

*INSTITUTE OF ECONOMIC RESEARCH  
OF SLOVAK ACADEMY OF SCIENCES*

*Economic Development of  
Slovakia in 2005*

**(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 2005**

In political life of Slovakia, the year 2005 was a pre-election year in which individual political parties and groups strove for strengthening of their positions before forthcoming competition for re-division of political power. Persistent pressure between government coalition and opposition was intersected with vibrations inside government coalition caused mainly by different value orientations (liberals, conservatives, pragmatics). Gradual erosion of government's position in the parliament led in the beginning of 2006 to an announcement of early election. However, also in the year 2005, all political actions were taken in the framework of the rules of parliamentary democracy functioning.

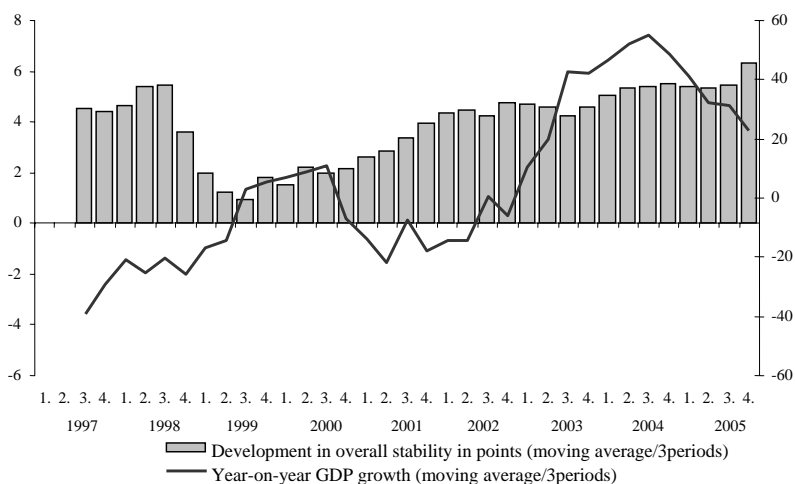
Economic development in 2005 was influenced favourably by the tax, labour market and public finance reforms that had been performed already in the previous periods. Initiation of pension reform and continuance in health-care system reform (including the reducing of its indebtedness) in 2005 contributed to accomplishing of the substantial part of government's reforms program. Reform activities included adoption of rules related to the provision of individual state aid to foreign investors, adoption of anti-monopoly regulations in the sector of communication services, and further progress in privatization, particularly in energetics and transportation. Taking into consideration practical experience and reaction of public, the government decided to "adjust" or correct some reform steps especially in the spheres of social security system and health-care system.

Treaty establishing a constitution for Europe (before its refusal in French and Dutch referendum) has been ratified in National Council of the SR by votes of majority of government coalition's as well as opposition's representatives. The relationship between Slovakia and the European Union was influenced by certain pressure between coalition and opposition, indeed. Unexpected speed-up in Slovakia's accession

to ERM II system was conditioned probably – besides its objective advantages – also by the fear that results of upcoming elections could lead to the changes in present economic policy and thus to delays in Slovakia’s entry into Eurozone. Developing of the *Lisbon Strategy for Slovakia* was not accomplished in cooperation of both, government and opposition political powers necessary for fulfillment of the long-term development strategies.

Graph 1

**Development of the Slovak economy performance and stability in 1997 – 2005**



<sup>1</sup> Overall stability trend summarizes development of its following partial components (indicators): year-on-year rate of core inflation, ratio of public finance balance combined with quarterly values of the share of public consumption in GDP to GDP, net export to GDP ratio, and difference between increase in labour productivity and increase in real wages. Values of each partial indicator recorded in given period are figured separately in points (in the range +100 to -100) according to their ratio to the mid-span between the maximal and minimal value of relevant indicator in whole time series. The average of summation of points achieved in individual periods by partial indicators is considered as the value of overall balance.

Average level of overall balance in the SR for examined period is identified in the graph as its zero value. Positive values express its above-average level and negative its below-average level.

The year 2005 was the third consecutive year in which high rate of economic growth was combined with favourable development in macroeconomic stability (see graph 1),<sup>1</sup> what is an evidence of well established macroeconomic policy. These are the assumptions for maintaining a high growth rate in the next periods.

In the contrary to similarly high economic growth rates attained by the Slovak economy in 1994 – 1996 concurrently with the high prosperity of the western-European countries, the 6 % GDP growth in Slovakia in 2005 was recorded during relatively low, 1.6 % GDP growth rate in EU-25. In this point of view, it was a record increase in GDP and was attributable by 37 % to the increases in used resources (labour and tangible capital) and by 63% to the growth of total factor productivity.

As regards the view of demand, that is shown in graph 2 (part a), it is obvious that in the year 2005, analogously to the year 2004, favourable development in performance of the Slovak economy was considerably influenced by the growth of domestic demand. In its framework, the high growth rate of final consumption was accompanied by the large increases in investments, or gross capital formation. This fact (illustrated in graph 2 part b) provides a good prospect for continuation in high GDP growth rates also in the forthcoming periods.

The development of prices and related monetary policy contributed in 2005 markedly to the maintaining a macroeconomic stability at the level supporting the confidence of investors and all economic activities. The headline inflation rate as well as core inflation rate achieved (see table 1) the lowest levels in the whole period of the Slovak economy transformation and they approached significantly the level of relevant Maastricht criterion.

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<sup>1</sup> Approximately one half of a decrease in overall stability in 2005 comparing with 2004 was caused by worsening of development in net export of goods and services and approximately one quarter can be assigned to increased rate of net inflation and one quarter to deterioration of relation between development in real wages and labour productivity.

Table 1

## Socio-economic development in 1996 – 2005

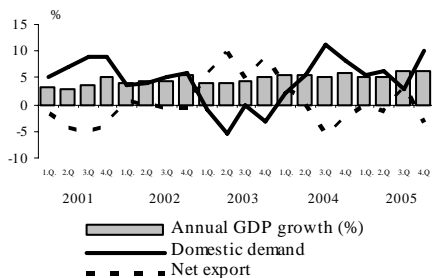
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	<b>A. Development in performance of economy</b>									
GDP Index <sup>1</sup> Previous year = 100 1989 = 100	106.1	104.6	104.2	101.5	102.0	103.8	104.6	104.5	105.5	106.0
Labour productivity index <sup>2</sup> Previous year = 100 1989 = 100	94.7	99.0	103.2	104.7	106.8	110.9	116.0	121.2	127.9	135.6
Cost Profitability in non-fin. org. in %	102.4	105.5	104.5	104.6	103.5	102.7	104.5	102.6	105.2	103.8
	107.6	114.0	119.3	124.4	129.3	133.4	140.3	144.0	152.4	158.2
	2.8	2.5	0.4	1.4	2.7	4.5	4.5	6.0	7.0	7.1
	<b>B. Indicators of stability</b>									
Inflation rate in % <sup>3</sup>	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5	7.5	2.7
Of which: core inflation rate in %	.	.	6.1	6.0	5.7	4.3	2.1	2.6	2.6	1.1
φ interest rate on credits in % <sup>4</sup>	13.3	18.4	19.4	16.9	11.8	9.3	9.1	7.6	7.9	6.0
Balance of public finance/GDP in %	-7.4	-6.2	-3.7	-7.0	-12.3	-6.0	-5.7	-3.7	-3.3	-2.95
Annual Δ in productivity <sup>2</sup> – annual Δ in real wages in national economy, in points	-4.7	-1.1	1.8	7.7	8.4	1.7	-1.3	4.6	2.7	-2.5
Net export of goods and services/GDP in % at current prices	-8.6	-7.6	-10.7	-2.2	-0.3	-3.8	-7.1	-1.5	-2.7	-4.4
	<b>C. Social development</b>									
Year-on-year employment index <sup>5</sup>	103.6	99.1	99.7	97.0	98.6	101.0	100.2	101.8	100.3	102.1
φ unemployment rate in % <sup>5</sup>	113	11.8	12.5	16.2	18.6	19.2	18.5	17.4	18.1	16.2
Annual change in real wages in %	7.1	6.6	2.7	-3.1	-4.9	1.0	5.8	-2.0	2.5	6.3
Index of real wages in nat. economy 1989 = 100	86.3	92.0	93.6	91.0	86.9	87.8	92.8	91.3	93.6	99.5
Index of real household consumption/cap. 1989 = 100	89.0	94.0	99.5	102.1	101.1	106.4	112.3	111.4	115.4	122.1
Share of social benefits in household consumption in %	23.6	23.3	22.8	23.3	22.5	21.3	21.2	21.6	20.2	19.6

<sup>1</sup> At constant prices. <sup>2</sup> According to GDP at constant prices per 1 worker. <sup>3</sup> According to consumer prices, in average per year. <sup>4</sup> From credits drawn from commercial banks, in average per year. <sup>5</sup> According to Labour force survey, in average per year.

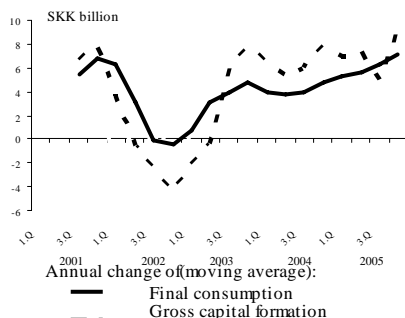


Graph 2

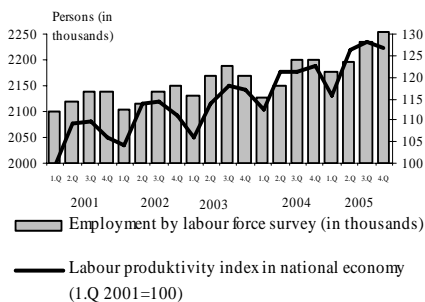
a) Share of domestic demand and net export in GDP generation, in points



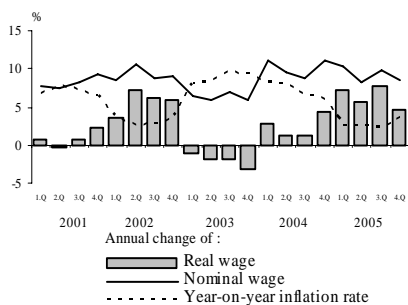
b) Consumption and investments



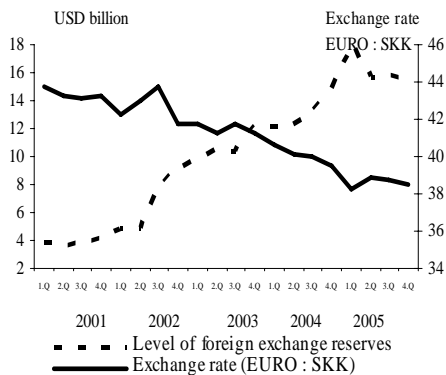
c) Employment and labour productivity



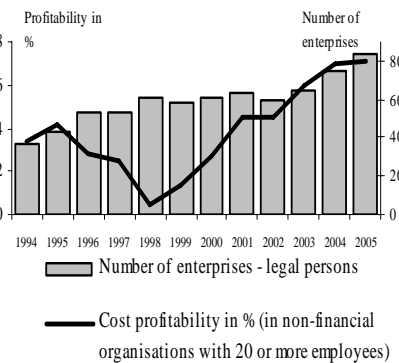
d) Prices and wages



e) Foreign exchange reserves and SKK exchange rate



f) Number of enterprises and profitability



Fiscal policy in 2005 not only kept the development of public finance in the outline of favourable trend from the previous years, but in its result – in the value of public finance balance - it achieved for the first time the level under 3 % of criterion obligatory for the Eurozone accession. Good results of public finance (presented in details in chapter 5) resulted mostly from the growth of tax incomes related to the high economic growth rate. However, they were influenced also by a decrease in budgetary expenditures on state debt service.

The relation between labour productivity development and real wages development had a moderately negative influence on the macroeconomic stability in 2005. Inflation expectations copying inflation rates from the previous period were apparently reflected into the real wages growth surpassing the growth in labour productivity. Faster growth of wages in 2005 was affected probably also by the pressure caused by their unfavourable development since the end of the 90's. Comparing to the year 1998, labour productivity in 2004 grew by 27.7 %, but the real wages did not change (in 1998 as well as in 2004 achieved 93.6 % of the 1989 level). Presented facts contribute to the explanation of the sustained growth of profitability rate in the non-financial organisations (see graph 2, part c), but document also lasting interest of the foreign investors in enterprising in Slovakia.

The factor which influenced the development and state of macroeconomic stability in 2005 unfavourably was the foreign trade result, even when net export of goods and services improved the results of GDP generation at constant prices - and thus also the growth of real GDP (in 2005 it achieved SKK 12.9 billion and contributed to 6.0 % GDP growth by 1.6 percentage point). GDP generation at current prices was influenced by the negative balance of international exchange of goods and services in the amount of SKK 63 billion. Approximately one third of this balance was caused by the growth of prices of imported commodities, most of all prices of energy carriers.

High growth rate of GDP in 2005 was also connected with good results in social development. The biggest extent was attained by employment growth continuing already for 5 consecutive years. Notable



### B. Comparison of social situation in regions

NUTS 2	Rate of unemployment			Relations of average monthly wage Slovakia = 100		
	1999	2002	2005	1999	2002	2005
Bratislava	7.4	8.7	5.2	129.1	130.5	134.4
Western Slovakia	14.2	17.5	12.4	89.6	88.9	87.5
Central Slovakia	18.6	21.3	19.4	88.6	87.7	86.1
Eastern Slovakia	21.3	22.2	23.0	89.7	88.7	87.2
<i>Slovakia</i>	<i>16.4</i>	<i>18.6</i>	<i>16.2</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>

### C. Comparison of development trends

	Indexes of real GDP/cap. 1996 = 100			GDP/cap. growth rate in % 1997 – 2005	Indexes of real monthly wages 1996 = 100			Real wages growth rate in % 1997– 2005
	1999	2002	2003		1999	2002	2005	
Bratislava	114	134	139	4.8	110	114	127	2.7
Western Slovakia	109	116	124	3.2	103	105	111	1.3
Central Slovakia	110	124	128	3.6	105	106	112	1.3
Eastern Slovakia	109	122	125	3.2	105	106	112	1.3
<i>Slovakia</i>	<i>110</i>	<i>123</i>	<i>128</i>	<i>3.6</i>	<i>110</i>	<i>112</i>	<i>121</i>	<i>2.1</i>

Based on the indicators of the socio-economic development in Slovakia described in table 1, it was possible to evaluate the year 2005 as rather successful period of the Slovak economy development. However, data in table 2 corrects this presented evaluation in such meaning that large regional differences are hidden behind the satisfactory average values. In all compared groups of indicators, especially the difference between the level of socio-economic development achieved in Bratislava and in other regions can be observed. When analyzing the table 2 carefully, we can see also other - from the west towards the east growing – negative disparities.

The differences in GDP/cap. generation as well as in volume of industry outputs/cap. between Bratislava and other three regions deepened during the examined period. Position of the Western Slovakia

in proportion to the average performance of the Slovak economy is improving moderately, while in the Central and Eastern Slovakia, we can observe a stagnation (as regards GDP/cap.) or worsening (as regards the sales in industry/cap.) of their relation towards the Slovak average.

Also the information on disparities in social situation of the regions is in the accordance with presented findings. Especially remarkable is the case of unemployment rate decreasing after 2002 not only in Bratislava, but also in the Western Slovakia. On the contrary, growth in unemployment rate has continued in the Eastern Slovakia also after 2002. Deepening disparities between Bratislava region and other regions are evident also in the development of wages.

When comparing development trends in the economy (table 2 part C), it can be stated that differences in the growth rate of GDP/cap. between the capital city of Slovakia and other NUTS 2 regions do not exceed the differences common in the other countries of EU 25. The differences between Bratislava and other three regions in the growth rates of real wages are considerably high. They reflect larger share of highly-qualified labour force that has been generated in Bratislava region from several reasons; not only because it is political-administrative, financial, and in wider context also cultural centre of Slovakia; but also because Bratislava has thanks to its advantageous geographical location high concentration of foreign direct investments (FDI) and close cooperation relations with developed foreign regions.

Knowledge of regional development of other - more developed countries of the EU proves that faster development of the capital cities' regions than the other ones is a natural process which is an assumption of the overall socio-economic development of respective country. Thus, it can be expected that faster development of Bratislava would in the further periods, together with targeted support of development in other regions, influence favourably the improvement of socio-economic situation of whole Slovakia.

## 2. PRODUCTION DEVELOPMENT

The real 6.0 % growth of gross domestic product was attained in 2005 on the base of 5.1 % value added growth and 14.7 % growth of taxes on products (decreased by subventions on products). The growth of value added contributed to GDP growth by 4.6 percentage points (p. p.) and growth of taxes (minus subventions) by 1.4 p. p. As a consequence of slower growth of value added comparing to gross production (6.1 % against 5.1 %), the share of value added in gross production decreased moderately - from 38.7 % in 2004 to 38.3 % in 2005.

The largest contribution to GDP growth in 2005 was generated by industry (2.4 p. p.), the contribution of service sector decreased in comparison with the preceeding periods to 1.1 p. p. The overall development tendencies are shown in table 3.

Table 3

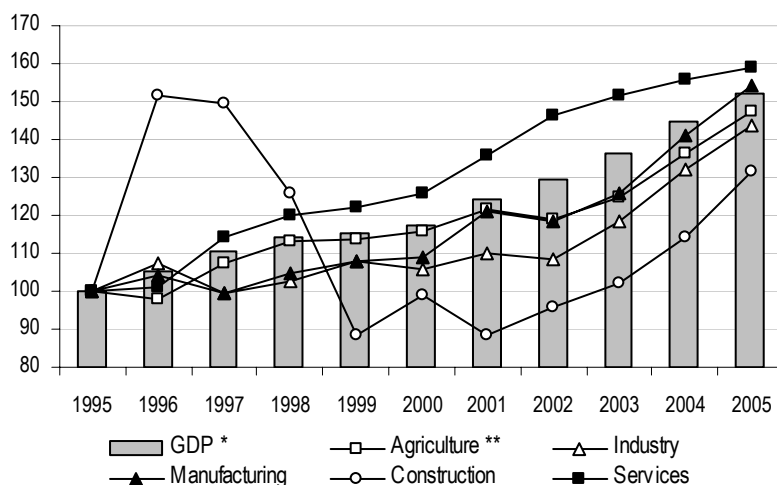
**Development of GDP generation in the years 2002 – 2005 (at constant prices)**

	2002	2003	2004	2005	2002	2003	2004	2005
	Year-on-year changes in %				Contribution to GDP growth in p. p.			
GDP	4.6	4.5	5.5	6.0	.	.	.	.
of which:								
agriculture	9.5	5.8	9.7	6.1	0.4	0.3	0.4	0.3
industry total	-1.3	9.1	11.5	8.7	-0.3	2.3	3.0	2.4
manufacturing	-2.0	6.1	11.9	9.5	-0.5	1.4	2.7	2.3
construction	8.4	6.8	11.8	15.6	0.3	0.2	0.4	0.6
services total	7.4	3.6	3.0	2.0	4.1	2.1	1.7	1.1

Despite higher GDP growth rate in 2005 comparing with 2004, all key sectors of the Slovak economy, except of construction, recorded lower real growth rates of value added than in the previous year. However, it remained (with the exemption of service sector) relatively high.

Value added has risen in real terms in all basic sectors of national economy in the last years. Based on the development tendencies characterised in table 3 and graph 3, it can be observed that value added (VA) increases permanently and constantly during the last three years relatively quickly in all production sectors, while in sector of services the growth rate decelerates.

Graph 3  
**Development of value added in key sectors of the SR economy in %**  
 (1995 = 100, at constant prices)



\* GDP excl. other components

\*\* Agriculture, hunting and forestry, fishing

It is a substantial change in development of supply-side of economy, which becomes even more apparent when we calculate contribution of individual sectors to the average annual GDP growth rate (without other components) before and after 2002. While in the years 1995 – 2002 3.3 p. p. of the 3.8 % growth was attributed to the growth of value added in service sector, in the years 2002 – 2005 the 5.4 %

growth was attained due to growth of value added in all sectors: industry contributed by 2.8 p. p., agriculture and construction by 0.4 p. p. each, and service sector by 1.8 p. p.

The real growth of value added in *manufacturing* by 9.5 % was achieved in 2005 thanks to its increases in manufacture of machinery, electrical and transport equipment by 5.0 p. p.; in other manufacturing sectors<sup>2</sup> by 2.8 p. p.; and in manufacture of food products by 1.7 p. p.

However, as regards the manufacture of chemicals, crude oil and rubber products and manufacture of basic metals and metal products, value added – after notable growth in the previous year – stagnated.

In the long-term context, the development of value added in manufacturing is characterised by its above-average growth in manufacture of machinery, electrical and transport equipment, in manufacture of metals and metal products and in other sectors of manufacturing; while stagnation or decrease is evident in manufacture of food products and in the chemical industries (see graph 4).

In the service sector, in 2005 the high growth of value added was recorded in trade and transport and telecommunications; while a drop of VA was observed – already the second year in row - in education (-3.6 %), and in healthcare and social assistance (-16.1 %).

Production in industry<sup>3</sup> increased in 2005 by 3.8 %<sup>4</sup> (on year-on-year basis), of which in manufacturing by 5.2 %, in electricity, gas and water supply by 2.9 %; in mining and quarrying sector production fell by 3.7 %. The high growth was attained in manufacturing n. e. c. (17.5 %), in manufacture of wood (13.4 %), in manufacture of machinery n. e. c. (13.2 %), and in manufacture of electrical and optical equipment (12.1 %); production fell down in manufacture of textiles and textile products, of coke and crude oil products and of transport equipment.

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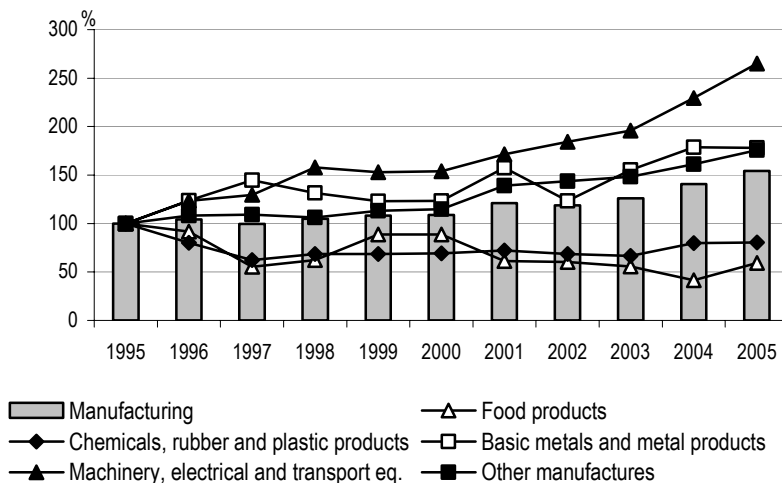
<sup>2</sup> Includes manufacture of textiles and textile products, manufacture of leather and leather products, manufacture of wood and wood products, manufacture of pulp and paper, publishing and printing, manufacture of other non-metallic mineral products and manufacturing n.e.c.

<sup>3</sup> According to the index of industrial production.

<sup>4</sup> During the year the growth rate went up gradually – from 0.7 % in the 1<sup>st</sup> quarter to 6.4 % in the 4<sup>th</sup> quarter.



Graph 4  
**Development of value added in manufacturing sectors**  
 (1995 = 100, at constant prices)



In a long-term perspective, the development of production in manufacturing diverges significantly. During the previous five years, the production in manufacturing was increasing annually in average by 7.1 % – in individual sectors in interval of 17.3 % to -0.9 %. Especially the manufacture of electrical equipment (17.3 % annually in average), manufacturing n. e. c. (14.8 %), manufacture of machinery n. e. c. (14.8 %), of rubber and plastic products (10.8 %), and of transport equipment (9.5 %) grew dynamically. Manufacture of chemical products and of food products stagnated, manufacture of textiles and textile products decreased.

The year 2005 can be consider as the first year in which successful growth in industry was expressed – more noticeably than in the previous years – also in the growth of employment<sup>5</sup> which has risen in total by 3.1 % (17 thousands of employees), of which in manufacturing

<sup>5</sup> Average registered number of employees according to the monthly reporting.

by 4.1 % (21 thousands of employees). The biggest absolute increase in number of employees in manufacturing was reported in manufacture of metal constructions (11.2 thousands), in manufacture of electrical equipment (7.1 thousands) and in manufacture of wood (6.3 thousands). The growth of labour productivity contributed in 2005 to production growth in industry at lower level – it achieved 0.7 % (1.1 % in manufacturing).

The real growth of receipts from sales for own performances and goods of industrial companies slowed down on year-on-year basis, from 6.9 % to 5.3 %, in manufacturing from 8.4 % to 6.1 %. The biggest growth in sales was achieved, during the second consecutive year, in manufacture of electrical equipment (35.5 %), in manufacture of metal constructions (20.7 %), and in manufacture of wood (21.3 %). In manufacture of transport equipment the real sales decreased by 9 %.

The growth of *exports in manufacturing* accelerated a little bit in 2005 (from 10.1 % in 2004 to 11.4 % in 2005) and growth of its imports slowed down moderately (from 13.0 % to 12.5 %); the total surplus of foreign trade exchange in goods of manufacturing reached SKK 54 billion comparing with SKK 56 billion in 2004 and SKK 69 billion in 2003.<sup>6</sup>

Strong growth in exports was achieved in manufacture of electrical equipment (38 %), in manufacture of coke and crude oil products (31 %), of food products (29 %); exports in manufacture of transport equipment fell down by 9 % and in manufacturing n. e. c. by 13 % (see graph 5).

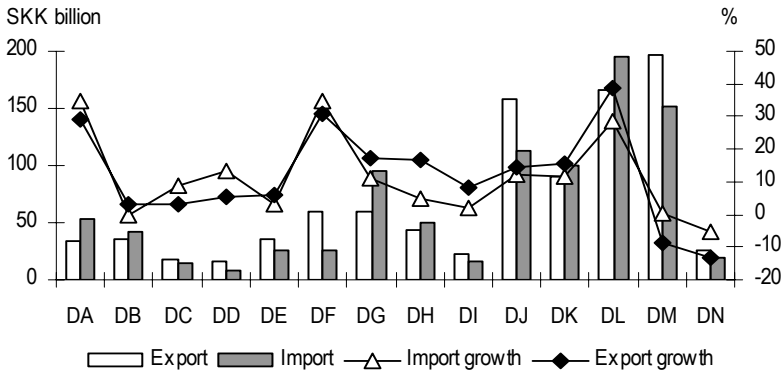
The highest share in total exports of manufacturing in 2005 remained preserved in manufacture of transport equipment (20.5 %), the second place is – for the first time - occupied by manufacture of electrical and optical equipment (17.3 %), and the third one is traditionally

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<sup>6</sup> Total deficit of trade balance in 2005 was higher comparing with 2004 by SKK 26.5 billion, mainly as a result of higher deficit in trade with mineral resources by SKK 22 billion, and partly because of a decrease in exports of transport equipment by SKK 19 billion.

occupied by the strong export sector – manufacture of basic metals and metal products with its share of 16.5 %.

Graph 5  
Exports and imports in manufacturing sectors in 2005<sup>1</sup>



<sup>1</sup> In SKK billion (left axis); growth in % (right axis)

DA	Man. of food products, beverages and tobacco	DH	Man. of rubber and plastic products
DB	Man. of textiles and textile products	DI	Man. of other non-metal. miner. products
DC	Man. of leather and leather products	DJ	Man. of basic metals and metal products
DD	Man. of wood and wood products	DK	Man. of machinery and equipment n.e.c.
DE	Man. of pulp, paper, publishing and printing	DL	Man. of electrical and optical equipment
DF	Man. of coke, refined petroleum products	DM	Man. of transport equipment
DG	Man. of chemicals, chem. products and fibres	DN	Manufacturing n.e.c.

During the last three years in the row, exports of the goods categorised as the high technologies increased markedly (by SKK 10 billion in 2003, by almost SKK 22 billion in 2004, and by SKK 43 billion in 2005). In 2005 its increase generated almost one half of the growth in total exports of manufacturing. A comprehensive view on increases in exports according to technology intensity is shown in table 4.

The share of the exports from high technology industries in exports of manufacturing increased in 2005 by 3.8 p.p. (from 7.6 % in 2004 to 11.4 % in 2005). Of course, not all manufactures included in this segment are developing similarly successfully. Graph 6 clearly

shows that fast growth of exports, as well as improving of foreign trade balance were recorded only in the following industries: 30 – office, accounting and computing machinery and 32 – radio, TV and communications equipment.

Admittedly, the exports of goods in high-tech category still represent a weak point of our foreign trade. Particularly, the trade balance deficit in the high-tech segment continues to represent a specific problem – although it declined in 2005 comparing with the previous period, it is still exceptionally high (SKK 54 billion).

Table 4  
Year-on-year increase in exports (in SKK billion)

	1999	2000	2001	2002	2003	2004	2005
High technologies	4.1	3.6	8.1	-1.2	10.1	21.7	43.0
Medium high technologies	23.9	58.3	14.6	22.4	108.4	17.1	-0.2
Medium low technologies	4.8	41.6	17.0	6.6	20.2	43.7	41.0
Low technologies	10.5	20.3	20.7	11.1	10.7	2.1	10.0
Total	43.3	123.9	60.4	39.0	149.4	84.6	93.8

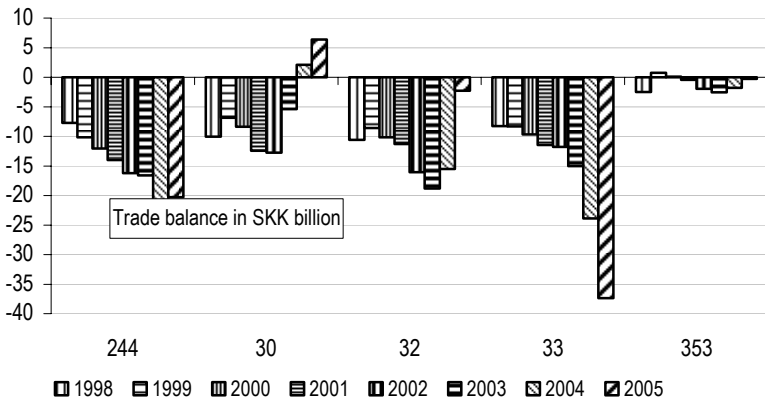
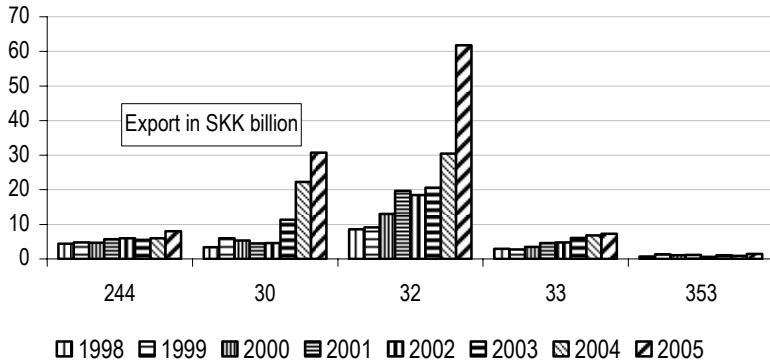
As graph 6 reveals, especially high deficit was observed in the trade with pharmaceuticals (SKK 20 billion) and in the trade with medical, precision and optical instruments (in the framework of this group, the import of optical and photographic equipment increased in 2005 by SKK 14 billion).

The balance of trade in goods categorised as medium-high technologies recorded in 2003 – 2004 a significant surplus (SKK 58, or 50 billion), which, however decreased in 2005 to SKK 21 billion as a result of fall in exports of motor vehicles. A positive development in this segment was attained in the industries: 31 – electrical machinery and apparatus, as well as in 29 – machinery and equipment, n.e.c.

A trade balance surplus increases systematically during the last three years in the segment of medium-low technologies, mostly thanks to the growing exports in crude oil products and basic metals and fabricated metal products. On the contrary, a surplus in low technology

segment went down in the last two years, what is related mainly to the growth in imports of food products (especially meat) and tobacco products.

Graph 6  
Development of foreign trade in segment of high technologies

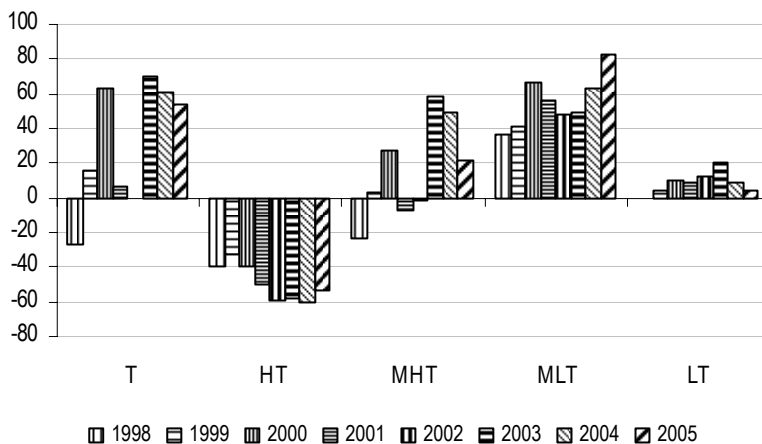


Notes:  
244 – pharmaceuticals, 30 – office, accounting and computing machinery, 32 – radio, TV and communications equipment, 33 – medical, precision and optical instruments, 353 – aircraft and spacecraft.

The overall view on the development of trade balance in manufacturing is presented in graph 7.

Graph 7

**Development of trade balance in manufacturing segments by technology intensity (in SKK billion)**



*Notes:*

T – manufacturing in total, HT – high technologies, MHT – medium high technologies, MLT – medium low technologies, LT – low technologies.

The growth in *construction* continued also in 2005, concurrently with significant improvement of growth rates in all basic indicators. Production grew in real terms by 14.7 % (by 9 p.p. more than in 2004); employment by 6.9 % (increase by 4.2 p.p.), and labour productivity by 7.3 % (4.4 p.p. more than in 2004). Year-on-year growth of production was influenced positively by new construction, modernisation and restructuring, as well as by construction activities related to repairs and maintenance and construction works abroad.

In *agriculture*, the receipts (sales) for own products increased in real terms by 1.7 %, when receipts for crop production went up by 13.3 % and for livestock products fell down by 3.4 %.

*Financial performance of corporations* in 2005 was developing relatively favourably. Overall financial position represented by total profit/loss result improved, comparing with the year 2004, almost by SKK 70 billion. Its growth was influenced significantly by the sector of financial corporations which after three years of a loss realized a profit at the level of SKK 28.7 billion. In the sector of non-financial corporations a profit increased in comparison with the year 2004 by SKK 28.5 billion (see table 5).

Table 5

**Development of financial situation of corporations in 2001 – 2005**

	2001	2002	2003	2004	2005
	Profit/loss result in SKK billion				
Non-financial and financial corporations - total	134.8	133.7	138.0	180.0	249.5
Financial corporations	12.8	-5.5	-15.1	-12.3	28.7
Non-financial corporations	122.0	139.1	153.1	192.3	220.9
of which:					
Agriculture	1.2	1.9	-1.9	1.0	-0.3
Manufacturing	44.7	42.6	53.2	70.0	73.1
Construction	4.9	8.9	8.4	10.2	12.3
Services – total	55.0	56.0	55.4	67.4	86.2
Profitable and unprofitable non-financial corporations with 20 or more employees	86.2	95.3	115.2	149.3	172.9
of them: profitable	112.3	127.4	146.6	173.0	204.1
unprofitable	-26.0	-32.2	-31.3	-23.7	-31.2
	Cost profitability in %				
Non-financial corporations	5.2	5.7	6.0	7.0	7.1
Agriculture	1.7	2.7	-3.1	1.6	-0.5
Manufacturing	5.2	4.7	5.0	6.2	5.7
Construction	4.8	8.6	7.8	8.6	8.3
Services - total	5.2	5.0	5.1	5.6	6.3

As regards the non-financial corporations, a positive profit/loss result was achieved in almost all sectors (with an exemption of agriculture and education); however its increases were considerably lower

than in the year 2004 in majority of the sectors. Particularly, it is the case of industry with its profit increase of SKK 8.8 billion (22 billion in 2004), and manufacturing with its profit increase of SKK 3 billion (comparing to SKK 17 billion in 2004). An increase in profit of electricity, gas and water supply sector stayed approximately at the level of the previous year (app. SKK 5 billion). The largest profit increase among the manufacturing sectors was generated by manufacture of basic metals and metal products; but fell down in manufacture of crude oil products (by SKK 3 billion) and in manufacture of transport equipment (almost by SKK 5 billion). Positive results were obtained in construction (a profit increased by SKK 2 billion) and in service sector - aggregate profit grew in this sector almost by SKK 19 billion, of which SKK 6.7 billion was generated in transport, postal services and communications and SKK 6.1 billion in real estate, renting, commercial activities and other services.

Approximately 30 % of the total number of non-financial corporations with 20 or more employees reported a loss in 2004, just like in the two years before. However, the total volume of their loss, after a temporary fall in 2004, increased again to the level of 2003 and reached the value of SKK 31 billion. On the other hand, a profit in profitable corporations grew faster; it increased by SKK 31 billion.

The biggest share (53.6 %) in volume of non-financial corporations' profit was generated by large enterprises, medium-sized enterprises contributed with 15.3 % and small enterprises with 31.1 %.

### **3. LABOUR MARKET DEVELOPMENT**

The favourable tendencies that had been present in the labour market since 2002 (even with changeable significance) were emphasized during the year 2005. Strengthening of such favourable tendencies was - in quantitative terms - reflected in decrease of unemployment



rate, but mainly in the record-high<sup>7</sup> growth in number of employed persons as well as in the record-strong growth of real wage.

The signs of positive developments in labour market were obvious already since the last quarter of 2004. At that time, the values of all key indicators of labour market changed in desired manner and thus compensated the negative results of the previous quarters of 2004. Practically a “jump improving” of labour market parameters at the end of 2004 promised the better outlooks for 2005. And these were fulfilled in full force.

High economic growth was reflected in labour market in the form of rise in demand for workforce. In 2005, employment in the economy increased annually on year-on-year basis by 2.1 % (to 2 216.2 thousands of persons) in average. Similarly to the previous years, the dynamics of growth in number of entrepreneurs (without employees) was substantially higher; their number rose as much as by 11.5 %. Number of employees grew only by 1.3 %. These values probably reflect also a phenomenon of the forced transition from the employee status to the status of entrepreneur (self-employed); however the size of this phenomenon cannot be quantified. The highest growth rates in number of employed were recorded in market services, mostly in the sectors of hotel and restaurant services and real estate, renting and commercial activities.

Relatively strong (at least in the conditions of the SR labour market) growth in employment was expressed also in a drop of unemployment rate. Unemployment rate reported by the Statistical Office of the SR on the basis of labour force survey fell down on year-on-year base to 15.3 % in the last quarter of 2005, that is indeed high but still the lowest one since the 1<sup>st</sup> quarter of 1999. Annual average unemployment rate declined from 18.1 % in 2004 to 16.2 % in 2005. However, the “hard core” of unemployed strengthened henceforward – the

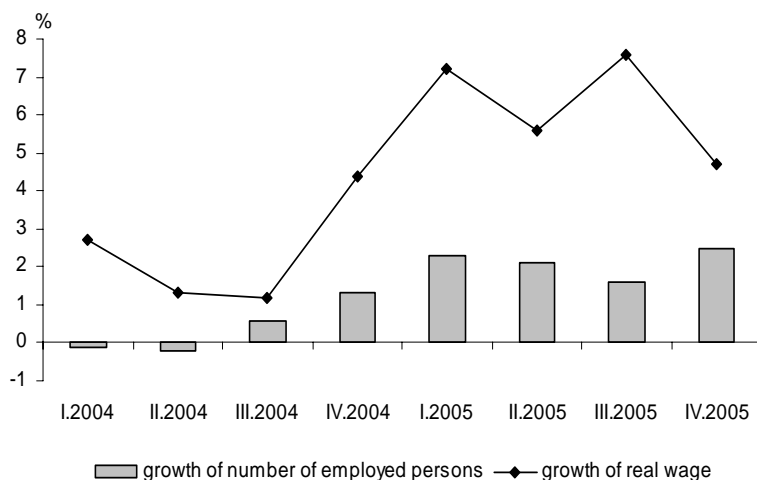
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<sup>7</sup> The term „record“ does not mean the highest value during the whole history, but the highest one during several previous years, in concrete, the real wage growth was the highest in the last 8 years (after the year 1997) and growth in number of employed persons was the highest in the last 11 years (after the year 1994, i. e. since the methodology of labour force surveys was implemented).

number of persons unemployed longer than two years grew again, in concrete, by 2 % to almost 219 thousands of persons (in other words to 53.7 % of total unemployed). So in time of decreases in the number of unemployed in all other segments (according to the duration of unemployment), the most problematic segment, which requires help in the form of specific measures of labour market policy, continued to rise.

Graph 8

**Year-on-year changes in number of employed persons and real wage**



A decrease in unemployment rate affected also the regions with traditionally the sharpest imbalance in the labour market (the regions Banská Bystrica and Košice). Despite this fact, the unemployment rate in the most problematic region (Košice, 24.7 %) was almost five times higher than in the region of capital city (Bratislava region, 5.2 %).

The unemployment rate identified on the base of the number of registered unemployed persons achieved the level lower by more than 4 percentage points in comparison with above mentioned values reported by labour force surveys (annual average of 11.7 %).

This difference is caused not only by the different methodology of unemployment calculation, but also by the different object of this calculation: labour force surveys identify the number of persons without job (no matter whether they are registered), and the rate of registered unemployment identifies the number of persons registered in the labour offices' unemployment registers.

Tightened rules for being recorded in the labour offices' registers during the period from 2003 caused an exclusion of certain segment of unemployed job applicants from the registers, although not all of them became employed.

High growth of nominal and real wage definitely captures attention among the other results of the labour market functioning in 2005. Average wage in 2005 reached the value of SKK 17 274, by 9.2 % more than in 2004. Real wage increased by 6.3 %. Already in the first half of the year, after announcement of data on wage growth in the 1<sup>st</sup> quarter of 2005, NBS Bank Board responded to such growth with certain discomposure. The fact is that growth rate of wages was higher than growth rate of labour productivity. However, we do not suppose that it would automatically means the problem for competitiveness:

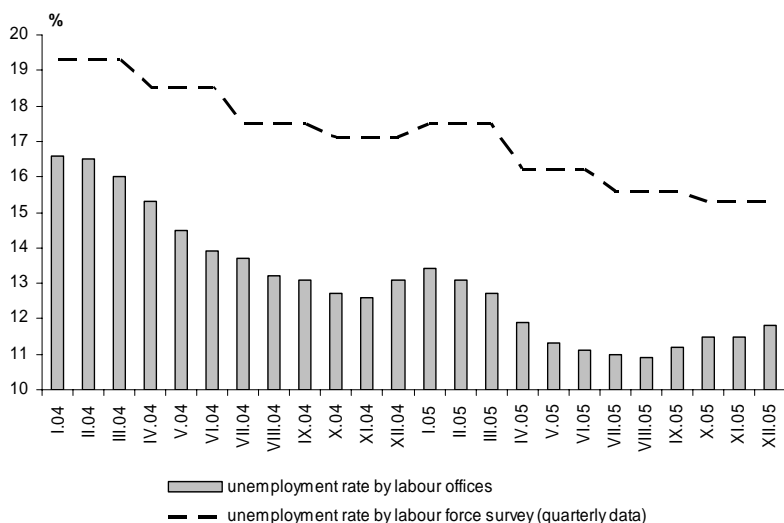
1. In the period before 2005, there was an opposite long-term situation – the growth of wages lagged behind the labour productivity growth. During 16 years of transformation of the economy the gap between strongly growing productivity and variably developing real wages has risen markedly. Therefore, it should not be a surprise if the opposite situation will appear also in the future and growth of wages will surpass the labour productivity growth. It does not mean automatically the threat for macroeconomic stability.
2. It is hardly probably that such expressive advance of wage growth comparing with the productivity growth, that was recorded in 2005, will persist in the long-term. The growth rate of nominal wages will slow down gradually while the productivity growth rate

will remain high henceforward. Organs involved in wage negotiations will probably react to substantially lower inflation rate.

3. Even the high growth rate of wages did not threaten an ability of corporations to make a profit. In a matter of fact, the growth rate of a profit in non-financial organisations increased almost in double rate than nominal wages. It means that high growth rate of wages in 2005 did not influence significantly the financial performance of corporations in a negative way.

Graph 9

**Unemployment rate according to both methods of its calculation**



Inequality in the growth of wages led to the further deepening of disparities between the regions: average wage rose by the biggest percentage where its level was already the highest (growth by 10.4 % in Bratislava region where its level was SKK 23 212) and by the lowest rate where its level was the lowest already (growth only by 5.2 % in Prešov region where its level achieved SKK 13 185). Repeated appearance of such proportions led to the fact that in 2005 the average

wage in Prešov region achieved only 57 % of the average wage in Bratislava region.

The labour market policy and social policy underwent changes which revised the former policy aimed at tightening of regulations for social support and activation of unemployed persons. The Ministry of Labour, Social Affairs and Family of the SR prepared a set of measures related to the support for unemployed persons in searching for a job, with a special concern for disadvantaged groups of persons. However, the substantial part of these measures will expressed themselves in the labour market no sooner than in 2006. In contrast to the tendency in the previous years, the new measures are not exclusively of the character of tightening of regulations for unemployed persons. In certain areas the state policy will be more accommodating towards unemployed. The measures are oriented on more effective prequalification, on wider possibilities of supporting the persons disadvantaged in the labour market, and on increasing of mobility in border regions (reimbursement of the travel costs when commuting to work in the neighbouring country).

### *Outlooks for 2006*

The employment rate in 2006 will be influenced by further high economic growth, and especially by the launching of production in the new factories of automobile industry (even not yet in their full capacity); at the lower level will be influenced by strengthening of programs oriented on employment of the persons disadvantaged in the labour market. However, the comparison base of the year 2005 is so high that 2.1 % growth in 2005 will probably not repeat. The year-on-year growth of employment in the interval 1.4 – 1.8 % is highly probably indeed. The rate of unemployment decreasing to 14.6 – 15.0 % (according to labour force surveys) will be an attendant phenomenon.

It is also hardly probable that 6.3 % growth of real wage will be recorded again in 2006. The high growth of real wage in 2005 was caused by the inflation rate decreasing significantly at temporarily

preserved growth rate of wages in “usual corridor”. Further drop in the inflation rate in 2006 can be barely expected (the results of the first three months of 2006 manifest rather possible moderate increase in inflation rate), while the wage negotiations will be probably affected by a slow down in price level growth in comparison with the values commonly recorded before 2004. Also the factors acting against a significant deceleration of nominal wage growth will be present in 2006 – especially growing scarcity of labour force in certain occupations and industries, persistently decreasing unemployment rate and further substantial growth of labour productivity. Therefore it is highly probable that the nominal wage growth will be operating in the interval of 8.0 – 8.6 %, what means the growth rate of real wage at the level of 4.5 – 5.0 %.

#### **4. PRICE LEVEL DEVELOPMENT AND MONETARY POLICY**

The process of disinflation in the Slovak economy advanced in 2005 significantly, when average annual inflation rate (calculated by the consumer price index) reached the lowest level during the whole transformation period. Achieved level of inflation – 2.7 % - represented a troublefree fulfilment of defined parameters of NBS inflation targeting, and hereby represented a decrease in the rate of inflation to the one third of its previous year level (see graphs 10, 11).

In the previous years, the level of inflation rate was mainly a function of the size of price regulations and changes in indirect taxes. And especially markedly lower extent of such administrative interventions caused a decrease in inflation rate in 2005. Neither unexpected rise in prices of gas, steam and hot water in October,<sup>8</sup> nor high prices of

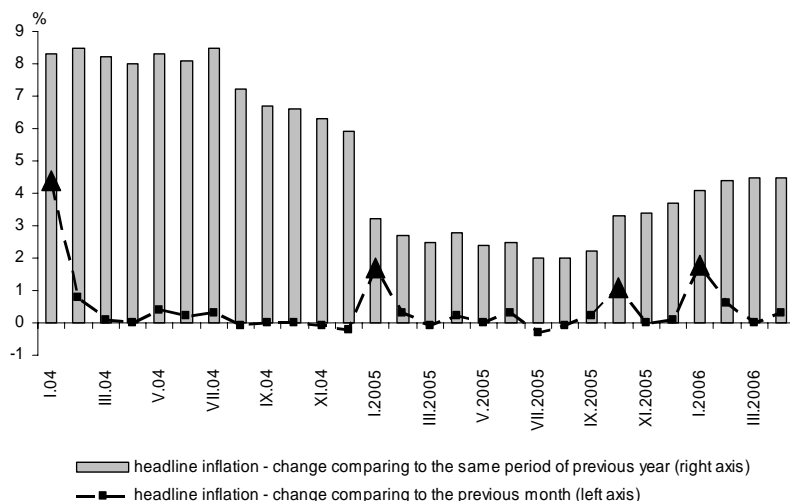
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<sup>8</sup> After several steep increases in prices of gas during the period 1999 – 2004 the Office for Regulation of Network Industries as well as Slovenský plynárenský priemysel (Slovak gas industry - SPP) declared termination of cross-subsidies and establishing of such price that would cover eligible costs, as well as so-called reasonable profit. Therefore, substantial rise in gas prices and prices of other forms of energy was not expected.

However, SPP (referring to the high prices of hydrocarbon fuels on world markets) enforced in regulation office further rapid, more than 20 % high, rise in the prices. At the end of 2005, higher costs of

fuels complicated achieving of NBS objectives in the field of inflation; and the rate of inflation fell to the bottom level of expectations. Further strengthening of competitiveness in retail trade and wholesale trade was an additional cause of preservation of low level of inflation.

Graph 10  
Consumer prices growth rate



Note:

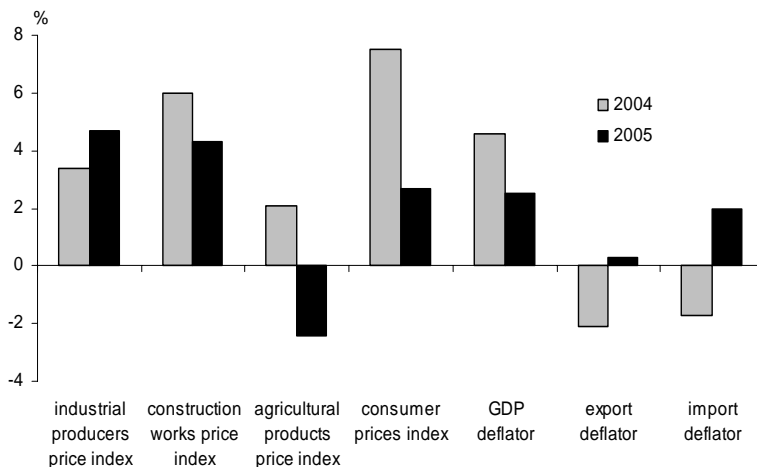
The points of changes in price regulations or rates of indirect taxes are marked by triangles.

The development of the indices of producers' prices was heterogeneous (see graph 11). Deflation (decline in the price level) was recorded in prices of agricultural products. Industrial producers price index as well as price index of construction works grew faster than index of consumer prices.

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energies were probably translated into prices not immediately; certain part of inflation impulse was manifested no soon than in the first months of 2006, together with further increasing of regulated prices.

Graph 11  
Year-on-year changes in price indices and deflators



The fact that in the contrary to the year 2004, also prices of exports and imports increased, should be concerned. However, in 2005 as well as in 2004 the relation between growth in prices of imports and growth in prices of exports was unfavourable. In 2004, prices of imports recorded lower decrease than prices of exports and in 2005 higher growth than prices of exports. This represents unfavourable development of terms of trade which is a sign of not optimal structure of foreign trade.

Monetary policy of the National Bank of Slovakia was affected by the fact that the rate of inflation was heading towards the bottom level of expectations during the whole year. Thanks to this (but mainly because of the local currency appreciation) NBS could approve further decreasing of basic interest rate, from 4 % to 3 %.<sup>9</sup> Similarly, average interest rate on credits extended by commercial banks showed a downward tendency, too (from 7.64 % in January 2005 to 5.99 % in December). The other feature of a relatively relaxed monetary policy was

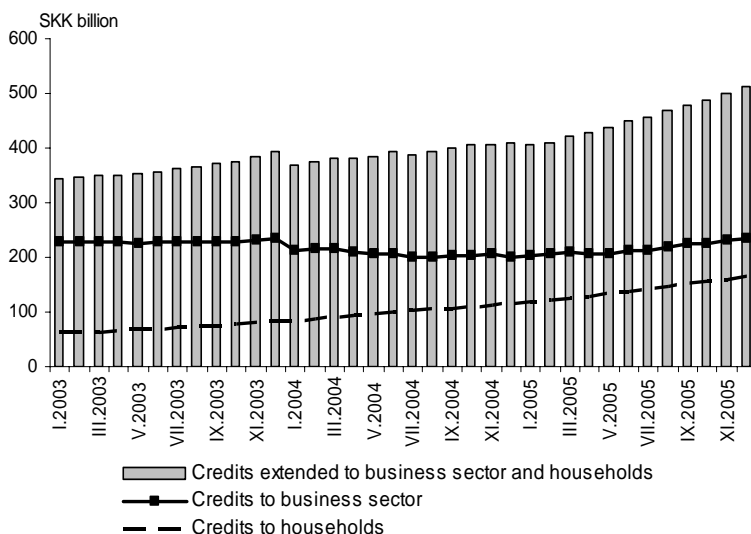
<sup>9</sup> The level of basic interest rate thus declined to one quarter of its initial level determined during the NBS establishment in 1993. At that time the term *discount rate* used to be applied (until 2002).



the strengthening of growth rate in volume of credits extended by commercial banks. As graph 12 indicates, markedly high growth of credits to households preserved in 2005 (the growth of their volume – by 41 % - was comparable to that one in 2004 - by 37 %). However, the fact that the development of credits extended to business sector also improved was more important (their decrease in 2004 was replaced by their growth by 15 %).

Graph 12

**Development of credits (in Slovak crowns) extended to business sector and to households**



The growth of credits to households attracts notable attention, the possibility of households indebtedness or threat of their insolvency is discussed frequently. Admittedly, the dynamics of growth in credits to households is significant, but the structural characteristics of these credits provide a possibility to correct negative scenarios:

1. Substantial part of these credits is designed for financing of real estate. Approximately 67.6 % of credits to households in 2005

were extended especially for this purpose. Therefore, the arguments that households cover their current consumption by credits and loans are barely correct. It is rather a matter of change in consumer buying behaviour: population prefer earlier usage of goods and savings are created ex post (in the form of credit instalments).

2. Only about 5.5 % of these credits were classified (“bad credits”) or standard with qualification (“watched or specially mentioned credits”) so far. This means a moderate growth of the share of “problematic” credits (in concrete by 1 percentage point comparing with 2002 and 2003), but it does not represent any dramatic turnabout (moreover, comparing with 2004 it is a modest improvement).

The NBS policy was – at the beginning of 2005 – similarly to the previous year, targeted to an elimination of exceedingly fast appreciation of the Slovak currency, but in the situation when the Slovak crown despite favourable domestic economic results responded to the imbalance on wider regional markets by its depreciation, NBS started to defend the Slovak crown position and even intervened directly in favour of the currency. Unexpected early entry into the ERM II exchange rate mechanism (already in November 2005) was also supposed to contribute to the better resistance of the Slovak crown to influences caused by fluctuation on wider regional markets. The impulse for such surprising step represented the effort to prevent the speculative exchange rate movements before formerly announced date (initially announced for June 2006). When becoming a member of ERM II mechanism, Slovakia began to meet another condition for introduction of Euro related to the currency stability.

Fiscal consolidation and consistent observance of convergence program enabled completion of negotiation on ERM II entry in sooner time than expected. Slovakia entered the system with the central parity (official exchange rate) of 38.455 SKK/EUR. The movements of the Slovak crown in the system are limited to no more than 15 % of deviation (appreciation or depreciation) from the central parity.

The principle of ERM II functioning represents especially the proving of relative stability of exchange rate. Motivation to “separate” from the fluctuations in financial markets of the central-European region could be reasoned by a doubt about less responsible fiscal policy of some countries in the region, as well as by the experience that possible imbalance in even one of these countries can be reflected in financial markets of the whole region.

The ERM II membership represents a serious challenge for the government’s budgetary policy and the central bank monetary policy and acts as an argument against the breach of fiscal discipline. The membership also brings the new requirements for coordination between NBS and government policies.

### *Outlooks for price development in 2006*

The rate of inflation achieved in the first two months of 2006 higher levels than would be the optimal ones for a successful fulfillment of the NBS inflation targets. Year-on-year growth in consumer prices by 4.4 % (average for January till April) is a result of changes in price regulations and excise taxes, as well as a result of probable transfer of a certain part of inflation impulses from October 2005 (an increase in regulated prices affect partially the other prices involved in the new price calculations from the beginning of 2006). The National Bank of Slovakia responded to these developments by increasing of the basic interest rate. Therefore, more restrictive monetary policy can be expected in 2006 comparing with 2004 and 2005.

Also high prices of fuels will act against any rapid drop of inflation rate. A decrease in year-on-year inflation rate can be expected at the end of the year, when the previous year comparison base will increase (concretely, from October). However, this will be not sufficient for NBS continuing in further disinflation and it is highly probable that growth rate of consumer prices in 2006 will surpass the inflation rate of the previous year, in concrete, it will reach approximately 3.5 – 4.0 %.

## 5. PUBLIC FINANCE

The ongoing public finance reform contributed significantly to the creation of a stable and predictable framework heading towards more effective utilization of public finance. The objectives set in the framework for public finance integrated in the SR Convergence programme (the aim is to achieve balanced or near balanced public finance until the year 2010) and in a mid-term outlook of public finance development are being accomplished to a great extent. In the last years, we are witnesses of even better results in public finance in comparison with planned figures. From the aspect of more precise forecasting of planned state budget expenditures, the adoption of investment incentives rules can be assessed positively. The investment incentives rules based on this legislative framework provide - for the investors on the one side and government on the other side - clear and transparent conditions for investments. It eliminates individual and ad-hoc negotiations with investors realized in the past, which from the view of public finance governance posted certain risks.<sup>10</sup>

For the year 2005, the government's objective was to achieve the public finance deficit at the level of 3.4 % GDP, excluding the costs of the launching of the second pension scheme pillar. The result of public finance deficit was better by 0.5 p. p. as planned. The real public finance deficit reached the value of 2.9 % GDP (SKK 42.4 billion), fulfilling the Maastricht budgetary criterion. The results of public finance deficit were influenced by some specific transactions. On the expenditure side, the deficit was influenced negatively by SKK 13.6 billion as a result of development aid action in the form of debt pardon towards developing countries. On the revenue side, the additional sources were obtained in the value of SKK 4.7 billion due to increased demand of the retail sector for tobacco products, and also the fine to the Slovnaft company increased the revenues by SKK 1.3 billion. The

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<sup>10</sup> However, individual negotiations are also a part of the new investment incentives legislation. Based on this rules, individual negotiation are only applicable with investors investing more than SKK 10 billion.

fine has become revenue of the state budget already in the previous year, despite the ongoing legal process against this company. It is a decision of the Supreme Court of the Slovak Republic, to what extent this fine will be permanent revenue of the state budget. Without the influence of these specific transactions, the public finance deficit would account for 2.4 % of GDP, i. e. 1 p.p. lower as planned for the year 2005.

Table 6  
Public finance components' implementation results

Public finance components	Plan/Budget	Implementation	Difference
Central government	-57 336	-47 109	10 227
State funds and other organizations	2 897	9 648	6 751
State contributory organizations	-168	248	416
Public higher education institutions	0	-462	-462
Upper tier territorial units and municipalities and their contributory organizations	327	-2 910	-3 237
Social Insurance Agency <sup>1</sup>	5 789	-9 511	-15 300
DSS – Pension asset management companies	0	9 259	9 259
Health insurance companies	685	-1 628	-2 313
General government – total	-47 806	-42 465	5 341
<i>Public finance deficit as % of GDP</i>	<i>-3.40</i>	<i>-2.95</i>	<i>0.45</i>

<sup>1</sup> deficit includes the influence of the second pension system pillar

Source: MF SR.

Tax revenues were higher by SKK 15.3 billion compared with the plan for the year 2005. From these higher revenues, SKK 6.8 billion were obtained by upper tier territorial units (VÚC), towns and municipalities on financing their functions. Residual SKK 8.5 billion was used to reduce the public finance deficit. Other important savings on the expenditure side totalling SKK 7.8 billion resulted from the lower debt service costs. The positive effects of these factors have reduced the public

finance deficit by SKK 16.3 billion. The positive outcome of public finance development influenced favourably also the general government debt, which reached SKK 507.4 billion (35.33 % of GDP) by the end of the year 2005.

Gradual improvement in rating evaluation of the Slovak Republic leads - to some extent - to a reduction of the interest rate on the debt service. Positive influence on debt consolidation was also determined by using of privatization revenues on reduction the public debt. Positive effects on debt stabilization were also invoked by a reduction of granted state guaranties that is in accordance with the SR Ministry of Finance policy oriented towards reducing the state guaranties, thus improving the sustainability and transparency of the public finance.

## **5.1. State budget**

In 2005, the state budget developed favourably. The revenues accounted for SKK 258.7 billion, SKK 1.5 billion more as planned for year 2005. The expenditures accounted for SKK 292.6 billion, that is by SKK 26.2 billion less as planned. The state budget ended with a deficit totalling SKK 33.9 billion, SKK 27.6 billion less comparing with the approved act on the state budget for 2005.

The revenue side of state budget (in total revenues items) was in accordance with the approved state budget act. As regards its fulfilment, the development of state budget revenues can be assessed as a positive one. The budget revenues were higher by 0.6 % (SKK 16.2 billion) as compared with the plan. From the structural view of individual revenues components, higher revenues were recorded especially in the field of tax revenues. Tax collection on income, profit and capital assets was higher by 26.5 % (SKK 10.1 billion) as planned; of which personal income tax was higher by 35.8 % (SKK 735 million).

Table 7

## Development of revenues and expenditures of the state budget, 2001 – 2005

	Actual implementation (in SKK billion)					Difference the 2005 plan (SKK billion)
	2001	2002	2003	2004	2005	
<i>Total revenues</i>	205.4	220.4	233	242.4	258.6	1.4
of which:						
A. Tax revenues	165.1	188.8	200	209.4	222.5	20.6
of which:						
Tax on income, profit and capital assets	57.5	69.3	70.1	60.5	48.7	10.2
Tax on goods and services	102	115.6	123.2	144.2	172.3	9.6
Tax on international trade	3.9	4.0	4.0	1.8	0.5	-0.2
B. Non-tax revenues	24.8	20.8	17	21.1	21.1	5.5
C. Grants, transfers and other revenues	13.7	10.7	12.4	9.8	14.9	-24.7
of which:						
EU budget funds	.	.	.	4.5	13.9	-12.6
<i>Total expenditures</i>	249.7	272	289	312.7	292.5	-26.2
of which:						
A. Current expenditures	213.3	237.1	250	.	261.1	-15.8
B. Capital expenditures	27.5	32.4	31.1	.	31.4	-10.3
C. Property share and loans	8.9	2.4	7.8	.	.	.
Surplus (+), Deficit (-)	-44.4	-51.6	-55.9	-70.2	-33.8	-27.7
Share in GDP (in %)	4.6	5.0	4.7	5.3	2.3	.

Source: SO SR, own calculations.

As compared with the year 2004, the revenues from this tax were higher by 11.1 %. Significant revenue growth (by 96.7 %) comparing with the plan was achieved by the tax on enterprising and self-employment, which increased on year-on-year basis by 80.6 % to the level of SKK 6686.7 millions. Similarly, the legal entities income tax surpassed the budgeted level by 39.9 % at the year-on-year growth of 42 % and reached the level of SKK 42 billions.

In 2005, the state budget expenditures were lower by 8.2 % (SKK 20.1 billion) compared with the planned volume. Highest savings SKK 10.2 billion were in the field of capital expenditures and in the field of interest payments and other payment related to credits, where the savings reached SKK 6.6 billion.

The main cause for better state budget development was favourable economic growth of the Slovak economy, in 2005. Tax revenues exceeded the plan by SKK 20.6 billion. Besides positive development of direct taxes the revenues from VAT also exceeded planned values. Savings were also achieved in the field of state debt due to remaining low interest rates and the function of the State treasury system. Savings in these field totalled SKK 6.6 billion. To favourable development (concerning mainly the state budget deficit) contributed the changes in budgetary rules. The expenditures not implemented in the year 2005 are becoming expenditures of the year 2006. From the view of individual ministerial expenditures, most allocated funds were not drawn by the Ministry of Transportation, Posts and Telecommunications (SKK 8.8 billion), Ministry of Economy (SKK 2.2 billion) and by Ministry of Agriculture (SKK 3.2 billion).

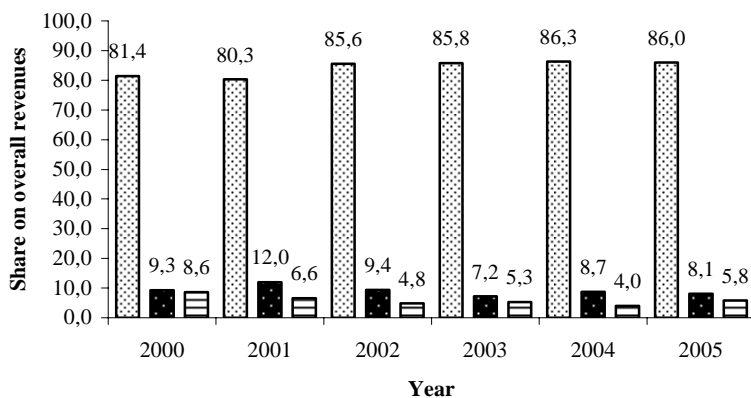
A significant share of transferred funds – totalling SKK 7.8 billion – are from the field of structural funds and Cohesion Fund which were supposed to be used for co-financing of selected projects. Despite rapid drawing at the end of the year, the expenditures in this field were below the planned values. The insufficient drawing of EU Funds reduced the revenues as well as expenditures of the state budget by another SKK 12.6 billion.



The positive development of the state budget allowed not only a significant reduction of the state budget deficit, but also allowed financing of expenditures which were not planned – additional expenditures on the investment incentives for Ford (SKK 1.6 billion), Kia (SKK 1.6 billion), interventions acquisitions of corn and sugar (SKK 2.0 billion) and additional fund for construction of the Slovak National Theatre (SKK 0.5 billion). Negative influence on cash state budget deficit had other tax revenues, and dividend revenues. Dividend revenues were not used as state budget revenues but were directly used to reduce the state debt.

Graph 13

**Share of state budget individual revenues on total revenues, 2000 – 2005**



□ A. Tax revenues ■ B. Non-tax revenues □ C. Grants, transfers and other revenues

Source: MF SR.

Development of individual revenue share on overall revenues in 2000 – 2005 is shown in graph 13. We can see that in the observed period the tax revenue share increased from 81.4 % in 2000 to 86.0 %

in 2005 by parallel decrease of non-tax revenues a slight growth in the chapter grants, transfers and other revenue. From the development of budget revenues we can observe a clear trend towards the increasing share of taxes on products and services and decreasing share of personal income tax, capital assets tax on its overall volume.

## 5.2 State debt

The central government debt (resulting from systematically deficit running of the state budget) amounted to SKK 483.5 billion by the end of 3<sup>rd</sup> Q of 2005. We can observe the trend of continued growth of state debt through the whole examined period. A confirmation of this trend for the whole year is not fully possible due to lack of relevant date for the last Q. However, we assume that the share of public debt in GDP will be lower due to high dynamics of economic growth in 2005. Strong influence on the state debt was caused also by the functioning of the *Agency for debt and liquidity management* and the *State treasury system*. The development of central government debt is illustrated in the graph 14.

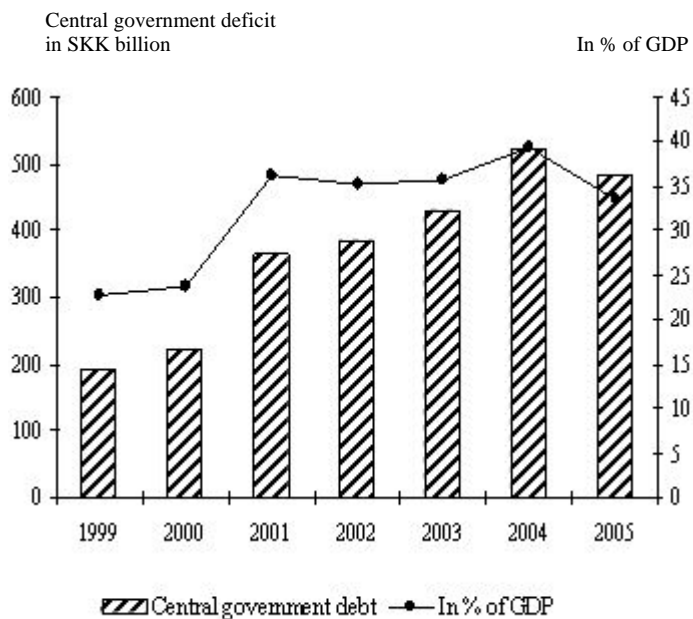
An important step, which influenced the structure of public finance, is the implementation of fiscal decentralization related to the transfer of competencies from the central government to the self-government authorities of upper tier territorial units (VÚC).<sup>11</sup> In 2005, the regional self-governments obtained SKK 41.9 billion, which is SKK 3.2 billion more than planned in the state budget for the year 2005.

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<sup>11</sup> Fiscal decentralization is related to financing of self-governing functions of municipalities and VÚCs as defined in present legislative status. Competences, which municipalities and VÚCs perform in the regime of transferred realization of state administration, will be also in the future financed by the state budget subsidies from the respective budget chapter. The implementation of fiscal decentralization induced the approval of several legislative acts – Act on budgetary rules on revenues from personal income tax in local self-government, Act on local taxes and local fees for communal waste and small construction waste, Act on budgetary rules of local self-government, Act on budgetary rules of public self-government, which came into force in 1. January 2005.

Graph 14

**Development of the central government debt, 1999 – 3<sup>rd</sup> Q 2005**



Source: MF SR, SO SR, own calculations. For 2005 only data for the first 3 Qs available.

Table 8

**Comparison of planned and real revenues of the regional self-governments in 2005**

Indicator (in SKK million)	Budget 2005	Anticipated values for 2005	Difference	%
Personal income tax	31 354.9	33 360.0	2 005.1	106.4
Real estate tax	4 900.0	6 000.0	1 100.0	122.4
Motor vehicles tax	2 500.0	2 600.0	100.0	104.0
Total tax revenues	38 754.9	41 960.0	3 205.1	108.3

Source: MF SR.

A crucial share of these higher revenues was obtained from personal income tax collection. After the fiscal decentralization only 6.2 % of total personal income tax revenues are flowing to the state budget. The total volume of financial sources transferred to regional self-governments reached SKK 35.5 billion, that is 13.3 % higher as planned. The development of revenues from real estate tax was also favourable; the revenues were higher by SKK 1.1 billion.

The overall financial sources entrusted to the regional self-governments should increase annually. In the period 2006 – 2008 the overall allocation should reach SKK 44.9 billion. The expected development of the self-governments revenues is show in table 9.

Table 9  
**Estimated distribution of personal income tax revenues in 2005 – 2008**

Indicator	Budget			
	2005*	2006	2007	2008
Personal income tax	33 418.0	39 302.0	43 421.0	48 224.0
Distribution of total revenues from personal income tax	37324.3	39 302.0	43 421.0	48 224.0
Of which:				
Municipalities	23 500.5	27 589.0	30 359.0	33 707.0
VÚC	7 854.4	9 220.0	10 149.0	11 268.0
State Budget	2 063.1	2 493.0	2 913.0	3 249.0
Total regional self-government	31 354.9	36 809.0	40 508.0	44 975.0

Source: MF SR.

\*The data for 2005 are preliminary. The data will be available after publishing by the MF SR.

An important step towards stabilization and sustainability of economic environment is represented by the realised reform of public finance and its continuing implementation. All implemented measures are aiming to the lower financial burden for future generations as well as increasing of transparency of financial flows.

The public finance reform is closely connected to other structural reforms – healthcare system reform, educational reform, public administration decentralization a social system reform. Since 2004, also other system-based measures related to the public finance reform have been implemented to the system of public finance. They include first of all: multi-annual budgeting, programme budgeting, ESA 95 principles, State treasury system and The Debt and Liquidity Management Agency. Their implementation in the forthcoming years will contribute to more effective and more transparent use of public sources.

The intentions of political parties after this year's parliamentary elections can be assigned to the risks, which could influence the development of public finance in the forthcoming years. The implementing of the proposals - mainly in the expenditure side of the budget, which can be found in the election programmes of several parties, could lead with a high probability to an increase of the general government deficit, mainly due to higher state budget deficit.

Some risks are connected with the financing of the second pillar pension system (however, a mid-term budget outlook includes these expenditures) and unrealised investments in several fields that are a part of so-called basic state functions.

## **6. EXTERNAL ECONOMIC RELATIONS**

### **6.1. A general overview as regards the balance of payments**

Slovakia's economic relations with abroad, reflected particularly in the balance of payments (BP), can be generally considered as positive in 2005, as they continued to represent a trend of stabilization of exchange rate development as well as economic growth as a whole. Overall balance of payment attained a surplus of USD 2.6 billion (app. SKK 71 billion) that was in relation to GDP, comparing with 2004, higher by 1.4 percentage point (see table 10). This surplus repre-

sented an increase in foreign exchange reserves to the approximately 5-time multiply of the level of average monthly imports of goods and services in 2005.

It has to be stated that increase in the balance of payments surplus was achieved not by more favourable development of current account (by contrast, its deficit increased to USD 4.1 billion, i. e. SKK 126.1 billion; in relation to GDP from 3.5 % in 2004 to 8.7 % in 2005), but particularly thanks to the foreign sources in capital and financial account, the surplus of which grew from 7.2 % in 2004 to 13.8 % of GDP in 2005. Therefore also the coverage of the current account deficit by the capital and financial account surplus remains relatively high, 1.4-multiple (see table 10).

Table 10

**Development of basic items of the balance of payments in the Slovak Republic**  
(USD million)

Indicator	2002	2003	2004	2005
1. Balance of trade	-2 131.4	-641.4	-1 455.7	-2 449.6
2. Balance of services	455.5	234.5	285.1	320.4
3. Income balance	-456.4	-119.7	-408.7	-1 976.2
4. Current account	-1 938.9	-277.3	-1 447.4	-4 065.9
5. Capital and financial account	5 175.3	1 339.0	2 957.7	5 651.1
6. Overall balance	3 645.7	1 231.7	1 677.1	2 572.0
7. Current account/GDP, %	-8.0	-0.9	-3.5	-8.7
8. Overall balance/GDP, %	15.1	3.8	4.1	5.5
9. Coverage of current account by capital and financial account (5:4)	2.67	4.83	2.04	1.39

*Note:* 2002 – exchange rate 45,335 SKK/USD; 2003 – exchange rate 36,773 SKK/USD;  
2004 – exchange rate 32,255 SKK/USD; 2005 – exchange rate 30,938 SKK/USD.

*Source:* NBS, Monetary development, 2/2006.

## 6.2. Foreign trade

The year 2005 was the third consecutive year in which foreign trade represented an “engine” of economic growth in the manner of exports dynamics outpacing a dynamics of domestic demand. However, overall results of foreign trade with goods at current prices in comparison with 2004 worsened again, when its deficit grew by SKK 26 billion and reached SKK 76 billion. The rate of trade deficit in relation to GDP thus increased from -3.8 % in 2004 to -5.2 % in 2005 (see table 11).

Table 11

**Development of key indicators of foreign trade with goods in the SR during the period 2001 – 2005**

Indicator	2001	2002	2003	2004	2005
Exports, FCO, SKK billion, at current prices	611.3	652.0	801.5	898.1	993.5
Annual change, at current prices, in %	+11.4	+6.7	+23.2	+12.0	+11.5
Imports, OP, SKK billion, at current prices	714.1	748.0	826.6	948.5	1 069.5
Annual change, at current prices, in %	+21.0	+4.7	+10.5	+14.7	+13.7
Balance, SKK billion	-102.7	-96.0	-25.1	-50.4	-76.0
Balance/GDP, in %	-10.4	-8.8	-2.0	-3.8	-5.3
Export performance, % HDP	61.8	61.1	68.8	67.8	69.0
Import intensity, % HDP	72.2	70.1	66.9	71.6	74.0

*Source:* Foreign trade statistics of Slovakia for years 2001, 2002, Statistical Office SR; SO SR web site – foreign trade in 2003, 2004, 2005; GDP according to the Statistical Report on Basic Development Tendencies in the Economy of the Slovak Republic in the 1<sup>st</sup> to 3<sup>rd</sup> Quarter of 2003 and web site [www.statistics.sk](http://www.statistics.sk) for 2004 and 2005; own calculations.

Absolute and relative growth of passive balance of BP in 2005 in comparison with 2004 was caused by an increase of import intensity of economy (by 2.4 p. p.) surpassing an increase of its export

performance (by 1.2 p. p.). Especially the two following factors contributed to this advance.

First of all, it was a turbulent development in crude oil prices on the world markets, when the price was increasing further in 2005 comparing with 2004 (in average). The Brent oil price was recording from the beginning of 2005 (when its level was approximately 40 USD/barrel) a constant growth, interrupted only by short-term moderate declines. In September, it reached its historical maximum about 67 USD/barrel, but after signals of decreasing demand for oil in October and November (as a result of hot weather, economic consequences of hurricanes and rising oil reserves in the USA) the oil price fell down and by the end of November it reached about 57 USD/barrel.<sup>12</sup>

The second factor which influenced significantly the advance of import intensity comparing with export performance and increase of trade deficit represents the fact that with the FDI inflow also the import of its *investment and operational components* usually increases. This is the case of increased import of technological equipment for the automobile factories PSA Peugeot and Kia Motors newly built in Slovakia. The commodity structure of imports thus recorded the highest growth (besides mineral and agro-food products) in machinery and electrical equipment.

Besides presented factors, the growth in trade deficit was influenced also by some other features. On the side of imports, it was particularly an *adoption of the EU Common Commercial Policy* including customs tariffs and preferential regimes of the EU after Slovakia's accession to this integration bloc. This was reflected in continuation of higher dynamics of imports from developing countries including China (in comparison with lower dynamics of imports from "non-preferred" third countries, mainly the USA). Lasting trade deficit is in the long-term supported also by relatively *high material and energy intensity of production*, which is covered by import in notable size and which is a result of slow modernisation of process technologies.

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<sup>12</sup> ECB Monthly Bulletin, 12/2005.



On the side of exports, trade deficit in 2005 was influenced – in a direction of its compression – mainly by improved (in comparison with 2004) development of the world external environment of the European countries (which participated on the Slovakia's exports even by 85 %) supported by positive development in the USA. A *favourable development* of business cycle was observed also in developing countries, but their high import tariffs for relatively wide groups of products represent certain barriers for expansion of Slovakia's exports to these countries. Therefore, these territories did not increase markedly their share in the Slovak exports either in 2005 (see table 12).

The growth of the SR trade balance deficit can be attributed also to the *change of customs regimes* in some non-member states (e.g. USA, Japan, Canada) towards the new EU Member States, Slovakia included. The Slovak exports are currently realised in a regime of the Most-Favoured-Nation Clause (MFN) that brings higher tariffs burden than previous preferential regime. This influence can be seen also from data in table 12.

It can be admitted that certain *weakening of real effective appreciation* of the Slovak crown exchange rate (see graph 15), influenced mainly by the growth of inflation differential towards trade partners of the EU 25, contributed favourably to a dynamics of export growth.

Also in 2005, the changes in export structure by commodity groups (presented in table 13) affected overall results of the SR trade balance.

As data in this table shows, the groups of commodities which are commonly the most dynamic in developed countries (chemical products, measuring and medical instruments, machinery and equipment), participate only lightly on the Slovak export. Slovakia shows permanently the highest trade deficits in these groups of commodities. To a large extent, it is a result of significant prevalence of price competitiveness which replaces qualitative competitiveness achieved thanks to the qualitative product differentiation.

Table 12

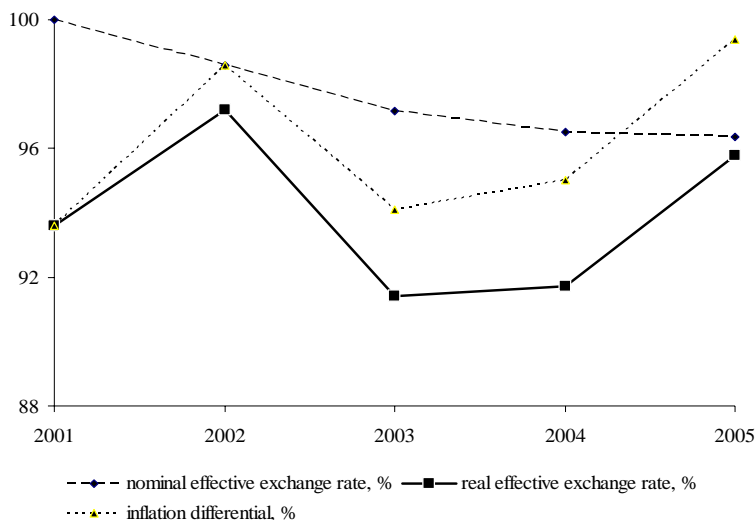
**Development of basic territorial structure of the SR foreign trade**

Country	2003			2004			2005		
	%		balance in SKK billion	%		balance in SKK billion	%		balance in SKK billion
	export	import		export	import		export	import	
Total	100.0	100.0	-25.1	100.0	100.0	-50.4	100.0	100.0	-76.0
of which:									
USA	5.3	1.9	26.1	4.8	1.6	27.4	3.1	1.4	16.1
Japan	0.4	1.9	-12.7	0.3	2.0	-15.9	0.3	1.9	-17.4
EU 25	84.6	74.4	63.9	85.2	73.6	66.1	85.4	71.1	87.7
Russia	1.2	10.8	-79.8	1.2	9.4	-77.7	1.6	10.7	-99.4
China	0.6	2.5	-15.3	0.3	2.6	-23.2	0.4	3.2	-30.6
Asia (Japan and China excluded)	1.9	4.1	-19.1	2.1	6.0	-37.2	2.7	6.4	-44.9

Source: Foreign trade of the Slovak Republic. Statistical Office of the SR, 2003; SO SR web site, 2005.

Graph 15

**Year-on-year development of NEER a REER for business partners in the EU 25, on the basis of EUR and CPI**



Source: Own calculations based on the data from NBS Monetary Survey, 1/2006.

Table 13

**Development of the SR export structure by commodity group**

Class of Custom Tariffs	Share in total exports, in %		BP balance, in SKK billion	
	2004	2005	2004	2005
Total	100,0	100,0	-50,4	-76,0
Agro-food products	3,9	4,4	-16,2	-21,5
Mineral products	7,3	8,0	-68,5	-85,9
Chemical products	3,4	3,4	-44,2	-47,1
Basic metals and products	15,0	15,3	39,8	45,2
Machinery and equipment	21,8	25,6	-46,9	-21,7
Vehicles	24,1	19,6	85,4	63,1
Measuring and medical instruments	0,9	0,9	-22,2	-35,1
Miscellaneous industrial articles	3,7	3,0	12,1	9,6

### 6.3. Foreign capital

A general overview of the development of foreign financial sources in 2005 in comparison with 2004 is shown in table 14.

As data in table 14 indicates, a positive balance of cross-border capital-financial flows, which over-financed a deficit of current account of the balance of payments, continued also in 2005 in its growing tendency, as a surplus in capital and financial account (C&FA) of the balance of payments increased from SKK 96 billion in 2004 to SKK 176.7 billion in 2005 (from USD 3 billion to USD 5.7 billion). This remarkable increase is attributable particularly to the transactions in short-term capital, where the growth from SKK 37 billion in 2004 to SKK 161 billion in 2005 was recorded. The main items were: the short-term deposits of non-residents and commercial credits extended by foreign subjects to domestic entrepreneurial entities.

Table 14

**Development of key items of the SR balance of payments' capital and financial account in 2004 and 2005, in SKK billion**

BP C&FA item	Net (credit ± debit) inflow/outflow	
	2004	2005
Foreign direct investment - total	40.6	54.7
Assets <sup>1</sup>	-1.2	-3.7
Liabilities <sup>1</sup>	26.2	59.1
Portfolio investment - total	28.3	-30.4
Assets	-26.6	-20.9
Liabilities	54.3	-9.5
Other long-term investment - total	-10.0	-6.9
Assets	-3.0	-9.9
Liabilities	-7.0	3.0
Other short-term investment - total	36.8	160.9
Assets	-8.1	-5.8
Liabilities	44.8	166.7
Capital and financial account - total	95.6	176.7
Assets <sup>1</sup>	-43.2	-43.1
Liabilities <sup>1</sup>	122.7	221.1

<sup>1</sup> Includes only equity capital and reinvested earnings.

Source: NBS, Monetary Survey, 2/2005, 2/2006.

The second item which supported a positive balance of BP C&FA also in 2005 was *foreign direct investment* at the level of SKK 54.7 billion what is – in comparison with 2004 - value higher by SKK 14.1 billion. This overall balance of FDI was influenced, on the one hand, by the net outflow of financial sources related to increasing intensity of direct investment of the Slovak enterprises abroad (which is a positive phenomenon); and on the other hand by the net inflow of FDI into the Slovak economy, the volume of which (expressed by equity capital and reinvested earnings) also increased significantly on year-on-year base – by SKK 32.9 billion to SKK 59.1 billion. Approximately two thirds of year-on-year increase in net FDI inflow were dedicated to reinvested earnings, while inflow of *the new non-privatization equity capital* decreased comparing with 2004. Therefore, the new FDI inflow was moving at the level about SKK 20 billion. The main investors were: South Korea (31 %), Germany (30 %), Czech Republic (8 %), Austria and Switzerland (7.5 % each).

The level of FDI as per 31<sup>st</sup> December 2005 reached SKK 417 billion (USD 13.1 billion), thanks to which Slovakia moved in the indicator of FDI/cap. to the level USD 2400 and thus improved its relation to the other new EU Member States.

Foreign direct investments in 2005 were directed almost exclusively to the corporate sphere and were of other than privatization character. From the view of sectors, they were directed mainly to industry (50 %), trade (19 %) and financial intermediation (17 %). As regards the regions, the largest volume of FDI in 2005 was allocated to Bratislava region indeed, but its share in FDI inflow decreased to 39 % in favour of Žilina region (35 %). Despite this fact, the regional distribution of FDI continued to express notable inequalities, with 67 % in Bratislava region.

Transactions in the field of *portfolio investments* attained in 2005 total net negative balance of SKK 30.4 billion, while in 2004 they recorded a positive balance of SKK 28.3 billion. This year-on-year

change (SKK 58.7 billion) was influenced mostly by the changed orientation of foreign portfolio investors from purchasing of domestic securities in favour of their sale (repayment). Total net negative balance *in other long-term financial credits* in comparison with 2004 decreased, mainly thanks to the lower installments of foreign commercial credits and lower deposit withdrawals of non-residents.

## **7. ECONOMIC GROWTH EXPECTATIONS FOR 2006**

A forecast of GDP generation is concerned particularly in the possible developments of individual demand components. When formulating the forecast, the outcomes of all analytical parts of this study as well as results of other domestic and foreign prognoses are taking into consideration.

### **7.1. External demand effects**

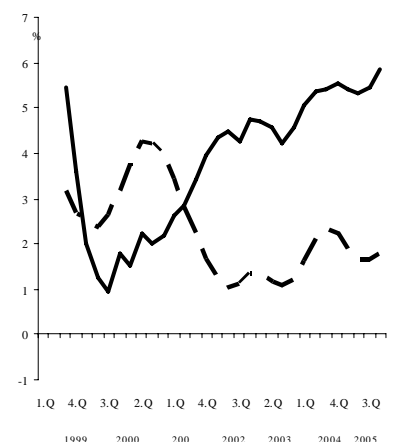
Only a few characteristics of the Slovak economy performed so persistent and fast growth trend like its openness towards world economy. The exports of goods and services in relation to GDP (at current prices) increased from 57 % in 1993 to 79 % in 2005. Thus, a dependence of the SR economy on economic development in the countries in which Slovakia realizes a substantial part of its production (by exporting) has strengthened. This is particularly the case of EU 25 countries to which 85 % of the Slovak export was directed in 2005. Certain features of the connections between economic development of the SR and EU 25 are illustrated in graph 16.

Part a) of the graph 16 indicates that in the first half of examined period (until 2<sup>nd</sup> Q of 2002, included), the GDP developments in Slovakia and EU 25 diverged. From the second half of 2002 the curves describing GDP development in the SR and EU 25 performed certain similarity. It can be expected that this trend resulted from decreasing impact of transformation process on economic development of Slovakia

and consequent strengthening of factors functioning in a standard market economy. In the contrary to above mentioned, the impact of development in the EU 25 economic activities (represented by trend of its exports) on industry development in the SR was permanently present and intensive during the whole examined period.

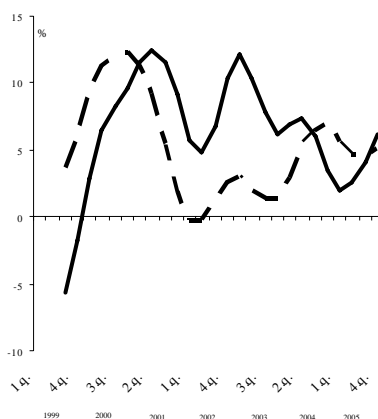
Graph 16

a) Comparison of GDP development in the SR and EU 25



Growth rates (moving average; sppy=100)  
 — SR GDP    - - EU25 GDP

b) Comparison of the developments in the SR industry and EU 25 export



Growth rates (moving average; sppy=100)  
 - - EU 25 exports    — SR industry

Considerable impact of economic development in EU 25 on main development trends in the Slovak economy can be expected also in 2006. From this point of view, the actual forecasts according to which the GDP growth rate in EU 25 should increase from 1.6 % in 2005 to 2.2 % (ifo München), or 2.4 % (Institut für Weltwirtschaft Kiel), or 2.3 % (Eurostat) seem to be favourable for Slovakia.

However, the forecasts of development in the European and world economy in 2006 are rather uncertain, or less categorical than in the previous periods. Considerably uncertain and doubtful assumptions in these forecasts are related not only to expectations of price development

of raw materials and energy carriers, but also (especially in Europe) to the course and outcomes of ongoing structural reforms.

The results of external demand development and its impact on economic growth in 2006 can be – in the Slovak conditions – hardly predicted not only because mentioned uncertainties in world economy but also because of a special, breakpoint situation in the Slovak economy. In 2006, the wave of large foreign investment into automobile industry will damp out. In doing so, it cannot be predicted in what period of the year its final phases connected with large imports of technologies will finish and when, or in what intensity will the new capacities begin their production, enlarge their export and improve the trade balance of the SR. From these reasons we cannot introduce a prognosis of exports and imports. We only estimate that net export (at constant prices, i. e. after reduction of import by probable growth in prices of imported energy carriers) will decline in 2006 approximately to the 60 % level of 2005.

## **7.2. Domestic demand – development expected in 2006**

The biggest component of domestic demand is represented by a households demand determined by household incomes, on the basis of which final household consumption is formed. The processes (sources, factors) of household incomes formation, their transformation to household consumption, as well as development trends of this process are illustrated in table 15.

The development in relation of household incomes and household expenditures to their final consumption, and namely permanent decrease in values of both presented relations, is a result of existence of two factors.

The first one is a limitation of the extent of distribution processes in which final household incomes are formed.



Table 15

**Share in increases of household consumption in points<sup>1</sup>****a) Development of structure of household incomes formation and use (final household consumption = 100)<sup>2</sup>**

	1998	1999	2000	2001	2002	2003	2004	2005	2006 <sup>p</sup>
Income - total	153.2	149.6	149.0	145.1	145.3	144.3	140.7	139.4	140.0
of which:									
compensations of employees	82.7	77.0	77.5	74.8	74.8	74.0	72.0	71.8	72.1
gross mixed income	34.7	36.1	37.9	38.8	39.4	39.7	39.1	41.2	42.3
Expenditures - total <sup>4</sup>	41.6	38.4	37.9	38.0	38.1	37.6	34.6	33.7	33.3
Gross disposable income <sup>5</sup>	111.6	111.4	111.4	107.4	107.5	107.1	106.5	107.3	108.6
Gross savings <sup>5</sup>	11.6	11.4	11.4	7.4	7.5	7.1	6.5	7.3	8.6
Final household consumption	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

**b) Impact of final household consumption components on its annual changes in percentage points<sup>3</sup>**

	1998	1999	2000	2001	2002	2003	2004	2005	2006 <sup>p</sup>
Income - total	7.8	0.4	-1.8	0.2	8.1	-2.1	1.3	6.9	8.5
of which:									
compensations of employees	3.9	-3.6	-0.2	-0.6	4.1	-1.3	0.5	4.0	4.5
gross mixed income	1.1	2.4	1.4	2.0	2.8	0.0	0.8	4.5	3.3
Expenditures - total <sup>4</sup>	1.7	-2.2	-0.9	1.2	2.2	-0.8	-1.9	1.0	1.3
Gross disposable income <sup>5</sup>	6.1	2.8	-0.7	-1.1	6.3	-0.8	3.6	7.5	7.4
Gross savings <sup>5</sup>	0.1	0.1	0.1	-3.5	0.8	-0.1	0.2	1.6	1.7
Final household consumption	6.0	2.7	-0.8	2.8	5.5	-0.8	3.4	5.9	5.6

<sup>1</sup> Own calculations according to data of the SR Statistical Office.<sup>2</sup> According to data at current prices.<sup>3</sup> According to data at current prices adjusted by household consumption deflators.<sup>4</sup> Positive values of expenditures are caused by their year-on-year decrease.<sup>5</sup> Gross disposable income and gross savings are adjusted by a change in net hous. rents, reserves and payments to pension insurance funds.

Since 1999, gross disposable income differs from the difference between incomes and expenditures by this change.

The second factor, which was – in examined period – represented by incomes related to compensation of employees, is a combination of unfavourable trends in the development of wages and unemployment.<sup>13</sup> However, since 2005, this factor is not in a force any more, therefore in 2006 only a moderate increase in a share of total incomes - as well as employees' compensation - in final income, or in final household consumption, is expected.

In accordance with a forecast of development in labour market (see chapter 3), the 4.7 % growth of real wages and 1.5 % growth of employment are reflected into the prognosis of development in employees' compensation and total incomes of population.

Already in 2005, the structure of usage of gross disposable household income was influenced significantly by the pension system reform. Social contributions (contributions to social funds) of a part of employed persons have been transferred from household expenditures to household savings. Therefore, household savings increased by 26 % in 2005 and their further growth by 24 % can be expected also in 2006. The growth rate of final household consumption will fall from 5.9 % achieved in 2005 to 5.6 % in 2006 indeed, however it remains one of the main driving powers of high economic growth rate.

A forecast of *public consumption* is based on the finding that the main factor influencing the changes of its extent is the development of current expenditures of state budget and budgets of municipalities and VÚC (upper-tier territorial units) decreased by expenditures on debt service. Presented finding emphasizes the need to consider the respective determinants of above mentioned public budgets approved for 2006 when elaborating the forecast of public consumption for the year 2006.

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<sup>13</sup> In the period 1999 – 2004, average annual change represented in real wages the value of -0.1 % and in number of employed persons in national economy -0.2 %.

Also the development of public consumption in the preceding years and repeated acceleration of its growth rate at the end of political cycle (in election years) has to be taken into account.<sup>14</sup> With respect to presented circumstances, we estimate the growth of real public consumption for the year 2006 at the level of 3.5 %. The economic growth rate expected in 2006 creates sufficient possibilities for such public consumption growth.

A forecast of *gross capital formation* follows the trends of investment activities and their structure in the previous years (see table 16).

Table 16

**Development of gross capital formation and its components in 2003 – 2006 (at constant prices)**

		2003	2004	2005	2006 <sup>f</sup>
Change in inventories		-2.1	18.6	24.7	18.5
Gross fixed capital formation	SKK billion	197.8	202.8	227.9	262.1
Gross capital formation		195.7	221.3	252.6	280.6
Gross fixed capital formation	Indices	98.5	102.5	112.4	115.0
Gross capital formation	S <sub>ppy</sub> = 100 <sup>1</sup>	91.8	113.1	114.1	111.1

<sup>1</sup> S<sub>ppy</sub> – same period of previous year.

<sup>f</sup> – forecast.

The volume of inventories increased markedly in the years 2004 – 2005. It was caused mostly by growing extent of unfinished investment construction, which has been reflected in the respective year in the growth of the value of gross fixed capital formation index.

Therefore, it can be expected that finishing of in-process investments will be one of the factors enlarging the increases of gross fixed capital also in 2006. As a consequence of expected fall down in inventories'

<sup>14</sup> Change in real public consumption in political cycles:

	1995 – 1998	1999 – 2002	2003 – 2006
φ annual change of real public consumption in %	7.8	1.0	2.3
Change of real public consumption in election year in %	12.5	4.9	3.5 <sup>f</sup>

<sup>f</sup> – forecast.

increase to two thirds of the 2005 level, we estimate for 2006 10.1 % increase of gross capital formation which is indeed lower than increase attained in 2005 (14.1 %), but significantly surpasses an average level of supposed increase achieved during the years 1997 – 2005 (2.6 %).

### **7.3. A forecast of economic performance of the SR in 2006**

The outcomes of external demand forecast and domestic demand forecast (of its components) eventuate into overall prognosis of GDP development in 2006, which is presented in table 17. An additional overview of the trends in GDP developments is presented also in graph 17, which illustrates a mid-term development in share of individual demand's components in used GDP generation.

The basic finding of table 17 is presented in a statement that GDP growth rate in 2006 comparing with 2005 will not slow down, but will be even higher by 0.2 %. The inside view on this determinant, thus on the structure of in the year 2005 attained and in the year 2006 expected GDP growth rate leads, however, to an unexpected question. How is it possible that GDP growth accelerates in 2006 comparing to 2005 if both components of GDP, its domestic and external demand, developed in 2005 more favourably than estimated for 2006.

The answer consist in a finding that the GDP growth rate recorded in 2005 by the SR Statistical Office has been determined as a ratio between GDP in 2005 which contained a statistical difference in the extent of SKK 0.3 billion and GDP in 2004 containing a statistical difference in the extent of SKK 7.9 billion (see web site of SR SO, quarterly national accounts). If the GDP growth rate has been calculated without a statistical difference, or if the GDP growth rate for 2006 was determined as in its 2006 forecast, then the GDP growth rate in 2005 would be equal to 7 %. It means that it would be higher than the prognosis for 2006, similarly as it can be seen in the comparison of components of GDP generation achieved in 2005 and expected in 2006.

Table 17

**Forecast of GDP development and structure of its use in 2006<sup>1</sup>**

	In SKK billion		Indices (previous year = 100)		Share in GDP use = 100	
	2005	2006 <sup>f</sup>	2005	2006 <sup>f</sup>	2005	2006 <sup>f</sup>
Household consumption <sup>2</sup>	448.5	473.6	105.8	105.6	51.2	50.9
General government consumption	162.0	167.7	102.0	103.5	18.5	18.0
Gross capital formation	252.6	280.6	114.1	111.1	28.8	30.2
Domestic demand	863.1	921.9	107.3	106.5	98.5	99.1
Net export of goods and services	12.9	8.0	.	.	1.5	0.9
Gross domestic product used	876.0	929.9	106.0	106.2	100.0	100.0
Final consumption	610.5	641.3	104.8	105.0	69.7	69.0
Gross savings	265.5	288.6	112.7	108.7	30.3	31.0

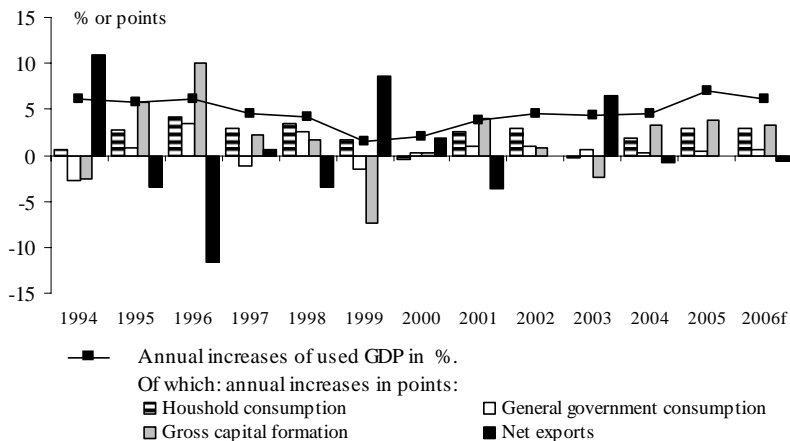
<sup>1</sup> At constant prices.

<sup>2</sup> Including consumption of non-profit organisations providing services to households.

<sup>f</sup> Forecast.

Graph 17

**Contribution of demand's components to an increase of used GDP<sup>1</sup>**



<sup>1</sup> At constant prices without statistical difference.

<sup>f</sup> Forecast.

Based on the table 17 and graph 17, it can be stated that economic growth of Slovakia will be in 2006, despite it is an election year, influenced by the same factors as in the previous year. Even a moderate increase in extent of public consumption, which was integrated in our forecast, will not change a long-term trend of decreasing share of public consumption in GDP.

Expected - or probable - development of structure of GDP use, which is reflected also in the share of individual demand components in the structure of GDP increase forecasted for 2006, creates favourable assumptions for economic growth after 2006.

## **8. AN OVERVIEW OF SELECTED LEGISLATIVE AND ECONOMIC-POLICY MEASURES**

Despite weakened position of government coalition in the parliament, it succeeded also in 2005 to adopt almost all submitted acts (with an exemption especially of the Act on student loans which was supposed to

introduce payments for a higher education). Trouble-free approval of state budget for 2006 can be considered as an important fact. In legislative process, the number of approved legal norms, in which the majority (more than two thirds) was represented by the amendments, has decreased moderately comparing with the previous year. Large part of these norms was oriented on finishing and improvement of legal norms related to realisation of the reforms (especially in health-care and pension system) and on implementation of the EU Law.

For instance, the Act on the organisation of state support to research and development; the Act on allowances to support substitute family care and the Act on illegal work and illegal employment belongs to the new legislative adopted in 2005. The Act on state debt and state guarantees (which limits significantly an approval of state guarantees) and the Act on local taxes (which introduces maximum limit for local taxes on land and buildings) have been amended. The amendment of the SR Constitution extends the control competences of the Supreme Audit Office of the Slovak Republic.

In social area, besides regular valorisations, increasing the minimum wage (to SKK 6900), increasing the tax bonus, etc., some new measures were approved. The following measures belong to them: special increasing of wages for elementary and high school teachers in average by SKK 2000 per month, and amendment of the Act on parental allowances which determines the provision of parental allowance at the uniform level of SKK 4110 also for employed parents who ensure child care by other natural or legal person. A serious intervention to households' social situation will be probably presented by the amendment of the Act on prices introducing deregulation of prices of rentals effective from 1<sup>st</sup> July 2006.

In the year 2005, the government approved several important documents of a long-term character. First of all, the *Competitiveness Strategy for the Slovak Republic until 2010 – National Lisbon Strategy*, which orientates the Slovak economy and society on the new way of its development based on knowledge, belongs to them. It is built on two pillars: on successful finishing of structural reforms and maintaining of their outcomes, and on systematic focusing on the priority development areas which can support the growth of creative potential of the Slovak economy.

The strategy defines 4 priority areas: information society; science, R&D and innovations; business environment; and education and employment (human resources). Individual priorities were concretized in four action plans, which comprehensively create a programme MINERVA (mobilisation of innovations in the national economy and development of science-educational activities).

In accordance with the EU Integrated Guidelines, the Slovak government adopted the *National Reform Programme for 2006 – 2008*, which is related to the strategy, its objectives and priorities in such manner so it shall contribute to the development of innovation potential of the Slovak economy, development of knowledge economy, and to the development of the SR population employment the most.

The *Convergence Programme of Slovakia*, which was updated for the period 2005 – 2010 at the end of the year, is a permanent component of the Slovak government's programme documents; besides this, the *SR National Euro Changeover Plan* was also adopted in 2005. Consistent fulfilment of the convergence programme enabled completion of the negotiations on Slovakia's entry to ERM II system in a half-year advance in November 2005. A central parity was set to 38.455 SKK/EUR, while a deviation of the Slovak crown exchange rate from the central parity is limited to the interval  $\pm 15\%$ .

In 2005, also the works on the *National Strategic Reference Framework* (NSRF) begun. The NSRF will be the base document regulating an exploitation of resources from the EU structural funds and cohesion fund in a programming period 2007 – 2013. During its session in June 2005, the government approved strategic objective and priorities,<sup>15</sup> which shall be followed in implementation of the EU cohesion policy in Slovakia. The first version of NSRF draft was approved by the government in October 2005; its elaboration shall be

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<sup>15</sup> The strategic objective has been set as follows: „By 2013, to greatly increase the competitiveness and efficiency of the regions and the Slovak economy as a whole, while respecting the principle of permanently sustainable development“; the strategic priorities are: a) infrastructure and regional accessibility, b) innovation, informatization, and a knowledge-based economy, c) human resources and education, and d) rural development.



completed during 2006. Generally, the NSRF should support markedly a realisation of the objectives set in Lisbon Strategy for Slovakia.

Also the *Proposal of Rules Related to the Provision of Individual State Aid to Foreign Investors* belongs to the important documents that were adopted by the government in 2005. The importance of proposal is multi-dimensional. Firstly, it creates up-to-now highly missing (uncertainty e. g. in the case of Kia/Hyundai or Hankook investment) system and order to the provision of investment stimulus; secondly, it orientates investors to the regions with higher rate of unemployment; as well as; thirdly, to the investments to more knowledge- and technology-intensive activities.

The government discussed and approved also the draft *Policy for the Implementation of Public-Private Partnership (PPP) Projects* in the interest of involving the private sector to infrastructure building or other investments of public interest. Presently, two PPP projects are being prepared: a build-up of the highway section between Žilina and Martin and the project of electronic highway toll collection system.

Privatization processes were concentrated mainly to the sectors of energetics and transportation. Basically during whole year, the negotiations with the ENEL company on privatization of Slovenské elektrárne, a. s. (Slovak power plants) were in a process – however, they were completed in 2006 though. As regards the Slovak Airlines a. s., 62 % of its shares were acquired by Austrian Airlines, in a tender on the sale of 66 % of Bratislava airport stakes the consortium Two-One (Vienna airport Schwechat with Austrian Raiffeisen Bank and the Slovak financial group Penta) has succeeded. Planned privatization of Cargo that has been prepared during 2005 will be not realised in this electoral term.

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## ECONOMIC DEVELOPMENT OF SLOVAKIA IN 2005

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