitious at the time of its formulation, today it seems to be even too conservative: average inflation rate in 2005 will be probably even lower than foreseen in the Updated Convergence Programme. The inflationary impact of changes in regulated prices on January 2005 was not substantial, and the average year-on-year inflation rate of the first three months of 2005 was as low as 2.8 %. The only known risk factor for price level developments in the remainder of the year is the development of prices of hydrocarbon fuels. Even with certain caution, average inflation rate in 2005 can be expected to reach the level of 2.7 %. This means that, in spite of relatively higher inflation rates in 2003 and in 2004, there is no known reason that would prevent the Slovak economy to fulfil the inflation convergence criterion within the same time horizon as its neighbouring new member states of the EU, and to introduce common currency in 2009.

4. Labour market

In the situation of a relatively favourable composition of main macroeconomic indicators, the indicators of the labour market continued to develop in a rather problematic manner. Although, on the one hand, wage development was more favourable than expected, the development of employment and unemployment indicators on the other hand failed to match the otherwise positive macroeconomic performance. Moreover, the gap between the indicators as reported by labour offices on the basis of unemployment registers and those reported by the Statistical Office of the Slovak Republic on the basis of labour force surveys, considerably deepened (see Graph 11).

Graph 11

Unemployment rate, by calculation method



After the labour market recovered from the critical 1999 – 2001 period, its indicators started to show slight improvements in 2002 and 2003. The year 2004 marked a temporary (short-term) intermission in

this process of improving labour market parameters. The set of labour market indicators offered a relatively complicated picture.

The unemployment rate identified by labour force surveys recorded a year-on-year increase at the level of 18.1 %, i.e. 0.7 percentage point, relative to the same period of the previous year. This happened at the time when labour offices and the ministry of labour repeatedly reported successful results in the reduction of unemployment. The unemployment rate reported by labour offices was substantially lower (14.3 %).[8] The increased disparity between the above two labour market indicators results largely from the tightening of the conditions for keeping the unemployed on the unemployment register. In concrete, relative to 2003 and 2002, the number of the registered placed unemployed who found employment with the help of labour offices in 2004 went down, and the number of those who were removed from the unemployment register for the lack of cooperation increased.[9] This means that the fall in the number of the unemployed reported by labour offices cannot be explained as a result of the better job placement achieved by labour offices.

Although the 2004 economic growth was more robust, this did not result in accelerating the employment growth. Just the opposite: the GDP growth by 5.4 % in the first semester was accompanied by a fall in the number of employed persons by 0.5 % (according to labour force surveys). The development trend changed in the second half of the year; especially in the last quarter all labour market indicators displayed a much more favourable trend than in the previous three quarters. The most important fact was an

---

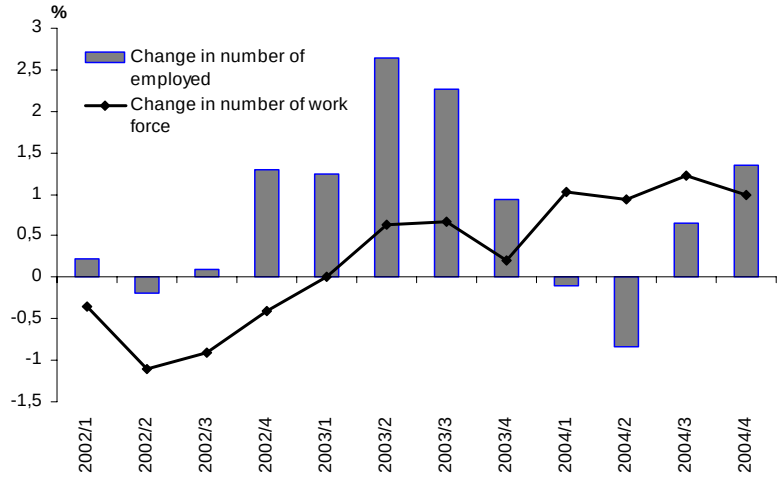
[8] Growing gaps between two unemployment rates caused by means of different methodologies (in certain periods they exceeded four percentage points – for instance, 17.5 % vs. 13.3 % in the 4th quarter) reached the value that attracted considerable attention. Both indicators serve their specific purpose, but require correct interpretation: Labour offices base their data on the number of persons kept on their registers (i.e. not the number of persons who are out of work), while the statistical office conducts sample surveys of labour force to identify the number of persons who report not to have a job (irrespective of whether they are included in the registers or not). Neither of the two indicators has the necessary information value that would make it possible to ignore the other indicator.

[9] For more detail see Morvay, K.: Labour market. *Slovenský mesačný spravodaj*, March 2005, M.E.S.A. 10.

increase in the number of employed persons. The growing number of employed persons by 1.3 % in the last quarter „pushed“ the annual figure up to 0.3 %. This, however, was not sufficient to bring about a year-on-year decrease of the unemployment rate. The increased number of employed persons was not induced by a higher demand for workers, but by a rise in the number of entrepreneurs – self-employed persons (the increase in the number of self-employed is partly due to the fact that employers urge their employees to obtain a self-employed status in order to avoid the obligation to pay statutory insurance on their behalf).

The paradoxical relationship between strong GDP growth and stagnating employment rate can be explained by several factors: one factor is related to an extraordinary increase in the number of persons of active age (work force) caused by the raising of retirement age (Graph 12).

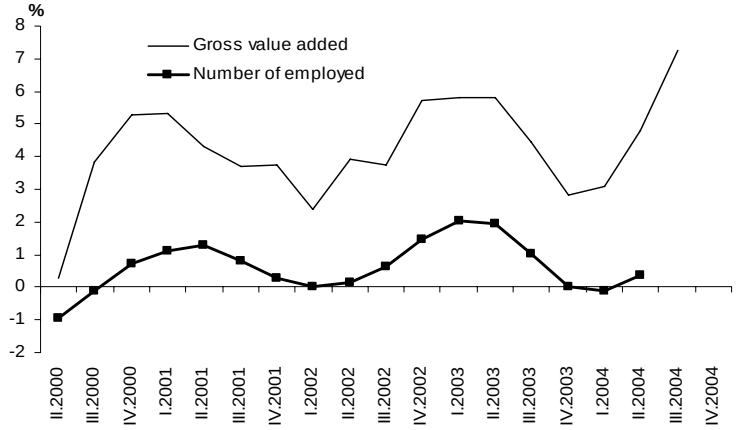
Graph 12
Year-on-year changes in the number of work force and the number of employed persons



While this factor exerted a very strong influence in 2004, its importance will gradually decline. Another explanatory factor is that the correlation

between the growth of gross value added and the growth of employment seems to be statistically more significant than the correlation between the growth of the GDP and the growth of employment (Graph 13).

Graph 13
Year-on-year changes in gross value added and the number of employed persons (moving averages)



Note: Moving averages for three periods. For better illustration, the value added variation curve was shifted back one period (since, in reality, value-added changes preceded changes in the number of employed persons by one period).

The growth of value added in the first semester was not significant and in year-on-year comparisons it declined. Gross value added displayed a robust growth in the second semester, and was again associated with an increase in the number of employed persons. Another factor is a strong pressure towards productivity improvements, which is inevitable for preserving the competitive position on the common market of the EU. Moreover, continued inflows of foreign investment can be expected to entail a higher growth in employment only in a medium-term horizon.

The development of nominal and real wages was much more positive than expected. In 2004 as a whole, average nominal monthly wage of

employees in the national economy recorded a 10.2 % year-on-year increase to SKK 15,825. Nominal wage increase was the highest since 1998.[10] Real wages (after accounting for consumer price growth) increased by 2.5 %. The real wage growth rate accelerated mainly in the last quarter of 2004: the rise in nominal wages (by 11 % year-on-year), in combination with a more sluggish price level increase, resulted in a robust increase of real wages of up to 4.4 %.

The activation principle – i.e. a proactive approach to and motivation for job search – continued to be applied in labour market and social policies. Labour offices started to draw up individual plans for the unemployed, taking account of the skills and abilities of every individual. This was one of the steps towards changing the role of labour offices from that of administrators to advisors for job seekers. In this connection, the regime of contacts between jobless persons and labour offices changed in accordance with certain criteria (replacing the former blanket rules) with an intention to work more intensively with higher-risk groups. The weak side of the government policy was certain formalism in introducing the above changes, and the lack of harmony between the pressure towards activation of the unemployed, and real possibilities for their activation. Moreover, labour market policy measures were too much one-sidedly oriented on the incentives directed to the supply side of the labour market (which is the stronger side of the market). But the key reason for unemployment is a weak demand side (inadequate job creation); low motivation on the supply side plays only a secondary role as a cause of the high rate of unemployment.

When formulating labour market and social policies, the Government had to come to terms with a new phenomenon having the form of a pressure of the socially weakest group of the population (Roma unrest). The Government, in a defensive move, adopted a series of 12 measures to rectify the impact of its reforms. On the positive side, however, the Government did not

[10] We point out that in 2003 real wages were still falling. Their 2 % decline reflected the growth of average nominal wage by 6.3 % in a situation of accelerating price level growth by 8.5 %.

resort in its response to non-systemic steps and hasty concessions. In fact, the series of measures adopted had an activating effect and was not in contradiction with the longer-term Government strategy.

Another principle applied in the labour market policy was the suppression of corporatism. One of its effects was the repeal of the law on tripartism.[11]

Outlook for 2005

The unemployment rate in the first few months of 2005, as reported by labour offices (based on the number of the registered unemployed), had unusually low values. It is rather peculiar that annual seasonal fluctuations in the unemployment rate at the turn of 2004 and 2005 were very limited. Only minimal pattern of cyclical movement - when the lowest unemployment rate, usually recorded in October, reaches its maximum in January - was observed in that period.[12] Given our experience to date with the discrepancy between the movements of unemployment rate obtained on the basis of labour force surveys and those based on unemployment registers run by labour offices, it would be premature to draw unequivocally positive conclusions from the favourable unemployment situation (as reported by labour offices) in the first two months of 2005. We are therefore cautious in making the predictions, and we base our unemployment rate forecasts on labour force surveys.

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[11] The immediate impulse for this step was the growing politicisation of the Confederation of Trade Unions of the Slovak Republic. After the change in the legislation, tripartite negotiations take place under the umbrella of the Council for Economic Partnership and Social Partnership of the Slovak Republic, set up as a standing advisory body to the government. The repeal of the law on tripartism does not mean the denial of the principle of tripartism; it simply removes certain obligations of the government laid down by law (such as its obligation to twice discuss every envisaged change having potential social implications within the tripartite mechanism).

[12] Besides the recovery of the demand for labour, this phenomenon is also due to a robust year-on-year growth in the number of persons who were withdrawn from the register of the unemployed on "other" reasons (i.e., it does not reflect their job placement or failure to cooperate with the office). A certain role may be played by the withdrawal from the register of persons who are affected by the increase in statutory retirement age (and, as a result, their withdrawal is postponed).

Positive developments of the last quarter of 2004 promise a better outlook for 2005: in all probability, the number of employed persons will grow by around 1.5 % (compared with 0.3 % in 2004), and the unemployment rate measured through labour force surveys will decrease to around 17 % (compared with 18.1 % in 2004). This will reflect the – already weaker – influence of the rise in retirement age, further relatively robust GDP growth, expansion of construction activities, and preparations for major investments in the industry.

5. External economic relations

5.1. General overview

The general overview of external economic relations of the Slovak Republic in 2004, as reflected in the balance of payments, shows that they continued to represent an important *stabilising* element of the dynamic economic growth. Their positive feature is that the overall balance of the flows of foreign currency funds in 2004 recorded a surplus, which was higher than in the preceding year by USD 446 million, and achieved the level of USD 1,677 million (SKK 55,205 million). This represents a 4.1 % GDP share compared with 3.8 % in 2003 (Table 6). The entire surplus represented an increase in foreign exchange reserves by USD 1,677 million (SKK 55,205 million). The above development of the balance of payments and increase in foreign exchange reserves created favourable conditions also for maintainning a stable exchange rate which continued to strengthen, in nominal and real terms, also in 2004 (see Graph 14).

However, the *degree of coverage* of the current account deficit by the surplus on the capital and financial account, which is an important criterion for evaluating the balance of external economic relations, worsened: it decreased from an almost 5-time multiple to a mere double in 2004 (see Table 6). This is mainly the consequence of a considerably higher

relative increase in the current account deficit (index 522.1) compared with the increase in the surplus on the capital and financial account (220.9). Nevertheless, the degree of coverage can be considered as sufficient and one having a stabilising effect, especially in comparison with its excessively low level in, for instance, 2001 (see Table 6) or in the period of a fixed exchange rate implementation, when current account deficits had to be financed out of foreign exchange reserves.

Table 6
The development of basic items of the balance of payments of the Slovak Republic (USD million)

Indicator	2001[1]	2002[2]	2003[3]	2004[4]
1. Trade balance	-2,134.7	-2,131.4	-641.4	-1,455.7
2. Balance of services	479.5	455.5	234.5	285.1
3. Income balance	-312.6	-456.4	-119.7	-408.7
4. Current transfers	211.9	193.3	249.3	132.0
5. Current account	-1,755.9	-1,938.9	-277.3	-1,447.4
6. Capital and financial account	1,719.6	5,175.3	1,339.0	2,957.7
7. Overall balance	140.4	3,645.7	1,231.7	1,677.1
8. Overall balance/GDP, %	+0.7	+15.0	+3.8	+4.1
9. Degree of the coverage of current account by capital and financial account (|6:5|)	0.98	2.67	4.83	2.04

[1] Exchange rate used: SKK 48.347/USD.
[2] Exchange rate used: SKK 45.335/1 USD.
[3] Exchange rate used: SKK 36.773/1 USD.
[4] Exchange rate used: SKK 32.255/1 USD.

Source: NBS, data for 2004 are preliminary.

5.2. Foreign trade

The development of foreign trade did *not quite match the favourable* and positive growth of Slovak economy. The deficit of foreign trade in goods, which rose in comparison with the preceding year by SKK 23.4 billion,

reached the value of SKK 47 billion, i.e. -3.5 % GDP. Within the framework of the current account, this deficit was reduced by a surplus in the trade in services; in 2004, it amounted to SKK 9.2 billion.

Although the relative balance of foreign trade worsened in comparison with its 2 % level in 2003, it still remained within the range that expresses external economic equilibrium. On the other hand, in contrast to 2003 and a number of previous years, international trade was not the "engine" of economic growth in 2004, since the growth of imports (at current prices) (13.8 %) exceeded the growth of exports (11.4 %).

Main trends of the development of foreign trade in goods over the last five years are shown in Table 7.

Table 7
The development of key foreign trade indicators of Slovakia in 2000 – 2004

Indicator	2000	2001	2002	2003	2004
Exports, FCO, SKK billion, current p.	548.5	611.3	652.0	803.2	895.2
Annual change, current prices, %	+29.5	+11.4	+6.7	+23.2	+11.4
Imports, OP, SKK billion, current p.	590.3	714.1	748.0	827.6	942.2
Annual change, current prices, %	+25.9	+21.0	+4.7	+10.6	+13.8
Balance, SKK billion	-41.7	-102.7	-96.0	-24.4	-47.0
Balance/GDP, %	-4.7	-10.4	-8.8	-2.0	-3.5
Export performance, % GDP	61.8	61.8	61.1	68.8	67.5
Import intensity, % GDP	66.6	72.2	70.1	66.9	71.1

Source: Foreign trade statistics of Slovakia for 2000, 2001, 2002, Statistical Office SR (SO SR); SO SR website – foreign trade in 2003, 2004; GDP according to the Statistical Report on Basic Development Tendencies in the Economy of the Slovak Republic in the 1st to 3rd Quarter of 2003 and website www.statistics.sk for 2004; own calculations.

As regards the *territorial structure* of foreign trade of Slovakia, the proportion of exports to the enlarged EU (EU-25) slightly increased in 2004 compared with 2003 from 84.6 % to 85.2 %, at the expense of the United States (from 5.3 % to 4.8 %) and Asia (from 2.9 % to 2.7 %). The proportion of exports to the EU-25 grew mainly in the direction of new member states, while exports to old EU countries went down in relative terms.

Conversely, the proportion of imports from the enlarged EU decreased (from 74.4 % to 73.6 %, mainly from the new member states of the EU), in favour of Asian countries whose products on the liberalised Slovak market (and on the EU-25 market in general) started to improve their competitive position. This resulted in an enormous growth of trade deficit with these countries. Slovakia continues to have a high deficit in its trade with Russia, although it was reduced in 2004 by more than SKK 2 billion. In its trade with the enlarged EU and the United States, Slovakia recorded a surplus mainly due to the expansion of trade with new members, while its trade surplus in relation to old members fell in comparison with 2003 by SKK 13 billion (Table 8).

Slovakia's foreign trade results deteriorated in 2004 compared with 2003 because of a significant decrease in the rate of growth of exports, and a moderate increase in the growth of imports. Lower export dynamics was related to the changes in and preparations for launching a new model in the Volkswagen plant in Bratislava, as well as a decrease or only a small increase in foreign demand on relevant markets, in particular Germany, Italy, Switzerland, the United States and China. This lower demand may be attributed to various factors: in the developed European markets, it is mostly the low rate of economic growth that was less than the estimated 2 % in 2004; on the US market, it was the withdrawal of preferential regimes for Slovakia after its accession to the EU.

Table 8

Basic territorial structure of foreign trade of the Slovak Republic

Country	2002			2003			2004		
	Share in %		Balance	Share in %		Balance	Share in %		Balance
	Exports	Imports	in SKK billion	Exports	Imports	in SKK billion	Exports	Imports	in SKK billion
Total	100.0	100.0	-96.0	100.0	100.0	-23.6	100.0	100.0	-47.0
of which:									
EU-25	88.1	72.4	32.7	84.6	74.4	63.9	85.2	73.6	69.0
EU-15	60.6	50.3	18.5	60.6	52.1	56.1	59.7	52.2	43.1
EU-10	29.5	24.7	7.8	23.9	22.3	7.8	25.4	21.4	25.8
USA	1.4	2.1	-6.6	5.3	1.9	26.1	4.8	1.6	27.2
Russia	1.0	12.5	-87.3	1.2	10.8	-79.8	1.2	9.4	-77.7
Ukraine	1.1	1.1	-1.4	1.0	1.0	-0.4	1.1	1.4	-3.8
Rumania	1.0	0.3	4.7	1.0	0.4	4.3	1.2	0.5	6.3
Bulgaria	0.3	0.1	1.3	0.3	0.1	1.6	0.3	0.1	1.6
Asia	3.1	7.7	-37.9	2.9	8.5	-47.1	2.7	10.6	-75.6
of which:									
Japan	1.0	1.9	-7.3	0.4	1.9	-12.7	0.3	2.0	-15.8
China	0.3	2.1	-13.8	0.6	2.5	-15.3	0.3	2.6	-22.4

Source: Foreign trade of the Slovak Republic, SO SR, 2002, 2003, 2004.

However, lower dynamics of Slovak exports may also reflect the lack of innovation efforts at the level of companies, aimed at quality improvements in competitiveness, mainly with respect to those commodities in which quality is a key competitive factor, or where price competitiveness is already hitting cost barriers. The need to intensify this type of innovations is felt especially in case of those products that are in sufficient demand on foreign markets and which account for the largest shares in trade deficits of the Slovak Republic. This applies mainly to machinery, instruments and electrical equipment, precision instruments, selected chemical products, plastic materials and products, and food products.

The growth of imports in 2004 was influenced by a variety of factors. It was mainly fuelled by dynamic economic growth, especially the increased need for intermediate consumption products, and by final domestic demand (entailed by real wage increases, wider use of consumer credits, reduced tax burden for entrepreneurs, and import of investment goods for the construction of car factories PSA Peugeot Citroën and Kia Motors).

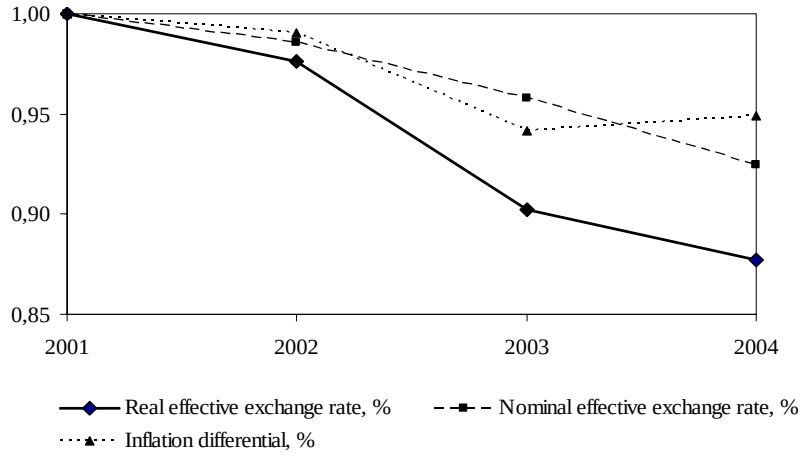
A structural weakness of Slovak economy – inadequate ability to meet more demanding needs of the economy through local production – has been reconfirmed: in an almost causal relationship: every increase in economic growth entails a deterioration in the foreign trade performance.

Another factor that has contributed to increasing the volume of imports in 2004 over 2003 was a significant increase in the price of *purchased crude oil*. If the price of Brent type of crude oil at the end of 2003 was around 29 USD/barrel, by the end of October it reached its historic maximum of 51.4 USD/barrel. Towards the end of the year, it moved around the nominal level of around 45 USD/barrel. However, not even the sustained appreciation of the exchange rate of Slovak crown to USD – the currency used to purchase crude oil – was sufficient to offset the oil price growth, and growing oil prices resulted in increasing imports in value terms.

Both nominal and real *appreciation* of the exchange rate of Slovak crown continued also in 2004 vis-à-vis the most frequently used currency

unit in Slovakia's foreign trade – the euro. This was yet another factor that had a suppressing effect on exports (according to gross calculations, by approx. 15 % – 20 %) and stimulated imports (by approx. 10 %). The trend of nominal and real effective exchange rate to euro is shown in graph 14.

Graph 14
The development of nominal and real effective exchange rate of Slovak crown to EUR (coefficient)



Source: Own calculations based on the data from NBS Monetary Surveys.

As it is evident from Graph 14, while nominal appreciation of the exchange rate to euro in 2004 was slightly faster than in 2003 (from 2.83 % to 3.49 %), real appreciation was significantly slower than in the preceding year (from 7.58 % to 2.77 %), since the movement of inflation differential was, in fact, negligible. This indicates a slowdown also in the convergence of comparable price level and competitiveness to the EU 15.

According to the *prediction* of the development of foreign trade of the Slovak Republic in 2005, the slightly deteriorating trend of 2004 will

continue. This prediction is based mainly on a not too optimistic conjunctural development in key trade partner countries, especially in the EU-25, where the estimates of real economic growth are mostly below their 2004 level. The value of imports may also grow as a result of anticipated resumption of energy price hikes. The imports of investment goods for the construction of automotive plants will continue. As regards foreign trade in services, it is expected to slow down, especially because of adverse consequences of a calamity on tourism in the High Tatras Mountains, and anticipated increases in the prices of inbound tourism. The 2005 foreign trade outlook for Slovakia is presented in Table 9.

Table 9
Outlook for foreign trade of the SR for 2005, at current prices

	2004 – actual	2005 – outlook
Exports of goods, SKK billion	895.2	985.0
Index	111.4	110.0
Export of services, SKK billion	120.2	115.0
Export total	1,015.4	1,100.0
Import of goods, SKK billion	942.2	1,055.0
Index	113.8	112.0
Import of services, SKK billion	111.0	108.0
Import – total	1,053.2	1,163.0
Balance – goods	-47.0	-70.0
Balance – services	+9.2	+7.0
Balance – total, SKK billion	-37.8	-63.0

5.3. Foreign capital

Although the covering of the current account by the surplus on the capital and financial account was reduced, especially as a result of a relatively higher current account deficit, this reduction was significantly offset by the positive development – i.e. the coverage was represented mostly by net revenues from foreign direct investment, which do not

increase the indebtedness (42.4 % in 2004 compared with 35.3 % in 2003), and from portfolio investment (positive balance of SKK 28.3 billion compared with negative balance of SKK 22.8 billion in 2003). As regards the revenues from other long-term investments, their decline was slowed down. Net revenues from short-term capital recorded a steep fall (Table 10).

Table 10
The development of net revenues from key items of the capital and financial account of the balance of payments (BP)

BP item	2003		2004	
	SKK billion	USD billion	SKK billion	USD billion
Foreign direct investment	21.3	0.6	40.6	1.3
Portfolio investment	-22.8	-0.6	28.3	0.8
Other long-term investment	-13.0	-0.3	-10.0	-0.3
Other short-term capital	74.8	1.6	36.8	1.2
Capital and financial account – total	64.5	1.3	95.6	3.0

Source: Balance of payment in 2003 and 2004 – preliminary data, NBS.

Net revenues (balance of assets and liabilities) from *FDI* were generated mainly as a result of FDI inflow to the Slovak Republic; however, their most important sources – property stake and reinvested profits – decreased in comparison with 2003 from SKK 30.9 billion to SKK 26.3 billion (by 15 %). Most foreign direct investment in 2004 came to the country apart from the privatisation process, and was channelled mainly to industry (54 % and, in its framework, to the production of crude oil products, automotive industry, production of machinery and rubber products), financial mediation (24 %), and trade in motor vehicles (20 %).

From the *regional* perspective, the decisive part of new FDI continued to be directed to the Bratislava Region (83 %), which already has the largest volume of FDI (of up to 70 %), and to the Trnava Region (15 %).

With this latest inflow, the FDI *volume* in Slovakia reached a level of SKK 373 billion, i. e. USD 11.5 billion (as of 30 September 2004), and the per capita value of around USD 2 200; however, it is still less than in the Czech Republic or Hungary.

The noticeable increase in net income from *portfolio* investment in comparison with 2003 was primarily due to the growth in foreign commitments connected with bond issues on foreign markets, and the purchase of government bonds denominated in Slovak crowns by non-residents. As regards foreign claims, the fact that the purchase of foreign bonds by Slovak entities exceeded their sale by a lower margin than in 2003 meant a reduced outflow of financial resources (by SKK 3 billion).

The slower outflow of financial resources in *other long-term investment* by SKK 3 billion compared with 2003 was connected mainly with long-term foreign claims of the corporate sector, where loan repayments exceeded the level of new loans.

According to the *prediction* of the development of foreign capital in 2005, continued inflow of FDI can be expected, in particular as a follow up to on-going investment activities in the production sphere. If the assumption of a slower appreciation of the exchange rate of Slovak crown is fulfilled, income from portfolio investment may be expected to fall and, conversely, the amount of foreign loans to grow. This could lead to a general, although not significant deterioration of the capital and financial account and, consequently, to a deteriorating relationship between the current account deficit and the surplus on the capital and financial account of the balance of payment.

6. Monetary development and monetary policy

The execution of monetary policy in 2004 was determined by the adoption of several strategic documents. A “Joint Declaration of the Government of the Slovak Republic and the NBS on the Procedure of Entry to the Euro Area” was adopted as early as 2003. In the document, the Government and the NBS

gave the undertaking to create all necessary conditions for introducing euro in Slovakia in the years 2008 to 2009. The "Updated Convergence Programme of Slovakia till 2010" notes that the Slovak economy is heading towards a sustainable fulfilment of Maastricht criteria in 2007. In September 2004, the Government approved a joint document of the Ministry of Finance and the NBS – "The Strategy for the Adoption of Euro in the Slovak Republic" – according to which it is realistic to expect the adoption of euro in 2009. These documents create the monetary policy framework for the fulfilment of inflation and exchange rate Maastricht criteria (naturally, this framework covers both monetary and fiscal policy). In general, monetary policy of the last years can be viewed as being in general agreement with the orientation towards monetary stability and rapid introduction of euro.

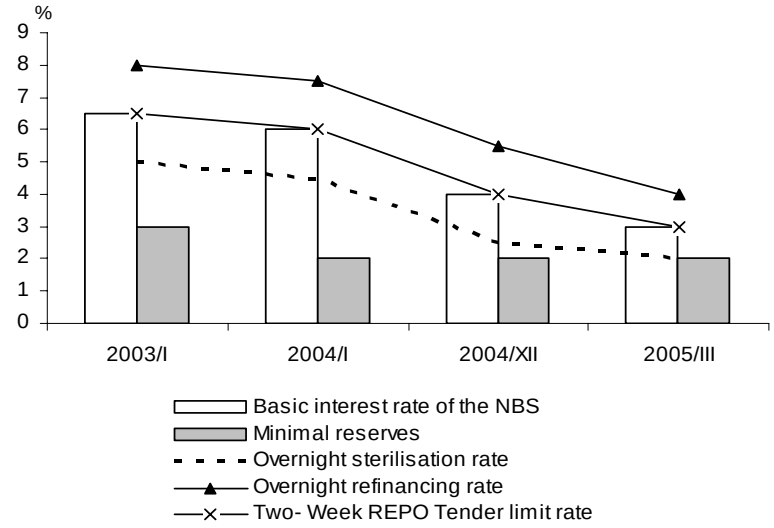
As regards policy orientation and its instruments, monetary policy implemented in 2004 was similar to that of the year before. Monetary policy continued to be relaxed. It was characterised by gradual decreasing of key interest rates (Graph 15). There were several reasons for such policy, including: the objective to prevent an excessive strengthening of Slovak currency, and the objective to promote private consumption and economic growth. The Government also contributed to creating conditions for relaxed monetary policy through its responsible budgetary policy, aimed at restoring the public finance balance. Moreover, keeping the rate of inflation within the programmed range and the absence of inflationary pressures on the demand side contributed to creating conditions for interest rate reductions.

The abovementioned steps taken to prevent an excessively fast strengthening of the exchange rate was perceived as a controversial element of monetary policy. The NBS carried out an unprecedented number of interventions in 2004 in order to slow down currency appreciation. The set of instruments used by the NBS included traditional verbal interventions (which, however, the market ignored), reduction of key interest rates, restriction of interest on two-week REPO tenders, and direct interventions to counter the appreciation of Slovak crown. The fact that the NBS passed

from interest rate manipulations to direct interventions was apparently connected with the motivation of speculators on foreign exchange markets: their interest in the Slovak crown was not motivated, first and foremost, by interest rates. Speculative purchases of Slovak currency were motivated by expectations of its appreciation in real terms rather than by favourable interest rates[13].

Graph 15

The development of interest rates fixed by the NBS Banking Board and minimum compulsory reserves



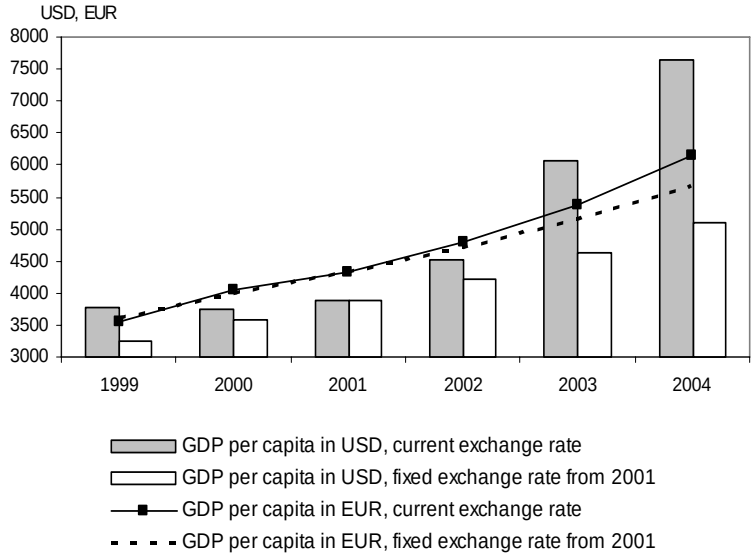
Manipulations with interest rates thus did not exert a sufficient effect on the pace of currency strengthening. The NBS explained its motivation for slowing down the appreciation of Slovak currency by its "excessive" pace of appreciation which, in the opinion of the NBS, had a restrictive impact on the

[13] For more details see Gajdzica, M.: Monetary policy and the financial sector. In: Kollár, M.- Mesežnikov, G. (eds.): Slovakia 2004. A Global Report on the State of the Society. Institute for Public Affairs, Bratislava 2005.

Slovak economy. The development of the exchange rate was taken into account not only in the current year, but also as a cumulative total for the preceding years.[14] However, the argumentation of the NBS for taking these steps was not very convincing, and relied on the assertions that were hard to prove (such as the argument about the restrictive effect of the exchange rate for the economy).

The fact that the Slovak crown was appreciating for the third consecutive year had an important effect also on certain macroeconomic parameters (where the exchange rate is one of their variables). By way of illustration, we mention the influence of exchange rate variations on the reported per capita GDP (using the official exchange rate).

G r a p h 16
Influence of exchange rate variations on the per capita GDP parameter



[14] This argumentation is based on the NBS Monetary Programme until 2008.

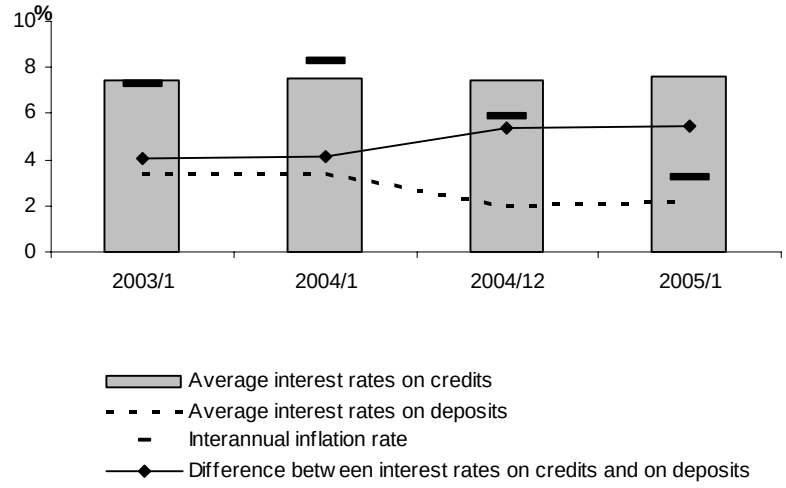
The data presented in Graph 16 show that exchange rate variations really have a considerable cumulative effect: in the period of 2001 – 2004, the value of per capita GDP went up from euro 4,340 to euro 6,160; while in case of a fixed exchange rate its value would be only euro 5,690. This difference stands out even more prominently when it is expressed in USD: the exchange rate factor accounts for up to 65 percentage points of the 96 % cumulative growth of per capita GDP (2001 – 2004). Naturally, if the purchasing power parity were used instead of the official exchange rates, per capita GDP would increase at a much lower rate. In concrete, the value of per capita GDP expressed in PPP (against USD) grew from 11,520 in 2001 to 14,320 in 2004.

However, the decline in interest rates fixed by the NBS failed to be reflected in a corresponding reduction of average interest rates on credits extended by commercial banks (although there were individual variations depending on the type of credit, long-term interest rates were falling). However, interest rates on deposits decreased. This resulted in increasing the difference between interest on deposits and interest on credits (Graph 17).

But the development of interest rates in 2004 is interesting also from another aspect. Thanks to significant declines in long-term interest rates from the mid-2002 (in combination with the reduction of risk premiums and, in 2004, also of the inflation rate), Slovakia fulfilled Maastricht criteria set out for long-term interest rates already in 2004. The narrowing down of the difference between interest rates reflected also advances in fiscal consolidation (which reduces risk premiums for creditors). The difference between long-term interest rates in the Slovak Republic and in the euro area in 2004 was only a few decimals of one percentage point.[15] Stability was thus maintained in spite of considerable differences between the rate of inflation in the Slovak Republic and in the euro area, because inflation in Slovakia was caused by temporary phenomena and, moreover, was accompanied by adequate productivity growth.

[15] Fore more detail see ECB: The 2004 Convergence Report, p. 199.

Graph 17
The development of interest rates on credits and deposits in the banking sector

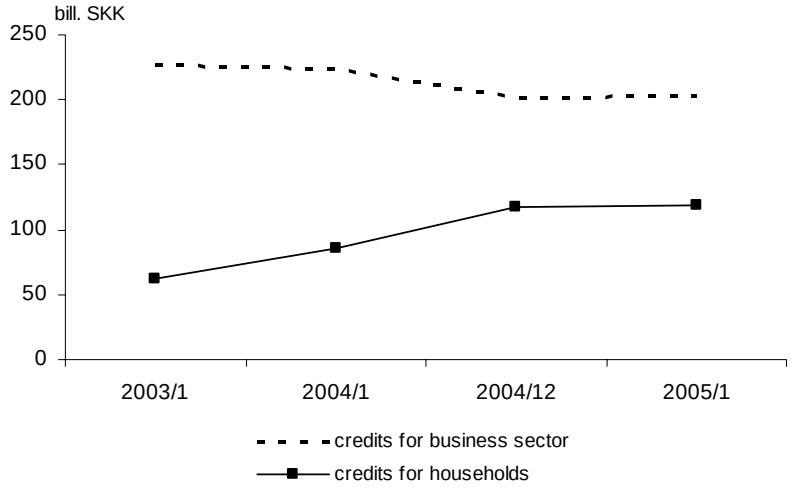


It was symptomatic that the credit exposure of banks was significantly greater in the direction of households than with regard to the corporate sector (Graph 18). While the volume of credits in Slovak crowns extended to corporations stagnated or was even falling, the volume of credits for the population continued in its steep growth (between the beginning of 2003 and the end of 2004, the volume of bank credits for the population doubled). The increased volume of credits for the population reflects the changes in the lifestyle (growing propensity to consumption, preference for the combination of immediate consumption and repayment of loans over savings), as well as the policy of banks (that identified the general population as low-risk clients for loans).

The year 2005 brought qualitative changes in the monetary policy. The NBS started to define a clear monetary policy framework in a medium-term horizon – not in the form of an outlook anymore (as it had been the case before), but as a binding target. From 2005 onwards, the monetary

policy regime changes into inflation targeting. This will create the basic anchor for monetary policy. In the medium-term horizon, the NBS set out the target year-on-year inflation rate, measured by the harmonised index of consumer prices, of less than 2.5 % as to December 2006 and less than 2.0 % as to December 2007 and 2008 with a view to fulfilling the Maastricht criterion based on average twelve-month inflation. Because the level of the Maastricht criterion is not fixed and known in advance, the 2007 and 2008 inflation targets were set out in a way that makes it possible to fulfil also the demanding criterion following the potential low inflation rate of member states of the EU. Preliminary results attained in 2005 indicate that it will not be a problem to reach the target value of year-on-year inflation set at the level of 3.5 % as to December 2005; in all probability, actual inflation rate will be even lower (see the section on price developments).

G r a p h 18
The volume of credits extended to companies and to population



Besides using interest rates as a central bank's monetary policy instrument, the NBS will aim to a greater extent at shaping inflation expectations of the public which represent an indirect, but strong instrument affecting inflation. The NBS apparently expects, quite justifiably, that the setting of a medium-term inflation target will create a more transparent and clearer framework enabling business entities to formulate their business and investment objectives, and conduct wage negotiations.

7. Public finance and fiscal policy

The development of public finances in 2004 had several distinctive features. Key systemic changes in the area of general government budgets include preparations for introducing the principle of multiannual budgeting, consistent implementation of ESA 95 methodology, strengthening of programme budgeting principles (including the definition of specific objectives and relevant budget allocations), implementation of the state treasury system[16], approval of fiscal decentralisation principles (whose practical implementation and budgetary consequences will be manifested in 2005), and incorporation of financial relationships with the European Union into the state budget.

For the first time in the history of Slovakia, the general government budget has been set out for the period of 2005 to 2007, i.e. applying the principles of multiannual budgeting. While in the previous years when the budget contained only budget outlooks, at the present the use of public finances is specified in advance for a three-year period for all public administration authorities. As regards the state budget, expenditures in individual chapters are specifically targeted to individual programmes for the next years. This practice has strengthened the principles of programme budgeting;

[16] However, the state treasury system is not fully operational; the process of the transition of clients to the State Treasury is currently underway.

nevertheless, it will be necessary to give attention to its consistent and effective implementation also in the forthcoming period since its present functioning is not quite adequate.

The accession to the European Union in May of 2004 had a significant impact on the entire area of public finances. The most important changes include the inclusion of EU funds into the state budget, and preparations for membership in the Economic and Monetary Union. The government-approved Convergence Programme sets out basic fiscal policy objectives, estimates the impact of individual structural changes in the economy on public finances, and provides an approximate forecast of their development up to 2010.

As regards the formulation of the budget for the next period, the beginning of the budgetary process was set at an earlier date in order to enable a broader political discussion about expenditure priorities of the Government.[17]

State budget

The 2004 budget was drawn up in a rather conservative manner because of uncertainties and risks connected with the introduction of the new tax system, accession of Slovakia to the EU, and preparation for launching the second fully-funded "capitalisation pillar" under the pension system reform.

An overview of state budget revenues and expenditures and budget implementation is given in Table 11.[18]

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[17] Based on this new principle, the Ministry of Finance prepares budget assumptions for the next year as early as February of the current year. In the months of July and August, individual programmes are analysed and discussed at the Ministry of Finance with the representatives of individual sectors. At the end of August or beginning of September, the budget is submitted to the Government.

[18] At the time of the preparation of the study, state budget expenditures were not available because of the transition of clients to the State Treasury system.

Table 11

The development of the state budget revenues and expenditures, 2000 – 2004

	Actual implementation (in SKK billion)					The 2004 approved budget in SKK billion	The 2004 budget implementation in %
	2000	2001	2002	2003	2004		
Total revenues	213.5	205.4	220.4	233	242.4	231.9	104.5
of which:							
A. Tax revenues	173.8	165.1	188.8	200	209.4	195.2	107.3
of which:							
Tax on income, profit and capital assets	60	57.5	69.3	70.1	60.5	52	116.3
Tax on goods and services	99	102	115.6	123.2	144.2	140	103.0
Tax on international trade	13.1	3.9	4	4	1.8	1.6	112.5
B. Non-tax revenues	19.9	24.8	20.8	17	21.1	13	162.3
C. Grants, transfers and other revenues	18.4	13.7	10.7	12.4	9.8	22.5	
of which:							
EU budget funds	.	.	.	.	4.5	14.2	31.7
Total expenditures	241.4	249.7	272	289	312.7	310.4	100.7
of which:							
A. Current expenditures	203.5	213.3	237.1	250	.	272.2	
B. Capital expenditures	25.4	27.5	32.4	31.1	.	37.2	
C. Property share and loans	12.2	8.9	2.4	7.8	.	0.98	
Surplus (+), Deficit (-)	-27.6	-44.4	-51.6	-55.9	-70.2	-78.4	89.5
Share in GDP (in %)	3.11	4.59	5	4.7	5.3	.	.

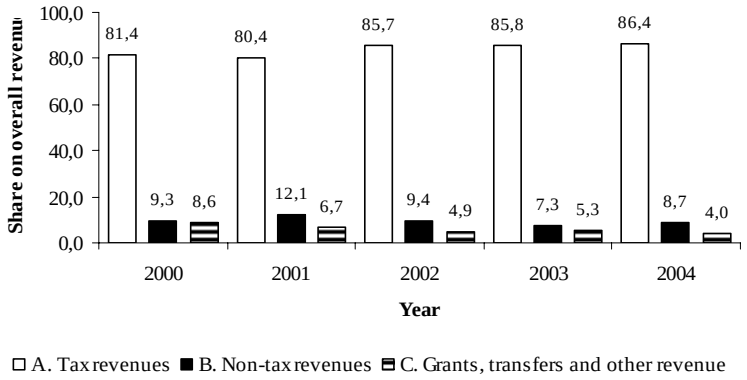
Source: SO SR, own calculations.

The situation in state budget revenues can be deemed as positive. The relatively conservative approach of the ministry of finance to setting individual tax rates resulted in bringing higher budget revenues than foreseen in the approved budget.

The evolution of the shares of different state budget revenues in total revenues in the period of 2000 – 2004 is illustrated in Graph 19. The graph shows a steadily rising share of tax revenues in the relevant 2000 – 2004 period, while the shares of other revenues, in particular non-tax revenues, were falling.

Graph 19

The development of the share of state budget revenues in total revenues, 2000 – 2004



Source: MF SR.

State debt

The central government debt (resulting from systematically deficit running of the state budget) amounted to SKK 522.5 billion at the end of 2004. It means that it continued in the trend that can be observed practically

throughout the entire period of the existence of the independent Slovak Republic. This development is shown in Table 12 and Graph 20.

Table 12

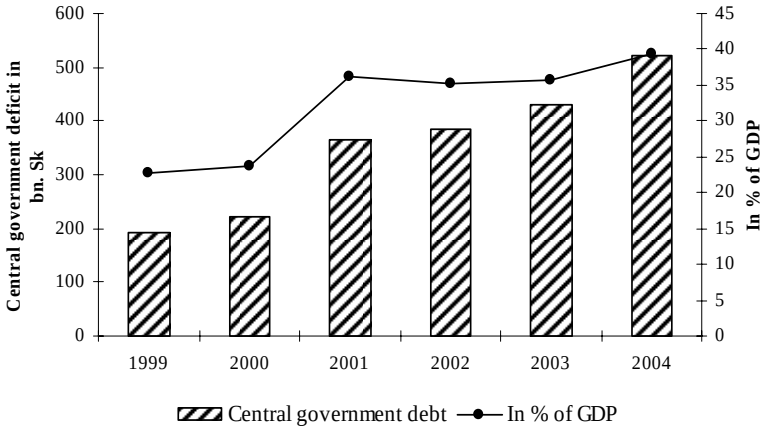
The development of central government debt, 1999 -- 2004

	1999	2000	2001	2002	2003	2004
Central government debt in SKK billion	192.2	222.6	365.8	386.2	429	522.5
in % GDP	22.8	23.8	36.2	35.1	35.7	39.4

Source: MF SR, SO SR, own calculations.

Graph 20

The development of the state debt of the Slovak Republic, 1999 – 2004



Source: MF SR, SO SR, own calculations.

Public finance

According to preliminary data of the MF SR, public finances[19] in 2004 ended up in a deficit of 3.3 % GDP (SKK 43.9 billion). General government budget thus performed better than planned due to the fact that around SKK 20 billion allocated to individual budget chapters failed to be actually used, and due to positive financial results of the Social Insurance Company. Available data indicate that the factors that partly contributed to the favourable situation in the public finance area include lower expenditures on investment incentives by the Ministry of Economy (investment of companies KIA – Mobis, PSA Peugeot Citroen) (by SKK 1.5 billion), lower expenditures on state debt servicing (by SKK 0.6 billion), lower demands for co-financing of the projects from EU Cohesion Policy funds (by SKK 1.0 billion), and others. "Extraordinary" expenditures which, however, according to ESA 95 methodology are not included in the overall deficit (since they were included in the state debt), include the payment of a liability towards the CSOB Bank (Czechoslovak Commercial Bank) in the amount of SKK 25.1 billion.[20]

It can thus be noted that the objectives set out by the Ministry of Finance have been fulfilled. The positive trend of a reduction in public finance deficit was maintained, no shortfall was observed in state budget revenues due to tax reform (just the opposite), important changes were recorded in the area of public finance management, and an important step was taken in the form of a joint formulation - by the MF SR and the NBS - of key elements of the strategy for the entry of Slovakia to the EU. If the current trend continues, the objectives of the NBS and of the MF SR in this area can be expected to be fulfilled.

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[19] At the time of writing the study, data on general government budget expenditures were not available.
[20] This one-off transaction will not have any dramatic effects on public finances; in the following years, a slightly negative impact may be expected of the increased costs of state debt servicing, having the form of net interest costs.

8. Economic growth expectations in 2005

In our forecast of the performance of Slovak economy, we are drawing attention mainly to the analysis of development trends of individual components on the demand side. Also all the facts presented in various parts of this study that are of relevance for forecasting purposes are taken in account.

Domestic demand – its possible developments in 2005

The most extensive part of domestic demand is the demand connected with the generation of income, and the related *final household consumption*. Its development in previous years and predictions for 2005 are presented in part a. of Table 13. Part b. of Table 13 gives information about the development of the structure of household income and consumption.

T a b l e 13 [1]

a. The influence of factors forming percentage changes in final household consumption, in points[2]

	2001	2002	2003	2004	2005[p]
Income – total	0.2	8.1	-2.1	1.3	6.9
Compensation of employees	-0.6	4.1	-1.3	0.5	3.6
Gross mixed income	2.0	2.8	0.0	0.8	2.3
Income from property	-1.9	-0.6	-0.6	0.9	0.5
Social benefits	-0.5	1.0	0.2	-0.7	0.5
Other current transfers - income	1.3	0.8	-0.3	-0.2	0.0
Expenditures – total[3]	1.2	2.2	-0.8	-1.9	1.3
Current income tax and property tax	0.5	0.7	-0.2	-1.2	0.3
Social contributions	0.4	1.2	-0.5	-0.9	0.6
Other current expenditure transfers	0.3	0.3	-0.1	0.2	0.4
Gross disposable income	-1.1	5.9	-1.3	3.2	5.6
Gross savings[4]	-3.9	0.4	-0.5	-0.2	0.1
Final household consumption	2.8	5.5	-0.8	3.4	5.5

b. The development of the structure of household income generation and use (final household consumption = 100 %) [5]

	2001	2002	2003	2004	2005[P]
Income – total	145.1	145.3	144.3	140.7	139.8
Compensation of employees	74.8	74.8	74.0	72.0	71.5
Gross mixed income	38.8	39.4	39.7	39.1	39.5
Income from property	5.7	4.8	4.2	5.0	5.1
Social benefits	21.3	21.2	21.6	20.2	19.5
Other current transfers – income	4.5	5.1	4.8	4.4	4.2
Expenditures – total	38.0	38.1	37.6	34.6	33.8
Current taxes	7.4	7.7	7.5	6.2	6.1
Social contributions	26.0	25.8	25.5	23.8	23.1
Other current expenditures	4.6	4.7	4.6	4.6	4.7
Gross disposable income	107.1	107.1	106.6	106.1	105.9
Gross household savings	7.1	7.1	6.6	6.1	5.9
Final household consumption	100.0	100.0	100.0	100.0	100.0

[1] Own calculations according to the data of the Statistical Office of the Slovak Republic.
[2] Data at current prices adjusted by household consumption deflators.
[3] Positive values of expenditures are caused by year-on-year reductions in their size. They express their positive influence on gross disposable income and, consequently, on final household consumption.
[4] Positive values of the influence of changes in gross savings on household consumption increase are reflected in the year-on-year decrease of gross savings. The growth of gross household savings reduces the increase of their final consumption.
[5] According to the data at current prices.
[P] Prediction.

Part a. of Table 13 speaks about short-term – in particular economic policy – influences on annual variations in the extent of household consumption. When the political cycle was drawing to its end in 2002, both key components of household income (compensation of employees and gross mixed income) were growing at a significant rate. In 2003, with continued price deregulation at the beginning of a new political cycle, real household consumption fell as a result of the fall in real wages of employees in the situation of real stagnation of gross mixed income. Negative influences of these factors on the development of household consumption were alleviated in 2003 by a decrease in real expenditures of the population.

Although the deregulation of prices continued also in 2004, its influence was outweighed by the more rapid nominal increase in the compensation of employees and in mixed gross income, coupled with a decrease in real expenditures of households. This can be expected to continue also in 2005; the factors that have a positive effect especially on the revenue side of household income and consumption may be even strengthened.

Part b. of Table 13 shows that several more permanent trends are distinctly present in the development of household income and consumption. They include, in particular, a continuously falling proportion of gross disposable income of households in their consumption, and a decrease in the rate of savings from disposable income. Another important trend is the fall of the proportion of overall income and an even more rapid fall of the proportion of overall expenditures in household consumption. It can even be argued that the relative decline in household expenditures and, within their framework, especially in tax expenditures and expenditures on social contributions, was one of the main factors underlying the positive development of household income and consumption in the relevant period. The 2004 results confirmed the existence of these trends, which may be expected to continue also in 2005.

The trend of development of final public consumption is closely linked with the trend of the development of expenditures on goods and services in public finances. We are using this link to forecast the development of public consumption in 2005 in Table 14.

The volume of public consumption in 2005 given in Table 14 is estimated on the basis of the forecast of expenditures on goods and services in public finances (and/or their annual index), derived from public budgets approved for 2005, and on the basis of the prediction of the ratio of expenditures on goods and services in public finances to public consumption, and/or prediction of their indices. It can thus be assumed that public consumption in 2005 will increase over its 2004 value at constant prices by SKK 4 billion, or 2.5 %.

T a b l e 14

	2000	2001	2002	2003	2004 o	2005 p
Expenditures on goods and services in public budgets [1] = A	66,0	70,4	73,7	76,6	78,7	81,9
Annual indices A = B	.	106.7	104.7	103.9	102.7	104.1
Public consumption at constant p. 1995 = C	139.5	145.9	153.0	157.1	159.1	163.1
Annual indices C = D	.	104.6	104.9	102.7	101.2	102.5
C : A = E	2.11	2.08	2.08	2.05	2.02	1.99
D : B = F	.	0.98	1.00	0.99	0.99	0.98

[1] In SKK billion. Adjusted by public consumption deflator; 1995 = 100.

[2] Estimate; data on the implementation of public budgets were not available at the time of writing the report.

[p] Prediction.

The forecast of gross capital formation in 2005 takes into account the unusual way of its growth in 2004, when inventory changes contributed to its 13.1 % increase with approx. four fifths (compared with the preceding year). Although the huge inventory growth recorded in 2004 increased the baseline that will be used for the comparison with subsequent changes in the formation of gross capital, it will also work to increase the formation of fixed capital in 2005 – since the growth of inventories is likely to reflect mainly pending investment projects. Positive expectations concerning the growth of gross capital formation in 2005 are reinforced by such circumstances as expectations of a growing volume of foreign direct investment, improving profitability and accumulation capacity of companies, anticipated substantial – 70 % – increase in the volume of investment into the transport infrastructure, increased volume of investment into environment improvement with the use of EU funds and, finally, increase in the volume of housing construction financed from household income and bank loans. Based on these assumptions, our forecast of GDP development in 2005 includes a 7.0 % growth rate of gross capital formation.

External demand – expected development and impact on the GDP in 2005

The development of GDP in the previous years and its 2005 forecast in the countries which account for the biggest share of Slovak exports are illustrated in Graph 21.

Graph 21

Economic growth rates in selected countries[1]

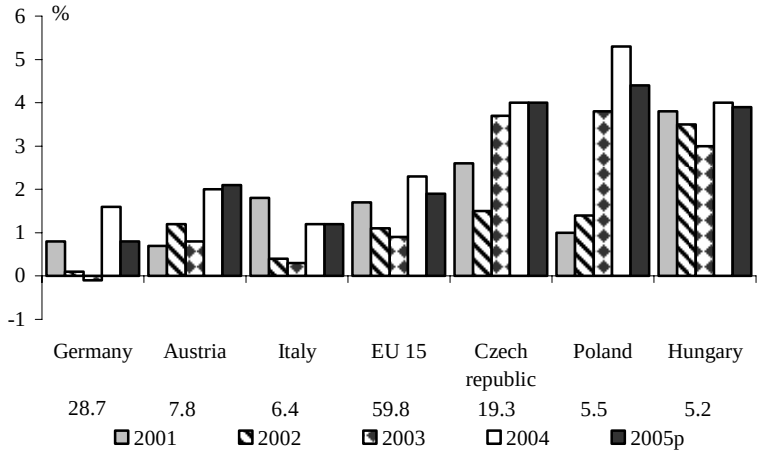

Figure under the country's name informs about its share on total export of SR in 2004 in %

[1] According to: the Statistical Annex of European Economy, Spring 2005. European Commission, March 2005.

According to the forecasts of conjunctural development, which were also used in Graph 21, the economic recovery that started to take place in 2004 in the EU 15 will, at best, no longer continue in 2005, or the economic

situation will even slightly deteriorate.[21] Nevertheless, new member states of the central European region are expected to continue attaining positive economic results also in 2005, with an approximately 4 % aggregate growth rate of the GDP. The share of these countries (Poland, the Czech Republic and Slovenia) in overall Slovak exports is, however, considerably smaller – in 2004 it amounted to 24.9 % – than that of western European countries which (including exports to EFTA countries) was at the level of 60.9 % in 2004.

The influence of the slight deterioration of conjunctural situation on the western European market, as well as the probability of continuously high fuel and raw material prices on the world market, are the less favourable components of the context for the development of Slovakia's foreign trade in 2005. On the other hand, foreign trade results of Slovakia are expected to show, already in 2005, positive effects of foreign direct investment carried out in Slovakia in 2004 and 2005. In the absence of massive inflows of speculative capital, the exchange rate of the Slovak currency can be expected – especially in the second half of 2005 – to moderately strengthen without having a negative influence on the development of foreign trade.

Under these circumstances, a moderate slowdown can be expected in 2005 in the growth of exports (for more details, see the section on external economic relations). According to our prediction, exports of goods and services at current prices will increase from SKK 1,015.4 billion in 2004 to SKK 1,100 billion in 2005. It is also expected that the annual values of export and import deflators in 2005 will remain the same as in 2004. According to these assumptions, the volume of imports of goods and services will increase in 2005 relative to 2004 by 12.3 %, with a parallel growth in exports of goods and services by 11.8 % (at constant prices).

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[21] The forecast of economic development of Western Europe in 2005, prepared by the association of six German economic research institutes, is even somewhat more sceptical than the prediction of the European Commission used in Graph 21. See: Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Frűhjahr 2005. Abgeschlossen im Kiel am 22. April 2005.

Predictions concerning the scope of individual demand components are summarised in Table 15 in the form of an overview of GDP development in 2005.

Positive development of the GDP and of its structure to date will continue also in 2005. Domestic demand will continue to grow, although at a slightly lower pace, due to the lower rate of gross capital formation (GCF). It must, however, be pointed out that the GCF growth in 2004 was achieved mainly thanks to an exceptionally high inventory growth. It contributed with 9.5 percentage points to the overall 13.1 % GCF growth (and its contribution to the annual GDP growth was as high as 2.3 points).

If the 2005 inventory changes were to attain the average relative (determined as a GDP share) level of the 2000 – 2003 period, gross fixed capital formation (GFCF) would have to increase by 6.4 percentage points out of the overall 7.0 % GCF growth forecast for 2005. Thus, it would have to increase by a much greater margin than in 2004, when GFCF increased by only 3.6 percentage points of the overall GCF growth. It should, however, be added that as regards the forecast of a faster GFCF growth in 2005, a substantial part of inventory growth in 2004 was apparently connected with pending investments; once these investments are finalised, they will become part of the 2005 gross fixed capital formation.

In a situation of a slightly suppressed growth of domestic demand, the GDP forecast in 2005 anticipates an increased rate of growth of total final consumption, both of household and public consumption. Net contribution of foreign trade in products and services to GDP generation in 2005 will be lower than in 2004. Its predicted level will be achieved primarily thanks to the fact that the 2005 value of export deflator will be (like in 2003 and 2004) lower than the value of import deflator. As a result, the ratio of export to import volumes in 2005 will be more favourable when expressed at constant prices rather than current prices.

T a b l e 15

Forecast of the development of gross domestic product and structure of its use in 2005[1]

	In SKK billion		Indices (previous year = 100)		Share in the use of the GDP = 100	
	2004	2005 p	2004	2005 p	2004	2005 p
Household consumption [2]	423.9	447.2	103.5	105.5	51.8	52.0
General government consumption	159.1	163.1	101.2	102.5	19.5	19.0
Gross capital formation	221.3	236.8	113.1	107.0	27.0	27.6
Domestic demand	804.3	847.1	105.5	104.9	98.3	98.6
Export of goods and services	806.3	901.4	111.4	111.8	98.5	104.9
Import of goods and services	792.0	889.3	112.7	112.3	96.8	103.5
Net export of goods and services	14.3	17.1	.	.	1.7	1.4
Gross domestic product used	818.6	859.2	104.5	105.0	100.0	100.0
Final consumption	583.0	610.3	102.9	104.7	71.2	71.0
Gross savings	235.6	248.9	8.9	106.0	28.8	29.0
Statistical difference	7.9	3.0	.	.	.	.
Gross domestic product generated	826,5	802,2	105,5	104,3	.	.

[1] At constant prices.

[2] Including consumption of non-profit organisations providing services to households.

p Forecast.

A moderate increase can be expected in 2005 in the share of domestic demand in the structure of GDP use, and within its framework, in the share of GCF, especially at the expense of the share of general government consumption. The share of foreign trade performance (exports and imports) in GDP will grow in 2005. This will further increase the openness of the Slovak economy.

Special attention should be given to the expected change in the relationship between the GDP generated and the GDP used. The 5.5 % increase in the GDP generated in 2004 can be attributed also to the relatively wide statistical difference between the abovementioned variables (this difference accounts for 1 percentage point of GDP growth generated in 2004). Since the GDP forecast for 2005 comprises a much smaller statistical difference, the growth rate of generated GDP will decrease from 5.5 % in 2004 to 4.3 % in 2005. However, in our forecast, the rate of growth of used GDP will increase from 4.5 % in 2004 to 5.0 % in 2005.

Thus, the objectives of economic growth forecast for 2005 are only seemingly lower than the results achieved in 2004. In reality, they are higher and more ambitious, especially considering deteriorating situation in the global conjunctural situation.

9. An overview of selected legislative and economic-policy measures in 2004

In 2004, the government coalition continued to fulfil its reform objectives set out in its Programme. It focused mainly on the finalisation of the pension reform, on the passage of the legislation on healthcare reform, on the continued decentralisation of public administration, and on the general public finance reform. In 2004, the Government did not succeed in reaching its reform objectives in the area of university financing, social security of students, and remuneration of university teachers.

The adoption of the act on social insurance and the act on old-age pension savings scheme was followed in 2004 by the *act on supplementary*

pension savings (3rd pillar of pension security), which transforms the existing system of supplementary pension insurance of employees to a system of supplementary pension savings, and the existing supplementary pension insurance agencies to supplementary pension companies.

Following the implementation of certain stabilisation measures in the health sector, six acts adopted in 2004 represent the basic legal framework for healthcare reform. They include: 1. *Act on healthcare and on services related to the provision of healthcare*. This legislation sets out clear definitions of healthcare and of the forms of its provision. 2. *The act on the scope of healthcare covered by public health insurance and on the payments for healthcare services.* It sets out the so-called basic healthcare package fully covered from public funds. It includes preventive check-up, medical interventions defined as necessary medical care, diagnostic tests and treatment of the so-called priority diseases (around 6 000 diagnoses), medications, medical aids, etc. 3. *The act on health insurance*. It sets out the legal framework for statutory public health insurance (it guarantees the provision of medical care in the extent defined by law) and for voluntary individual health insurance (provision of healthcare in the extent agreed between the policy holder insured and the insurance company). 4. *The act on health insurance companies and on healthcare supervision.* It lays down the transformation of health insurance companies to joint stock companies, defines the scope of their entrepreneurial activities and relationship to healthcare providers; and the setting up of the Office for the Supervision of Healthcare. 5. *The act on healthcare providers, healthcare personnel, and professional organisations in healthcare*. It creates the framework for the transformation of state healthcare providers to joint-stock companies, lays down the requirements for the performance of healthcare professions and for the work of professional organisations (chambers). 6. *The act on medical emergency service* – defines the position of the service and conditions of its financing.

As a follow up to the gradual transfer of competencies from state administration to self-governing authorities, a new system of financing was introduced in 2004 for municipalities and self-governing regions (Upper-tier

territorial units – VÚC). The basic framework for financial decentralisation is represented by the following laws: 1. *The act on budget allocation of the yields from personal income tax to self-governing authorities*. Under this law, municipalities and self-governing regions will finance the execution of their original competencies by their tax revenues (from personal income tax and local taxes), while the execution of devolved state administration competencies will continue to be financed from the state budget. 2. *The act on local taxes and on local charges for municipal waste and minor construction waste*. It sets out eight facultative local taxes (the decision on their introduction and rates is taken by municipalities) and one compulsory local fee for municipal waste and minor construction waste. A facultative local tax levied by self-governing regions is the tax on motor vehicles. 3. *The act on budgetary rules for local and regional self-governments* defines the status and content of the budgets of municipalities and self-governing regions, financial relationships connected with the budgets of municipalities, tightens the rules governing the use of budget funds, and the conditions for using returnable sources of financing.

A *new act on budgetary rules for public administration,* adopted in connection with the reform of public finance management, lays down comprehensive rules for budgetary processes in the entire public administration sector in conformity with the methodology applied within the EU, expands the principle of tight budgetary restrictions to all public administration bodies; introduces new rules governing the breach of financial discipline including the sanctions; sets out the definition of public administration sector, and reduces the number of budget chapters.

The new *act on financial market supervision* has introduced, with effect from 1 January 2006, the supervision over the entire financial market by the National Bank of Slovakia, which will also have the competence to adopt secondary legislation.

A *constitutional statute on cooperation between the National Council of the Slovak Republic and the Government of the Slovak Republic in EU-related affairs* was adopted in connection with the entry of Slovakia to

the EU. The law lays down the principle of a limited mandate of Government members in negotiations with the EU institutions − the positions of the Slovak Republic on legally binding acts and other acts discussed by the representatives of EU member states must be approved by the Parliament or the relevant parliamentary committee; members of Government will be able to depart from the approved position only when this is strictly necessary, and always in the interest of the Slovak Republic.

In the framework of the harmonisation of the national legal system with relevant EU directives, the act on consumer taxes and the *act on value added tax* were recodified in 2004, the *Civil Code* was amended (with the objective to strengthen consumer rights and their protection in conformity with European standards), the *act on retail chains* was harmonised with EU standards, and a *act on emission trading* was adopted, providing for the participation of Slovak companies in the trading in emission quotas within the framework of the EU.

A package of three energy acts (*act on energy, act on thermal energy, and amendment to the act on regulation in network industries*) was adopted with a considerable delay, which provoked criticism also by the EU; it constitutes a comprehensive legislative framework laying down the conditions for business entities in the energy sector and guaranteeing the transparency of relationships between consumers and dominant providers of energy services.

Several legislative activities of the Government were oriented on *promoting entrepreneurial activities* and/or removing barriers to entrepreneurship. Important legal norms adopted in this respect include an amendment to the *trade licence act* (reducing the time needed to register a company) and a new and improved *act on bankruptcy and restructuring* and the related *act on bankruptcy trustees.*

Economic development in 2004 clearly benefited from the steps taken by government bodies to attract foreign investors. This process has been positively influenced by the gradual harmonisation of the Slovak legislation with EU law, and by several specific legislative changes, such as an

amendment to the *act on support for establishment of industrial parks*, and amendment to the *act on land adjustments*.

Of special significance in the medium to long-term perspective have the approval of the *Convergence Programme of Slovakia for the 2004 – 2010 period*, which was presented to the European Commission, and the adoption of the *Strategy of Computerisation of the Society.*

A set of several measures was introduced with a view to rectifying the deficiencies of laws in the area of social policy that entered into effect at the beginning of 2004 and provoked unrest, especially among the Roma community. The amount of activation and protective allowances, and of allowances for graduate practice of unemployed students was raised from SKK 1,000 to SKK 1,500**.** Other measures include those in the area of the fight against usury, support for major activation projects, employment of particularly disadvantaged long-term unemployed, support for pupils and students in material distress. A lump-sum allowance of SKK 1,000 was paid to pensioners as a compensation for the impact of the reforms.

With effect from 1 October 2004, the amount of minimum monthly wage was raised from SKK 6,080 to SKK 6,500, or from SKK 35/h to SKK 37.40/h. New acts include *act on child allowances and supplementary child benefits* and the *act on the compensation for pain and compensation of social consequences of disability.*

Several acts were aimed at the *transformation of state property. The act on airport operators* enables the transformation of the Slovak Airport Administration into separate joint-stock companies (in which the Slovak Republic holds a 100 % stake). The *act on the transformation of the Slovak Post, state-owned company* to a joint-stock company with a 100 % stake of the state also entered into effect. The company with a 100 % stake of the state, foreseen under the *act on motorways and dual carriageway,* will be in charge of the development, administration, maintenance and repair of motorways, expressways and dual carriageways, and will concentrate the required financial resources from various sources.

In the autumn of 2004, the Government approved the *Concept for Further Steps in the Privatisation and Final Privatisation of Strategic Enterprises and Other Organisations.* Necessary conditions for these steps have been created by means of the amendment to the act on the conditions of transfer of state property to other persons, which entered into effect on 1 January 2004. In the energy sector, emphasis is laid on the final privatisation of a 51 % stake in 3 energy distribution companies, privatisation of a 51 % stake in heating companies, and the Slovak Electricity Company (it was carried out by selling a 66 %-share to Italian company Enel). Final privatisation of Slovak Airlines (89.49 %) is also envisaged, as well as the privatisation of airport companies (Bratislava and Košice), and of the newly created Railway Company Cargo (freight transport). A 90 % stake of the Steam-Gas Cycle (PPC) Bratislava was sold for SKK 2 billion, with a 10 % stake remaining in the portfolio of the Slovak Electricity Company.

ECONOMIC DEVELOPMENT OF SLOVAKIA IN 2004

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