

## Economic Development of Slovakia in 2012 and Outlook up to 2014<sup>1</sup>

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### Abstract

*After the unexpectedly severe recession (2009) and equally unexpected recovery (2010), the Slovak economy balanced between recovery and a second recession for two years (2011 and 2012). The Slovak economy was more resilient against “the second wave of the crisis” than previously expected. Although the euro area was in recession in 2012, the Slovak economy grew (albeit slightly). However, after the significant deceleration of economic growth in the last quarter of 2012, the expectations of a recession have returned. After approximately one and a half year of waiting, the Slovak economy will be fully confronted with the second wave of the crisis. The economy cannot resist the second wave of the recession (which has already hit the euro area) forever. Significant slowdown hits the economy at a time when the euro area economy has started to improve gradually. This could mean that the significant decline in economic growth could be coupled with a possible alleviation of the difficulties.*

**Keywords:** economic growth, economic stability, economic policy, country study – Slovakia, forecast, labour market, public finance, monetary policy

**JEL Classification:** D11, E23, E37, E52, E62, F14, F32, J20, L60, O10, O52

### Introduction

Since the Slovak economy overcame the 2009 recession, it has been in an unstable position between recovery and the threat of renewed recession. Since the second half of 2011, expectations of a second phase of recession have been

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increasing. However, the Slovak Republic has withstood – maybe surprisingly – the second recessionary dip. At the turn of 2012 and 2013, there were strong signs of the long expected weakening of economic growth (whereas most euro area economies were experiencing their second dip). It is highly probable that in 2013, the Slovak economy will experience the full force of the second phase of the crisis, which has been present in various forms for five years.

The authors from the Institute of Economic Research SAS regularly offer their analytical view of the economic development in the past year and estimate the development in the next period. Economic growth, economic stability, production development, external economic relations, labour market parameters, prices and selected economic policy segments are reviewed every year.

## **1. Overall Economic Development**

### **1.1. Political Changes**

The political parties in the centre-right coalition led by Iveta Radičová were unable to agree on a uniform opinion about the participation of Slovakia in the solving of the debt crisis in the euro area, which led to premature elections in March 2012 and the victory of the opposition. The left-wing party SMER-SD achieved the majority – 83 out of 150 parliamentary seats. This enabled SMER-SD to create a single-party government for the first time in the history of the independent Slovak Republic, which could then set its goals in line with its programme, irrespective of its (non-existent) coalition partners, and begin their realisation with sufficient support from the parliament.

The programmes of government of Robert Fico and the former government of Iveta Radičová have some common points and tasks. However, the programmes have a different understanding of their hierarchy and connections among them, and thus also of the strategic approach to the socio-economic development. Promotion of economic growth, mentioned in both programmes, was linked to the improvement of business environment by the government of Iveta Radičová. However, the government of Robert Fico ties it to “certainties for the people”. Thus, the current government of Robert Fico decided for a different approach than the government led by the same politician in 2006 – 2010, when it accepted and only slightly modified the reforms of the socio-economic system made by the governments of M. Dzurinda in 1998 – 2006.

In the first year of the government’s term, the discontinuity of the programme and related political and economic discontinuity of the left-wing government with the institutional framework of the functioning of the economy was revealed

primarily in three areas. Firstly, the flat tax principle was removed from the tax system and replaced by progressive taxation. Secondly, the second pension pillar, linking pensions to household savings, was weakened. The third group of economic policy measures dealt with the labour market with the aim to support the position of employees even at the expense of labour market flexibility. It is impossible to evaluate the consequences of the above-mentioned economic policy measures, as well as the results of other programme initiatives of the current government, because some of them have been in effect only since 1<sup>st</sup> January 2013 and others are being discussed in the parliament at the time of writing. Moreover, mainly the external environment, influenced by the fluctuation in the global economy and the tense situation in the euro area, determines the development of the Slovak economy. Furthermore, the current government linked the pledge to “assert legitimate interests of the Slovak Republic in the EU” with the declaration of “shared responsibility for the fulfilment of the strategic goals of the EU”. However, these declarations are very vague. Future development will determine and verify their real content and impact.

## **1.2. International Relations**

Because of the current high level of division of labour and globalisation of the world economy, the small Slovak economy can only function in a dense network of relations with abroad. Table 1 documents their intensity and development in the recent years.

The improvement in export performance of the Slovak economy continued also in 2012. The share of export of goods and services in the Slovak GDP was more than double the EU-27 average (the export to GDP ratio in the EU-27 equalled 40.1% in 2012 and 44.9% in 2012). In eleven EU countries, especially in the new member states and Ireland, the export to GDP ratio increased even faster than in the SR. Consequently, Ireland took the leading position in 2012 with 106.6%.

Data on the growing shares of foreign-controlled enterprises (FCE) in employment and industrial production show the increasing participation of the Slovak economy in the international division of labour (documented by the increasing export to GDP ratio) linked to changes in ownership. Data on the share of FCE in industrial production and employment and the share of the domestic enterprises in production and employment show that in 2011, labour productivity (measured as production per one worker) was 2.5-times higher in FCE than in domestic enterprises. The difference in productivity and the related difference in competitiveness indicate that in the future, the FCE sector will be further

reinforced in the Slovak industry, at least until effective economic policy measures are taken to support the competitiveness of domestic enterprises.

Table 1

**Selected Characteristics of Slovak Economic Relations with Abroad**

			2007	2008	2009	2010	2011	2012
Ratio of exports of goods and services to GDP, current prices, % <sup>1</sup>			86.9	83.5	70.9	81.2	89.1	95.6
Share of FCE <sup>2</sup> , % <sup>1</sup>	In employment in industry		51.3	54.1	56.5	59.3	61.1	.
	In industrial production		74.5	76.7	78.4	80.4	81.1	.
Ratio to GDP, %	Repatriation of profits <sup>3</sup>	To Slovakia abroad	1.0	1.6	1.8	2.1	1.5	1.5
		From Slovakia abroad	5.9	5.8	4.8	7.0	5.8	5.7
	Net direct investment <sup>3</sup>	From Slovakia abroad	-0.4	-0.4	-0.7	-0.7	-0.4	0.1
		From abroad to Slovakia	2.6	3.2	0.0	1.3	1.5	2.2

<sup>1</sup> SO (Statistical Office) SR database.

<sup>2</sup> FCE – foreign-controlled enterprises minus international public enterprises.

<sup>3</sup> NBS (National Bank of Slovakia) database.

The transformation of Slovakia into a small part of the world economy, which is more and more subject to the will of the foreign enterprises, has its roots in foreign direct investment (FDI). Although FDI inflows to Slovakia were interrupted in the 2009 recession year, they have been gradually recovering. The repatriation of FCE profits, which is part of the reverse flow to FDI, did not fall during the 2009 recession. Apparently, it was the contribution of Slovak subsidiaries to the functioning of parent companies.

It would be unprofessional and misleading to lose sleep over the consequences of the international flow of capital for Slovakia. Foreign direct investment and related repatriation of profits are advantageous for the investors, but hold many advantages for Slovakia as well. Not FDI inflows to Slovakia, but insufficient FDI outflows from Slovakia (visible when comparing the last two rows in Table 1) should be considered a disadvantage for the Slovak economy. Figure 1 shows Slovakia's insufficient export of capital compared with other countries.

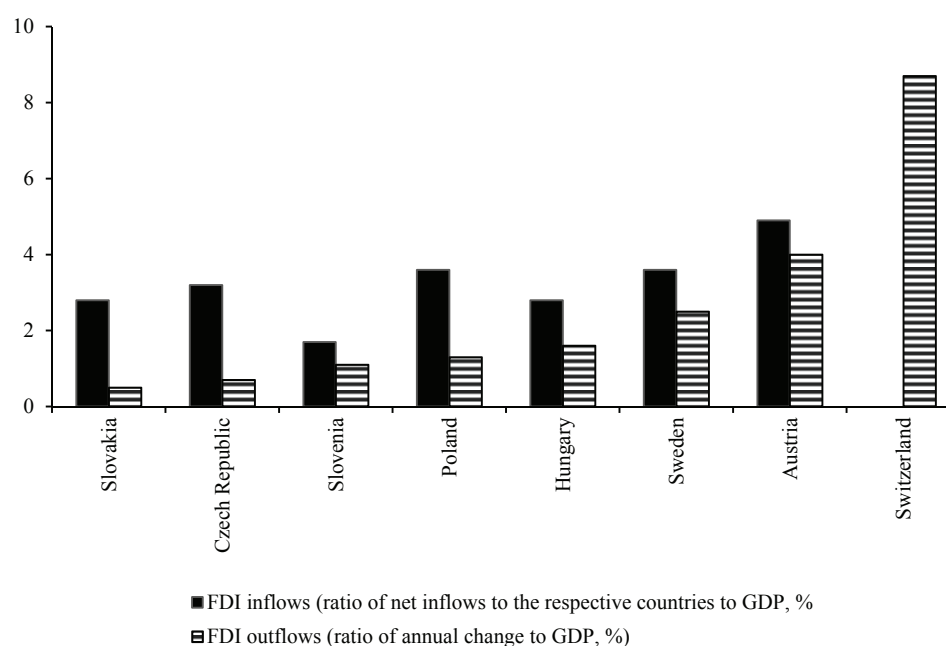
The relative five-year average of FDI inflows (measured as the ratio of net inflows to GDP) in 2007 – 2011 was approximately on the same level as in the EU member states included in Figure 1. However, among the selected countries Slovakia reached the lowest level in the relative outflows of FDI sent abroad in the selected period.

Table 1 indicates that: (1) the firm ties of the Slovak economy with abroad were weakened only temporarily and have been strengthening since 2009 (also in 2012). Data in Table 1 also show that: (2) Slovakia participated in the world

economy also in 2012, mainly as a passive recipient of foreign initiatives. The gradual strengthening of active links of the Slovak economy with the world is becoming a more and more urgent challenge for our economic policy. Slovakia has to fulfil this condition to proceed to a higher level of economic development.

Figure 1

**Comparison of the Relative FDI Inflows and Outflows** (expressed as FDI ratio to GDP, %) **in Selected Countries, 2007 – 2011 Average**



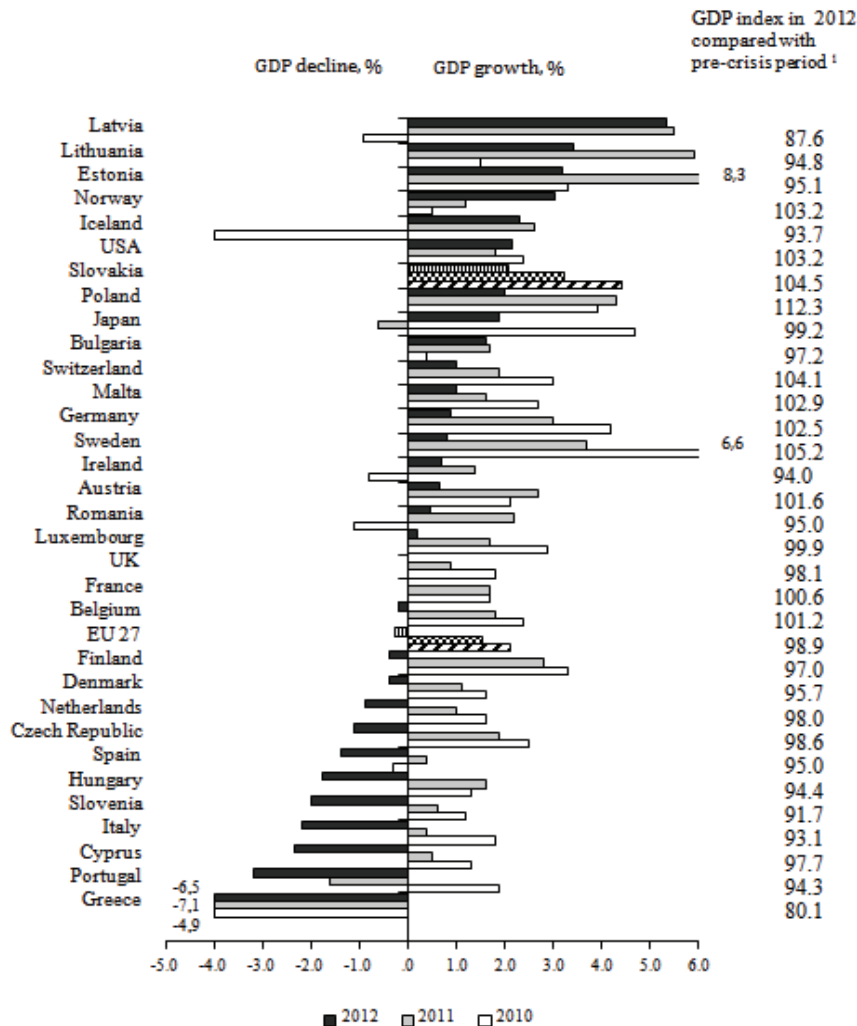
Source: Eurostat database (2013a).

Economic growth rate represents an important trend of Slovakia's economic development. Figure 2 shows the growth rate reached in 2012 in the context of previous development.

Figure 2 shows that the recovery of the European economy in 2010 and 2011 was interrupted by a new wave of recession. According to the standard definition of recession – a negative GDP change in two consecutive quarters – out of thirty European countries, included in Figure 2, twenty, i.e. two thirds, were in recession in 2012.

However, the second bottom was less deep than its predecessor was in 2008 – 2009. In 2009, the EU-27's GDP fell by 4.3%, which is 14-times the 0.3% decline in GDP recorded in 2012.

Figure 2  
Annual GDP Change in 2010, 2011 and 2012



<sup>1</sup> Year 2012 in Denmark, Estonia, Ireland, Italy, Latvia, Luxembourg, Sweden, UK and Japan compared with 2007, in other countries compared with 2008.

Source: Eurostat database (2013a).

In terms of the economic growth in 2012, Slovakia belongs among the few relatively successful European countries. GDP growth slackened considerably, but did not slide into negative growth. In the list of European countries by GDP index (2012/2009), Slovakia ranked third after Poland and Sweden. More positive economic growth results also helped Slovakia in the process of real convergence measured as GDP per capita (see Table 2).

Table 2

**Gross Domestic Product per capita, Current Prices (PPS; EU-15 = 100)**

Country	2000	2007	2012
Germany	101	104	112
Austria	110	111	119
Portugal	70	71	69
Greece	75	81	69
Hungary	51	55	60
Poland	41	49	61
Czech Republic	64	74	73
Slovakia	46	61	69

Source: European Economy (2012), pp. 47 – 48.

In 2008 – 2012, Slovakia reduced the convergence gap between itself and the advanced European economies (EU-15) by 8 percentage points (p. p.), and between itself and the Czech Republic from 13 to 4 p. p., reaching the level of Greece and Portugal. The paradoxical nature of this approach is that both countries (which are part of the EU-15) “reversed” towards the lower Slovak GDP level. This, together with the economic growth results in such advanced countries as Germany and Austria, force us not to overestimate the results reached by Slovakia in terms of real convergence in the recent years.

Comparing recessions, which hit the European economy in 2009 and 2012, should not create the impression that each of them is part of an independent business cycle. The first one – initiated by the global financial crisis – released in the form of a debt crisis in several European countries the trigger of the second one. However, the pathology of government and bank debts and the inability to finance them by further increasing the debt burden had been revealed already during the 2009 recession. This justifies the view that since mid-2008 until sometime in 2013 (impossible to predict yet), the European economy has been experiencing a crisis period with two recessionary bottoms – one deeper and one shallower.

Despite the close connection with economic development in the past three to four years, the immediate cause of the 2012 recession in Europe was the debt crisis in some euro area countries and the related uncertainty of their creditors and thereby of the future of the European economy. In 2012, uncertainty was also fuelled by doubts about the appropriateness and effectiveness of the policies (mechanisms) aimed at reducing the debt of the peripheral euro area countries, and also social eruptions and political turmoil in these countries, which led to recommendations that they should leave the euro area.

The form and execution of the decision to create a banking and fiscal union, which should enhance the European integration in the long run, remained uncertain. Because of the above-mentioned uncertainties, the private sector

confidence in the economic recovery in the euro area and the whole EU remained very low, “liquidity in core economy banks (the euro area and the EU) was being deposited at core central banks or in relatively safe government bonds” (IMF, 2012).

In 2012, uncertainty and falling confidence in the positive development of the European economy were fuelled also by the fact that extensive financial assistance for the troubled euro area countries is a prerequisite to lowering their debts to a manageable level, but in order to eliminate the causes of the debt crisis, it is necessary to restore their competitiveness. In countries with their own currency, this is achieved by traditional devaluation, which allows the current account of the balance of payments to return to black numbers. In countries remaining in the euro area, the solution to the debt crisis leading to the balancing of the current account without traditional devaluation can be achieved through the so-called real internal devaluation following a reduction in labour costs and public spending.<sup>2</sup>

Data in Table 3 are related to internal devaluation and restoration of competitiveness in the countries deep in crisis.

The data referred to in part A of Table 3 suggest that in 2012, there was still a current account deficit in all countries (except Ireland), in which the debt crisis unfolded in 2008 or 2009. Insufficient external competitiveness, which is also reflected in the negative GDP growth rate, was caused by a slower decline in wages, i.e. real costs per employee, but also by a slower reduction of the government budget deficit compared with the pace of internal devaluation, necessary to replace the traditional external – currency devaluation (see parts E and H of Table 3).

The restoration of external balance and economic growth without further internal devaluation would be theoretically possible if labour productivity growth accelerated because of increased investment. However, internal resources to finance investment cannot invigorate an economy in the debt crisis, because the savings in wages, which could be transformed into investment, are not high enough. The relatively high level of wages also hampers potential foreign investors awaiting an adequate return on invested capital. Because of the above-mentioned circumstances, the annual change in gross capital formation in the selected countries (see data in part D of Table 3) in 2009 – 2012 was negative.

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<sup>2</sup> “Unit labour cost reductions improve the competitiveness only if, and to the extent that, they reduce a country's goods prices... lower relative prices... can reduce the current accounts structurally, i.e. through improvements in competitiveness... the necessary rebalancing process of the Eurosystem will require a decade of austerity, stagnation and real devaluations in the deficit countries, coupled with an extended period of inflation in the surplus countries” (Sinn, 2013, pp. 11 – 12 and 19).



Table 3<sup>1</sup>

A. Ratio of Current Account to GDP, %					B. Annual Change in GDP, %			
Country	2009	2010	2011	2012	2009	2010	2011	2012
Greece	-14.4	-12.8	-11.7	-8.3	-3.1	-4.9	-7.1	-6.4
Cyprus	-10.7	-9.2	-4.2	-6.3	-1.9	1.3	0.5	-2.3
Portugal	-10.8	-9.7	-6.6	-3.0	-2.9	1.4	-1.7	-3.2
Spain	-4.8	-4.4	-3.7	-2.4	-3.7	-0.3	0.4	-1.4
Italy	-2.0	-3.5	-3.3	-1.2	-5.5	1.8	0.4	-2.2
Ireland	-2.3	1.1	1.1	2.3	-5.5	-0.8	1.4	0.7
<b>Slovakia</b>	<b>-2.6<sup>2</sup></b>	<b>-3.7<sup>2</sup></b>	<b>-2.1<sup>2</sup></b>	<b>2.3<sup>2</sup></b>	<b>-4.9</b>	<b>4.4</b>	<b>3.2</b>	<b>2.2</b>

C. Annual Change in GDP/Employee, %					D. Annual Change in Gross Capital Formation, %			
Country	2009	2010	2011	2012	2009	2010	2011	2012
Greece	-2.5	-2.4	-1.6	2.0	-13.7	-15.0	-19.6	-14.4
Cyprus	-1.3	1.3	0.0	1.7	-9.7	-4.9	-13.1	-22.0
Portugal	-0.3	3.0	-0.1	1.1	-8.6	-4.1	-12.1	-14.1
Spain	2.9	2.0	2.2	3.2	-18.0	-6.2	-5.3	-9.0
Italy	-2.7	2.7	0.3	-1.0	-11.7	2.1	-1.8	-8.1
Ireland	2.9	3.6	3.6	1.7	-27.7	-22.7	-12.2	-4.0
<b>Slovakia</b>	<b>-3.0</b>	<b>6.0</b>	<b>1.4</b>	<b>2.4</b>	<b>-19.7</b>	<b>6.5</b>	<b>14.2</b>	<b>-6.2</b>

E. Ratio of Government Budget Balance to GDP, %					F. Government Debt to GDP, %			
Country	2009	2010	2011	2012	2009	2010	2011	2012
Greece	-15.6	-10.7	-9.5	-10.0	130	148	171	177
Cyprus	-6.1	-5.3	-6.3	-6.3	59	61	71	90
Portugal	-10.2	-9.8	-4.4	-6.4	83	94	108	119
Spain	-11.2	-9.7	-9.4	-10.6	54	62	69	86
Italy	-5.5	-4.5	-3.8	-3.0	116	119	121	127
Ireland	-13.9	-30.8	-13.4	-7.6	65	92	106	118
<b>Slovakia</b>	<b>-8.0</b>	<b>-7.7</b>	<b>-5.1</b>	<b>-4.3</b>	<b>36</b>	<b>41</b>	<b>43</b>	<b>52</b>

G. Interest Rate on Long-term Government Bonds, %					H. Real Costs per Employee, Annual Change, %			
Country	2009	2010	2011	2012	2009	2010	2011	2012
Greece	5.2	9.1	15.8	.	1.2	-3.7	-4.4	-6.4
Cyprus	4.6	4.6	5.8	.	2.4	0.7	0.5	-2.5
Portugal	4.2	5.4	10.2	.	1.9	0.3	-1.4	-3.2
Spain	4.0	4.3	5.4	.	4.3	-0.4	-0.3	0.2
Italy	4.3	4.0	5.4	.	-0.4	1.9	0.0	-0.3
Ireland	5.2	5.7	9.6	.	3.9	-0.9	0.0	-0.9
<b>Slovakia</b>	<b>4.7</b>	<b>3.9</b>	<b>4.5</b>	<b>.</b>	<b>3.7</b>	<b>4.5</b>	<b>-0.6</b>	<b>-1.6</b>

<sup>1</sup> Based on European Economy (2012).<sup>2</sup> Based on NBS (2013c); SO SR (2013a).

Labour productivity increased despite the insufficient pace of internal devaluation and declining investment (see part C of Table 3), adding to unemployment growth. The impact of unemployment on further decline in wages and the steep rise in interest rates on government loans (see part G of Table 3), which puts pressure on the consolidation of government finances, influence the process of further real internal devaluation.

The summary of the previous findings is related to the fact that devaluation is the primary factor in restoring stability in the countries with their own currency. Rapid progress of traditional devaluation resulting from the nature of its mechanism quickly restores competitiveness and shifts secondary stability parameters (wage level, public finance parameters) so that economic growth can be restored (together with its prerequisites, investment and employment, which also recover).

Saving the single currency and at the same time excluding the possibility of its devaluation requires wage cuts and consolidation of public finances to take on the role of primary stability factors. Current account balance and the resulting competitiveness of the countries in crisis become secondary factors of stability, dependent on the development of internal devaluation. However, as shown in Table 3, despite the extensive financial support from the so-called temporary and permanent European rescue mechanisms, this process is very slow – it has already taken three years. Secondly, progressive devaluation does not prevent the deterioration of investment, employment and negative economic growth results. Consequently, the recession is being overcome more slowly in the countries hit by the debt crisis, which in turn extends the state of uncertainty and negative expectations across the EU.

The values of parameters describing the relation between several aspects of the debt crisis and recession in the risk countries of the euro area are compared with the processes in Slovakia and the EU-27. Development trends in the Slovak economy are more positive than in the risk euro area countries, particularly in terms of the relation between the performance and competitiveness of the economy.

The results of the Slovak economy are worse with regard to public finances. It will be impossible to separate the improvement of public finances from the improvement of the structure of expenditures and from focusing on sustainable growth factors (education and innovation). With regard to the expected levelling of competitiveness of the individual euro area countries, only this basis will ensure expansion of investment activity in Slovakia (overcoming of the decline in fixed capital formation) together with wage and employment growth, which are the main courses of social convergence.

### 1.3. Main Trends in the Slovak Economy

Even if we focus our attention on the processes in the Slovak economy and the internal factors of its development, we cannot avoid looking beyond the borders of Slovakia. Contrary to the previous analysis, which focused primarily on the trends in the European economy as a comparative basis for economic development in the Slovak Republic, from now on the elements of external development will be considered secondary and taken into account only sporadically as variables, which help to explain the ongoing trends in the Slovak economy.<sup>3</sup>

Table 4 confirms that the second recessionary bottom of the dragging economic crisis, which affected most European economies in 2012, resulted only in a significant economic slowdown in the Slovak economy. The asynchronous trends of the economic performance in the Slovak Republic and Europe are not out of accord with the deep integration and dependence on foreign (especially European) countries. Quite the contrary, the explanation is based on a strong penetration of FCE in the Slovak economy and especially the industry. In 2011, more than 80% of industrial production was made by foreign investors' enterprises, which utilized their high technical level (and related high labour productivity) and low cost of labour.<sup>4</sup> Thanks to that, "foreign-controlled enterprises in the automotive industry (and some other segments of the economy) in Slovakia generate resources for research, development and modernisation in the parent companies and other subsidiaries of the multinational corporations" (Morvay et al., 2012).

The FCE activities in the Slovak economy contributed significantly to keeping the economy growing, but did not prevent a significant slowdown. The main reason is that in 2012, the largest part of the economy, consisting of domestic enterprises, succumbed to recessionary pressures. The expansion of the industrial FCE also contributed to the result to a certain extent. The negative impact of the FCE on the economic growth and consumption trends is shown in Figure 3.

<sup>3</sup> It has been stated numerous times that in terms of division of labour and cooperative relations, (capital) fundaments and important components of the institutional and related economic policy framework, the Slovak economy is de facto an integral part of the European economy, functioning in the Slovak territory. The Europeanisation of the Slovak economic area (related to the formation of the European optimum currency area) is by no means finished. However, current decisions in favour of maintaining the euro area go beyond the point of possible return to the initial stage of the European economic integration.

<sup>4</sup> In 2008 (the last period with available data), production per worker in the automotive industry in Slovakia equalled 126% of the level reached in Germany (Eurostat – Data Explorer, 2013a). At the same time, in 2011, Slovakia only reached 22% in gross wages and 27% in net wages in the whole business economy compared with Germany (Eurostat – Data Explorer, 2013b).

Table 4

## Socio-economic Development of the Slovak Republic, 1998 – 2012

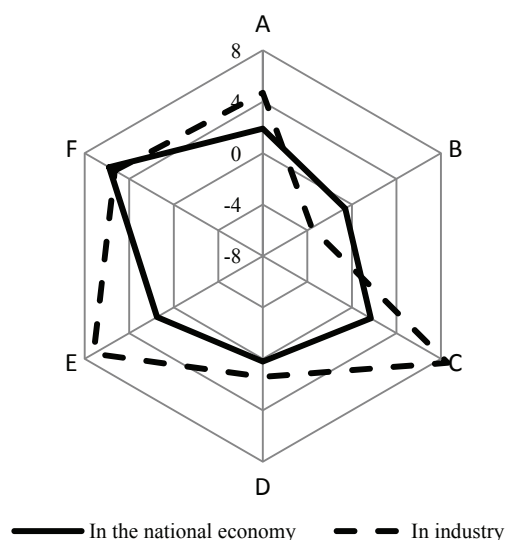
	1998	2000	2002	2004	2006	2007	2008	2009	2010	2011	2012
<b>A. Results and factors of economic performance</b>											
GDP index, previous year = 100 <sup>1</sup>	104.4	101.4	104.6	105.1	108.3	110.5	105.8	95.1	104.2	103.3	102.0
Labour productivity index, previous year = 100 <sup>2,5</sup>	104.9	103.4	104.4	104.8	104.3	107.9	107.5	97.8	106.3	101.4	101.4
Unit labour costs, PPP, Austria = 100 <sup>7</sup>	.	34.8	33.4	31.3	31.0 <sup>8</sup>	37.3	38.6	39.8	38.7	38.6	37.7 <sup>9</sup>
FDI, EUR billion	0.5	2.1	4.2	2.4	3.7	2.6	3.1	0.0	2.0	2.2	3.5
Cost profitability in non-financial corporations, %	0.4	2.7	4.5	7.0	7.7	7.6	6.2	5.1	6.2	6.3	5.5
<b>B. Stability indicators</b>											
Inflation rate, % <sup>3</sup>	6.7	12.2	3.5	7.5	4.3	1.9	3.9	0.9	0.7	4.1	3.6
Ø interest rate on household loans, % <sup>4</sup>	10.35	8.53	10.20	10.98	11.72	11.82	10.60	7.69	7.05	6.82	6.63
Public finance balance/GDP, %	-3.7	-12.3	-5.7	-3.3	-3.4	-1.9	-2.2	-6.8	-7.9	-4.6	-4.35
Share of general government consumption in GDP, % (c. p.)	22.2	20.1	20.3	19.0	18.8	17.1	17.5	19.8	19.3	18.0	17.6
Annual Δ in productivity <sup>2</sup> – Annual Δ in real wages in the national economy, percentage points	2.2	8.3	-1.1	2.9	2.8	3.8	0.2	-3.3	5.8	2.4	2.6
Net exports of goods and services/GDP, % <sup>1</sup>	-9.7	-2.5	-6.5	-1.5	-1.3	3.1	3.1	3.8	-1.0	8.0	11.2
<b>C. Social development</b>											
Year-on-year employment index, LFSS <sup>5</sup>	99.7	98.6	100.2	100.3	103.8	102.4	103.2	97.2	98.0	101.9	100.6
Ø unemployment rate, % <sup>5</sup>	12.5	18.6	18.5	18.1	13.3	11.0	9.6	12.1	14.4	13.5	14.4
Annual change in real wages, %	2.7	-4.9	5.8	2.5	3.3	4.3	3.3	1.4	2.2	-1.6	-1.2
Index of real wages in the national economy, 1989 = 100	93.6	86.9	92.8	93.6	102.8	107.2	110.7	112.2	114.7	112.9	111.5
Index of real household consumption per capita, 1989 = 100	99.5	101.1	112.3	115.4	129.8	138.8	147.3	146.0	145.6	144.7	143.8
Share of social benefits in disposable household income, %	22.2	21.9	22.4	21.3	21.3	20.7	20.1	22.3	20.4	22.3	23.3
Share of social protection expenditure in GDP, % <sup>6</sup>	14.5	14.5	14.9	12.1	12.3	10.6	10.2	12.3	12.2	11.9	.

<sup>1</sup> At constant prices (year 2000). <sup>2</sup> GDP at constant prices per one worker. <sup>3</sup> Based on Harmonized Index of Consumer Prices (HICP). <sup>4</sup> On loans taken from commercial banks, average per annum. <sup>5</sup> Based on Labour Force Sample Survey methodology (LFSS). <sup>6</sup> Public finance expenditures, based on Eurostat. <sup>7</sup> WIW (2011). <sup>8</sup> 2005.

Source: SO SR; NBS; MF SR.

Figure 3

**Parameters of National Economy and Industrial Development Influencing Consumption (Ø value in 2009 – 2012)**



	Parameter values	
	National economy	Industry
A – year-on-year change in production, %	1.9	4.7
B – year-on-year change in employment, %	-0.6	-3.6
C – year-on-year change in labour productivity (product per employee)	1.7	8.6
D – year-on-year change in real wages, %	0.2	1.4
E – adequacy of real wages to productivity development (E = C – D)	1.5	7.2
F – cost profitability in non-financial corporations, %	5.8	5.3

Source: SO SR: Slovstat database (2013b).

Because of the leading position of the FCE in the Slovak industry, trends in industry (compared with trends in the overall economy in Figure 3) can be interpreted as a consequence of the operations of industrial FCE.

The interest of international corporations in utilizing the best combination of factors of production at the disposal of their subsidiaries in the SR (modern technologies and low cost of relatively skilled labour) resulted in faster production growth (parameter A of Figure 3), but also faster decline in employment (parameter B of Figure 3) in industry compared with the overall economy. The combination of both processes resulted in a 5-times higher productivity growth in industry than in the overall economy (parameter C of Figure 3).

At the same time, in 2009 – 2012, industrial FCE sought to retain skilled workers by means of a slight increase in their real wages. This contrasts with the stagnation in real wages in the non-industrial economy (parameter D of Figure 3).

Nevertheless, Figure 3 (parameter E) shows a significant – almost 5-times higher – advance in labour productivity growth over the increase in real wages in industry than in the overall economy.

The above-mentioned consequences of industrial FCE expansion, which translated into development trends in the whole industry, limited the increase in household consumption (private consumption). Public consumption was reduced because of the efforts of the FCE to reduce profits (taxable income), which were realized e.g. through transfer prices when selling goods and services between parent companies and their subsidiaries in the SR. As a result, industry cost profitability declined below the level of the overall economy (parameter F of Figure 3).<sup>5</sup>

To summarize the above-mentioned trends, direct and indirect effects of the FCE activities can be seen on the national-economic level. Direct effects resulted in an increase in the FCE production, leading to an increase in net exports and GDP growth. Indirect effects, resulting from the FCE activities aimed at earning a higher return on invested capital, were the result of the way in which the FCE used their factors of production. This led to a decline in consumption, which is part of aggregate demand, and thereby to GDP decline. The dichotomy between direct and indirect effects of the FCE operating in the Slovak economy implies the existence of a labour market with an excess of the demand for job opportunities over the supply. Foreign-controlled enterprises in the Slovak industry not only utilized, but also supported such a market in 2009 – 2012. However, if we assess the FCE activities in the Slovak economy with regard to maintaining economic growth in this period, it is necessary to acknowledge that their direct – positive effects prevailed over the adverse – indirect effects.

Figure 4 shows the socio-economic development through selected partial but representative indicators. Changes in the base of the socio-economic development – in the development of economic performance – are illustrated by the development of gross value added (GVA). The expression of GVA at constant prices allows its comparison with the development of employment and labour productivity. The expression of GVA at current prices combined with the development of income makes it possible to examine the distribution of income and the links between performance development and changes in macroeconomic stability.

The expanding gap between the development of GVA at constant prices and the development of employment indicates the impact of labour productivity (and the underlying increasing impact of changes in technology and organisation) on the increasing economic performance of the Slovak economy. On the other hand,

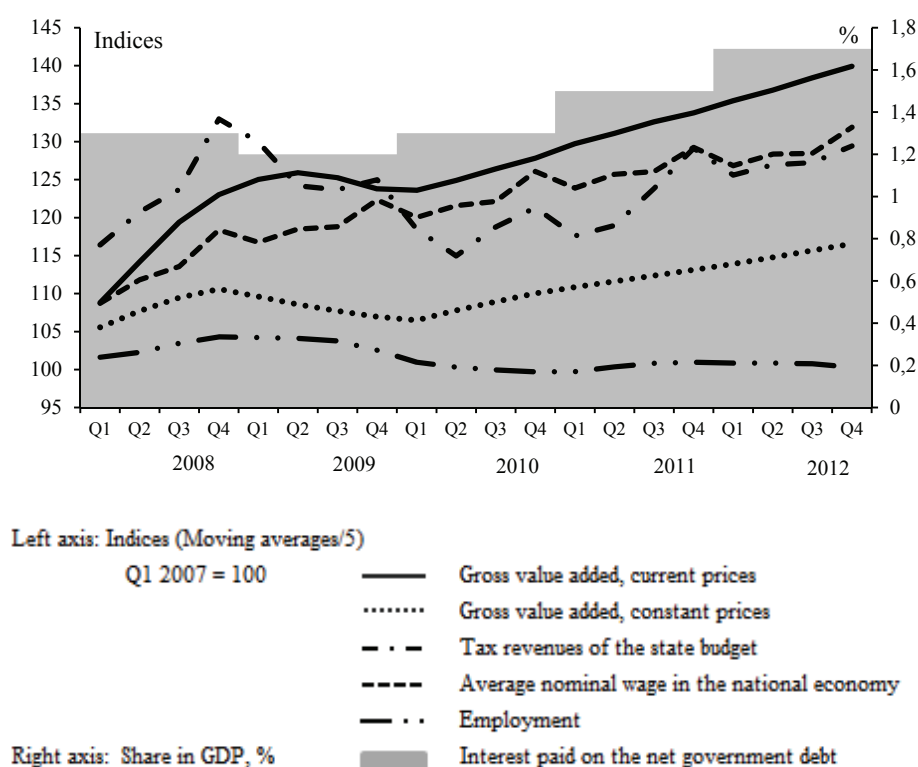
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<sup>5</sup> In 2009 – 2011, average cost profitability in industrial FCE was about a third lower than in the overall industry (SO SR, 2012a, pp. 35 and 44).

as shown in the analysis in Figure 3, the gap also indicates that labour productivity growth is not linked to real wage development, which could (as opposed to reality, in which it cannot) generate additional consumer demand and thus additional employment.

Figure 4

**Selected Trends of Socio-economic Development in the SR after 2007**



Source: Eurostat database; SO SR and MF SR.

Figure 4 also shows that nominal wage growth lagged behind the GVA growth at current prices throughout the whole period. A significant lag of the state budget revenues behind the GVA at current prices is recorded after 2009. The indicated changes in the distribution of GVA at current prices are (probably) to a lesser extent translated into an increase in profits of financial corporations,<sup>6</sup> and largely confirm the hypothesis that part of FCE profits is moved from Slovakia to parent companies through inter-company transactions.

<sup>6</sup> In 2008, financial corporations in the SR reached a loss of EUR 17 million. Later they reached a profit: EUR 767 million in 2009, EUR 554 million in 2010, EUR 1 125 million in 2011 and EUR 1 614 million in 2012, i.e. 2.3% GDP at current prices (SO SR, 2009 – 2013).

Macroeconomic stability development is represented by the interest paid on the net government debt, which in 2012 exceeded the level of 2009 by 42%. Even at its present size (1.7%) and especially with the expected lower rate of economic growth, it becomes a serious obstacle to the consolidation of public finances.

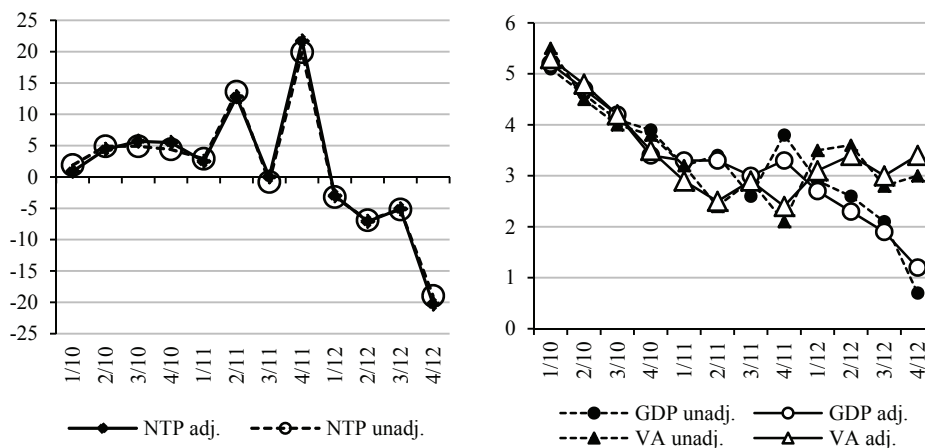
## 2. Economic Development by Branches

Despite the prevailing slowdown in economic performance, real growth in value added, which in general characterizes the performance of branches, did not decelerate in 2012 (unlike GDP). On the contrary, it accelerated to 3.2% compared with 2011.

The gap between GDP growth and value added was caused by the development of net taxes on production (NTP), which declined by 9.2%, resulting in a 1.2% lower GDP growth compared with value added. Figure 5 shows the unusual development of net taxes already in 2011. To some extent, the decline in 2012 is a consequence of the development in the previous year.

Figure 5

**Year-on-year Change in Net Taxes on Production, GDP and Value Added at Constant Prices (quarters of 2010 – 2012), %<sup>1</sup>**



<sup>1</sup>Indicators are both unadjusted and adjusted (seasonally and working-day adjusted).

Source: Eurostat database.

The gap between the development of GDP and value added is clear in the individual quarters, especially in the fourth quarter of 2012, when the development of net taxes on production resulted in a 2.3 p. p. lower GDP growth



compared with value added. Figure 2.1 shows that seasonally and working-day adjusted indicators reduce the negative results of the GDP development in the fourth quarter of 2012 to a certain extent – from 0.7% to 1.2%.

According to the quarterly SO SR estimates, value added in individual sectors of the economy developed in a significantly different way. In industry (and in manufacturing), information and communication, and professional services, value added growth accelerated and did not decelerate even in the fourth quarter (see overview in Table 5).

Table 5  
Value Added Creation by Branches, 2008 – 2012

	2008	2009	2010	2011	2012	2012			
						Q1	Q2	Q3	Q4
						Year-on-year change, % (based on 2005 prices)			
Value added total	6.4	-4.7	4.4	2.7	3.2	3.5	3.6	2.8	3.0
Agriculture <sup>1</sup>	11.6	-2.0	-13.6	20.5	-5.4	-11.9	-3.6	-0.1	-9.2
Industry total	4.4	-16.1	15.1	5.2	10.6	9.8	11.5	10.4	10.6
Manufacturing	7.7	-14.9	20.9	6.1	13.4	12.5	14.4	13.3	13.3
Construction	20.3	-7.6	-1.0	4.8	-6.2	-22.9	5.2	-0.6	-9.2
Trade, transportation and accommodation <sup>2</sup>	11.5	-7.4	0.2	-2.5	-0.7	-5.8	5.2	-4.6	2.4
Information and communication	-0.9	9.7	-0.2	6.1	9.4	15.0	8.1	4.2	11.2
Financial and insurance activities	-4.2	5.1	-2.5	5.3	-2.6	-2.4	-5.9	-3.0	1.1
Real estate activities	4.5	0.6	7.0	11.3	7.5	16.8	0.9	11.2	2.0
Professional services <sup>3</sup>	10.9	2.4	2.9	0.8	4.5	8.3	4.2	-0.7	7.0
Public services <sup>4</sup>	1.6	7.5	4.1	-5.0	0.3	10.4	-9.9	1.7	1.5
Other services <sup>5</sup>	-21.7	33.1	2.1	7.9	1.3	4.3	-3.6	4.2	-0.3

<sup>1</sup> Agriculture, forestry, fishing. <sup>2</sup> Wholesale and retail trade, repair of motor vehicles and motorcycles; transportation, storage, accommodation and food service activities. <sup>3</sup> Professional, scientific and technical activities; administrative services. <sup>4</sup> Public administration, defence, compulsory social security; education; human health and social work activities. <sup>5</sup> Art, entertainment and recreation; other activities.

Source: Slovstat database.

The 2012 data are *quarterly estimates*, which can change considerably in the revision of the national accounts, especially with regard to the development by branches.<sup>7</sup> Although the data in Table 5 are interesting, in our opinion, they are not very reliable and therefore will not be thoroughly analyzed. The development in individual branches is examined based on business statistics.

In 2012, the development in *agriculture* continued without any major changes. Although the harvest of main crops was lower than in the previous year, real

<sup>7</sup> Just two examples: according to 2011 data, reported in 2012, value added in agriculture, forestry and fishing declined by 20.2% at constant prices, but according to data published in 2013 it increased by 20.5%. Similar data appear in industry: 12.8% and 5.2% respectively.

revenues of farmers selling their own products increased by 2.1% (in 2011, it was 1.6%), and nominal revenues increased by 9.1%. Profits increased further in 2012 and reached EUR 49 million (compared with EUR 32 million in 2011). However, cost profitability in agriculture remains low – only 2.4%.

In 2012, exports of agricultural products increased by 31%; after two years of foreign trade deficit in this branch a positive balance was achieved.

In 2012, the increase in production in *industry*<sup>8</sup> was faster than in 2011 – according to the industrial production index it increased by 10.3%, compared with 7.2% in 2011. On the other hand, the increase in real revenues for own performances and goods slowed down to 7.3%, compared with 10.2% in 2011. After a temporary increase in 2011, employment in industry declined by 0.9%. The increase in production and real revenues slackened considerably in the fourth quarter of 2012, with the exception of the development of revenues at current prices, which was stable in all four quarters. Table 6 offers a more detailed view.

*Manufacturing* followed a similar trend, albeit with more positive values of the indicators. However, economic slowdown and a deepening decline in employment in the fourth quarter are obvious in this branch as well (Table 6).

**Table 6**  
**Selected Indicators of the Development of Industry in the SR**

	2008	2009	2010	2011	2012	2012			
						Q1	Q2	Q3	Q4
		Industry							
Revenues for own performances and goods <sup>1</sup>	3.8	-18.0	19.2	10.2	7.3	9.4	7.3	9.5	3.5
Industrial production index <sup>2</sup>	3.0	-14.1	18.3	7.2	10.3	9.4	12.8	16.0	3.4
Employment <sup>3</sup>	0.6	-15.0	-3.8	4.3	-0.9	0.2	-0.5	-0.8	-2.6
Revenues (EUR billion, current prices)	72.8	57.4	67.5	76.6	82.3	20.7	20.5	20.0	21.1
Employment (in thousands) <sup>4</sup>	586	498	479	500	495	499	497	496	488
	Manufacturing								
Revenues for own performances and goods <sup>1</sup>	2.9	-19.9	20.9	10.8	8.3	10.6	8.7	10.5	3.9
Industrial production index <sup>2</sup>	2.6	-15.5	20.1	8.9	12.2	11.6	15.7	18.3	3.7
Employment <sup>3</sup>	1.3	-16.0	-3.8	5.0	-0.6	0.6	-0.1	-0.5	-2.6
Revenues (EUR billion, current prices)	60.1	45.3	54.7	62.5	66.9	16.3	17.2	16.6	16.9
Employment (in thousands) <sup>4</sup>	533	448	431	452	449	453	451	450	443

<sup>1</sup> Year-on-year change based on constant prices. <sup>2</sup> Working-day adjusted data, year-on-year change. <sup>3</sup> Average number of employed persons based on monthly reports, year-on-year change. <sup>4</sup> Average number of employed persons based on monthly reports.

Source: Slovstat database.

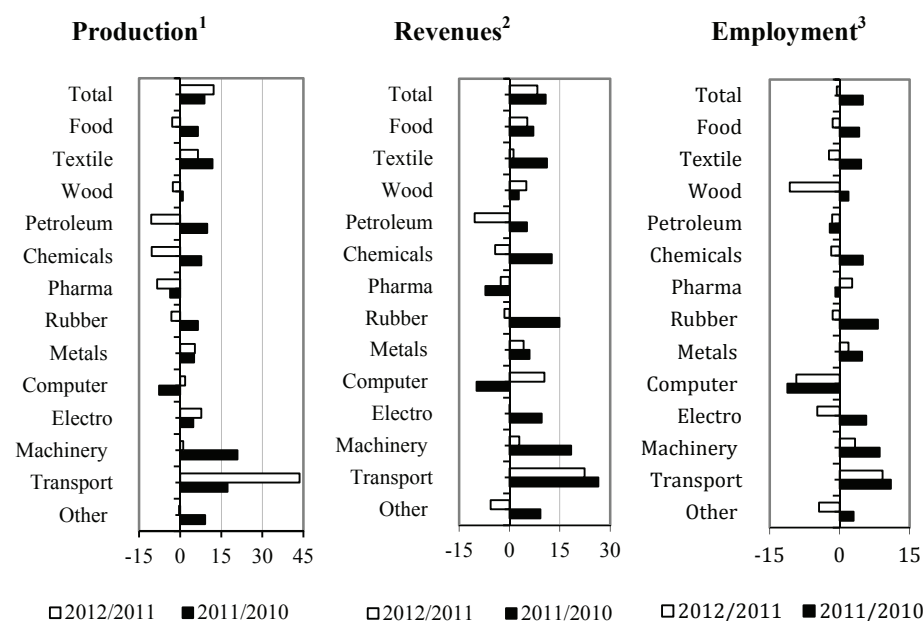
<sup>8</sup> Statistical Office of the SR published on its website (not in the Slovstat database utilized in this publication) the revised IPI (Industrial Production Index) because of the transition to the base year 2010 instead of 2005, which significantly changes all data.

In 2012, the manufacture of transport equipment increased by 43.6% and production increased in five other branches of manufacturing, although by less (between 7.7% and 1.1%). There was a decline in more than half of the branches.

In terms of revenue, the highest real growth was achieved in the manufacture of transport equipment and the manufacture of computer, electronic and optical products. The number of branches which achieved a decline was lower (two fifths). Employment declined in most branches and only increased in four (details in Figure 6).

Figure 6

**Year-on-year Change in Production, Revenues and Employment in Manufacturing Branches, %**



<sup>1</sup> Based on industrial production index. <sup>2</sup> Based on revenues for own performances and goods index at constant prices. <sup>3</sup> Average number of employed persons based on monthly reports.

*Note on the abbreviations used in the Figure:*

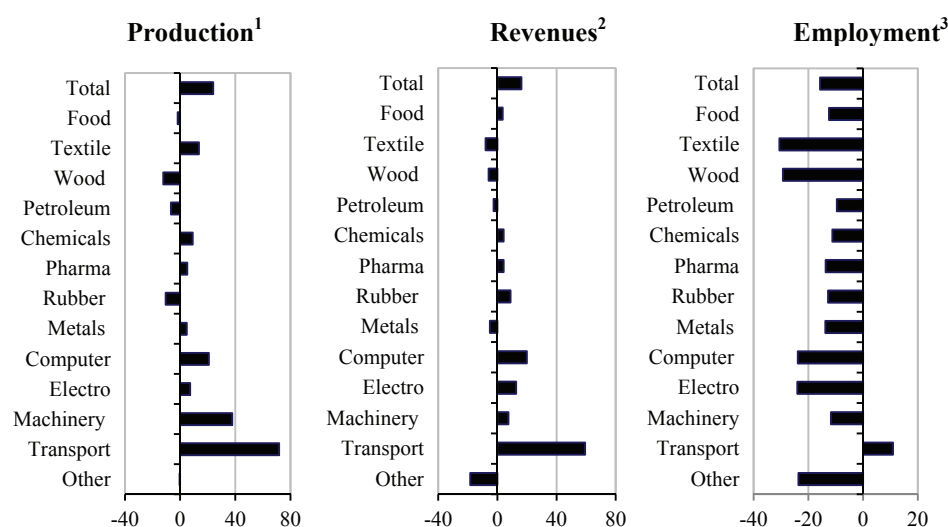
Total – Manufacturing; Food – Manufacture of food products, beverages and tobacco products; Textile – Manufacture of textiles, apparel, leather and related products; Wood – Manufacture of wood and paper products, and printing; Petroleum – Manufacture of coke, and refined petroleum products; Chemicals – Manufacture of chemicals and chemical products; Pharma – Manufacture of pharmaceuticals, medicinal chemical and botanical products; Rubber – Manufacture of rubber and plastic products, and other non-metallic mineral products; Metals – Manufacture of basic metals and fabricated metal products, except machinery and equipment; Computer – Manufacture of computer, electronic and optical products; Electro – Manufacture of electrical equipment; Machinery – Manufacture of machinery and equipment n. e. c.; Transport – Manufacture of transport equipment; Other – Other manufacturing, and repair and installation of machinery and equipment.

Source: Own compilation based on Slovstat database.

Industrial performance responded relatively well to the recessionary pressures. According to the industrial production index, in 2012, industrial production exceeded the 2008 level by 20.1% and production in manufacturing by 23.9%. In 2012, the revenues for own performances and goods (at constant prices) in industry and manufacturing were 15.6% and 16.2% respectively higher than in 2008, which is essentially true for most branches of manufacturing. As for employment, the consequences of the recession have not yet been overcome. Compared with 2008, it is 15.6% lower in industry and 15.7% in manufacturing. Only employment in the manufacture of transport equipment exceeded the 2008 level by 11%. Figure 7 shows the situation in individual branches.

Figure 7

**Change in Production, Revenues and Employment by Branches of Manufacturing in 2012 Compared with 2008, %**



<sup>1</sup> Based on industrial production index. <sup>2</sup> Based on revenues for own performances and goods index at constant prices. <sup>3</sup> Average number of employed persons based on monthly reports.

*Note on the abbreviations used in the Figure:* see Figure 6.

*Source:* Own compilation based on Slovstat database.

In 2012, there was a slowdown in foreign trade growth in the branches of manufacturing: exports fell from 16.0% in 2011 to 10.6% in 2012; imports fell from 12.8% to 7.3%. However, in 2012, the balance of trade in these products achieved the best result in the last five years – nearly EUR 10 billion.<sup>9</sup>

<sup>9</sup> The balance of trade surplus in manufacturing in 2008 – 2012 increased as follows: EUR 4.7; 4.7; 5.2; 7.3 and 9.6 billion.

Revenues from foreign markets fell as well – by 6.6 p. p. in industry and 5.7 p. p. in manufacturing because of the slowdown in exports in 2012. Revenues from the domestic market fell even more sharply – by more than 10.0 p. p. in manufacturing (from 14.7% in 2011 to 4.2%). To some extent, this reflects the relation between the sluggish or declining domestic demand and rapidly increasing foreign demand. Table 7 offers detailed information on revenues by individual markets.

Table 7

**Revenues for Own Performances and Goods by Individual Markets**

	2008	2009	2010	2011	2012	2011/ 2010	2012/ 2011	2012/ 2008
	EUR billion (current prices)					Change, % <sup>1</sup>		
<i>Industry total</i>								
Revenues total	72.8	57.4	67.5	77.1	82.3	14.2	6.8	13.0
Domestic market	36.0	28.1	30.7	34.5	35.8	12.3	3.9	–0.6
Foreign market	36.8	29.3	36.8	42.6	46.4	15.7	9.1	26.2
Euro area market	24.8	19.3	23.5	26.3	28.8	12.1	9.3	16.0
Non-euro-area market	12.0	10.0	13.3	16.2	17.6	22.0	8.8	47.4
<i>Manufacturing</i>								
Revenues total	60.1	45.3	54.7	62.6	66.9	14.4	7.0	11.5
Domestic market	23.9	16.9	19.5	22.4	23.3	14.7	4.2	–2.5
Foreign market	36.1	28.4	35.2	40.2	43.6	14.2	8.5	20.7
Euro area market	24.5	19.0	22.9	25.2	27.8	10.3	10.0	13.3
Non-euro-area market	11.6	9.4	12.3	15.0	15.9	21.4	5.9	36.4
	% domestic market in revenues					Change, p. p.		
Industry	49.5	49.0	45.5	44.8	43.6	–0.7	–1.2	–5.9
Manufacturing	39.8	37.3	35.7	35.8	34.8	0.1	–0.9	–5.0

<sup>1</sup> Based on current prices.

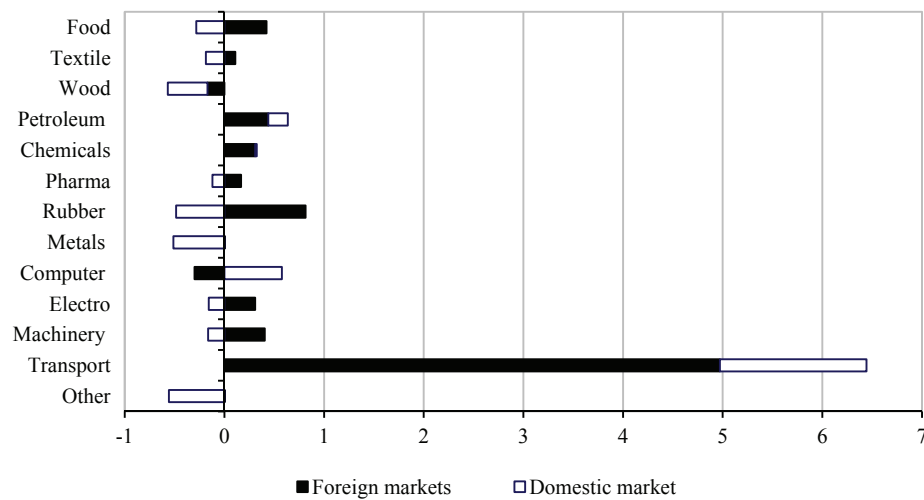
Source: Own compilation based on Slovstat database.

The share of revenues from the domestic market in total revenues has been steadily declining after 2008. Whereas in 2008 industry accounted for almost half of the revenues, in 2012 it was around 6 p. p. less, and the share of revenues in manufacturing declined by 5 p. p. The share of revenues from the domestic market in the total revenues increased only in the manufacture of computer, electronic and optical products (from 8% to 17%) and slightly also in the manufacture of transport equipment (from 22.4% to 22.5%). The share declined in all other branches of manufacturing.

In 2012, revenues from the domestic market were still lagging slightly behind the 2008 level, whereas the revenues from foreign markets exceeded the 2008 level in industry by 26% and in manufacturing by 21%. For more details, see Figure 8.

Figure 8

**Change in Revenues from Foreign Markets and the Domestic Market by Branches of Manufacturing in 2012 Compared with 2008 (EUR billion, current prices)**



*Note on the abbreviations used in the Figure: see Figure 6.*

*Source: Own compilation based on Slovstat database.*

Revenues from the non-euro-area markets are relatively high. In 2012, the increase in revenues decelerated after a rapid increase in the previous year. In 2012, revenues in these markets increased almost by half in industry and by more than one third in manufacturing compared with 2008.

In 2012, positive development in manufacturing was clearly supported by the manufacture of transport equipment. Production increased by an amazing 43.6%, real revenues increased by 22.4% and employment by 9.2%. The manufacture of transport equipment contributed 77% to the increase in revenues in manufacturing (at current prices) and 48% to the increase in exports. The balance of trade in transport equipment<sup>10</sup> reached a surplus of almost EUR 8 billion, compared with the total balance of trade in manufacturing, which reached EUR 9.6 billion.

It is questionable if such development can continue in 2013. The first results for 2013 suggest the opposite. Relatively optimistic values reached in January (year-on-year indicators reached higher levels than in the previous year) declined in February compared with the same indicators in 2012 and also compared with January 2013. For example, production in the manufacture of transport equipment

<sup>10</sup> Final motor vehicles (70% of exports), bodies (12%), electrical and electronic equipment (4%) and other parts and accessories for motor vehicles (14%).

increased in February 2012 by 24.3% and in 2013 by 7.7%, real increase in revenues in these periods reached 28% and 3% respectively. Nominal increase in revenues from foreign markets decelerated substantially (21.9% in February 2012 and 4.7% in February 2013; in the euro area 24.2% and –1.3% respectively). Better results are achieved in revenues from outside the euro area.

In 2012, *construction* recorded its largest decline since 2008, even larger than in 2009. Real revenues for own performances and goods fell by 15.2% and construction production by 12.5% (for details see Table 8). Since 2008, construction production declined almost by one fourth, and inland construction production of new buildings, reconstruction and modernisation declined by one third.

Table 8

**Selected Indicators of the Development in Construction in the SR**

	2008	2009	2010	2011	2012	2009	2010	2011	2012	2012
	2008	2009	2010	2011	2008	2009	2010	2011	2011	2008
	EUR billion (current prices)					Change, % <sup>1</sup>				
Revenues	10.3	9.1	8.6	9.0	7.7	–13.9	–6.1	3.2	–15.2	–29.2
Production total of which	6.3	5.7	5.5	5.5	4.8	–11.3	–4.6	–1.8	–12.5	–27.3
Inland production	6.1	5.5	5.4	5.3	4.6	–11.1	–3.4	–2.8	–13.8	–28.0
New construction	5.0	4.5	4.4	4.3	3.5	–10.8	–3.5	–3.3	–20.5	–33.8
Repairs	1.1	1.0	0.9	0.9	1.1	–14.1	–2.5	–5.0	19.1	–5.2
Production abroad	0.3	0.2	0.1	0.2	0.3	–16.6	–34.8	37.2	22.6	–8.5
	In thousands					Change, %				
Employment	181	184	180	173	165	2.0	–2.6	–3.6	–4.5	–8.6

<sup>1</sup> Based on constant prices.

*Note on the abbreviations used in the table:* Revenues – Revenues for own performances and goods in construction; Production total – Total construction production realized by own employees; Inland production – Inland construction production; New construction – Inland construction production on new construction, reconstruction and modernisation; Repairs – Inland construction production on repairs and maintenance; Production abroad – Construction production abroad; Employment – Average number of persons employed in construction.

*Source:* Own compilation based on Slovstat database.

Only 63% of the construction capacity, which adapted to the dynamics of the domestic demand for construction work, was used in the period of its decline. Construction still lacks major public contracts. For 2013, the directors of construction companies predict a further decline of 4.6%. However, the announced realisation of public contracts in 2014 should lead to modest growth (CEEC Research, Q1/2013). In our opinion, Structural Funds of the EU could be used promote construction activity not only via large infrastructure projects but also smaller contracts.

In 2012, *market services* development was relatively positive (Table 9).

Table 9

**Revenues for own Performances and Goods and Employment by Branches of Market Services<sup>1</sup>**

	2008	2009	2010	2011	2012	2009	2010	2011	2012
	Revenues, EUR billion, current prices					Year-on-year change, % <sup>2</sup>			
Trade and repair of motor vehicles	5.1	3.9	3.8	3.8	4.0	-17.9	-1.5	11.8	6.2
Wholesale	31.0	22.7	23.3	23.1	23.9	-26.8	2.6	-0.8	3.5
Retail trade	19.8	17.4	17.3	17.5	17.9	-10.3	-2.2	-2.8	-1.0
Accommodation	0.4	0.3	0.3	0.3	0.3	-23.6	-4.8	-1.9	0.1
Food service activities	1.1	0.9	0.8	0.8	0.8	-27.7	-9.1	-1.2	-0.9
Transportation and storage, postal activities	6.3	5.4	5.8	6.3	6.8	-13.6	7.1	9.4	8.0
Information and communication	4.7	4.9	4.5	4.9	5.2	3.3	-8.7	9.7	6.0
Selected market services	8.3	8.0	8.6	10.1	12.0	-4.7	5.7	14.3	15.3
Market services total	76.7	63.5	64.3	66.8	70.9	-17.2	1.2	3.9	6.2
	Employment, in thousands					Year-on-year change, %			
Trade and repair of motor vehicles	25	23	21	21	20	-9.9	-7.4	-0.5	-5.0
Wholesale	135	107	95	95	94	-20.5	-11.2	-0.6	-0.6
Retail trade	161	156	152	154	152	-3.0	-2.1	0.8	-1.3
Accommodation	11	10	10	9	10	-6.8	-6.8	-1.0	1.5
Food service activities	39	31	29	29	29	-20.7	-7.5	-0.1	0.8
Transportation and storage, postal activities	111	112	111	112	110	0.9	-1.1	1.4	-1.9
Information and communication	36	38	33	38	40	5.0	-11.6	13.8	5.9
Selected market services	132	124	121	127	141	-6.0	-2.5	5.6	10.4
Market services total	649	600	571	585	595	-7.5	-4.8	2.3	1.7

<sup>1</sup> Statistical information on employment in individual branches of market services is complementary to the corresponding information on revenues and differs significantly from total employment in given branches, which also includes non-market entities.

<sup>2</sup> Based on constant prices; year-on-year change in Wholesale; Transportation and storage; Information and communication; and Market services total based on current prices.

Source: Own compilation based on SO SR data.

Total revenues for own performances and goods increased by 6.2% (based on current prices) compared with 3.9% in 2011. Employment growth decelerated to 1.7%.

From all the market service segments, information and communication and selected market services were the most successful in overcoming the consequences of the recession. In both segments, revenues and employment exceeded the 2008 level in 2012.

Compared with the development in industry, the revenue growth rate in market services (at current prices) was slightly slower – 6.2% compared with 7.4% in industry. However, employment growth in market services continued, unlike in industry (where employment declined by 0.9%).

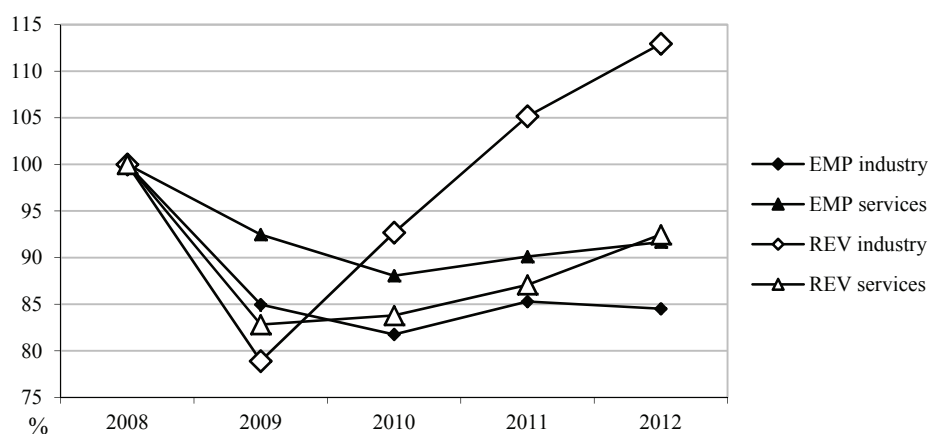
Figure 9 shows the convergence trend in performance and employment development in market services after the recession, while in industry both indicators diverge significantly. Both in market services and in industry, the average



number of employed persons has remained considerably lower than in 2008 – the difference is 84 000 persons in industry and 54 000 persons in market services.

Figure 9

**Revenues for own Performances and Goods at Current Prices (REV)  
and Employment (EMP) in Industry and Market Services (2008 = 100)**



Source: Own compilation based on SO SR data.

Table 10

**Development of Corporate Financial Position, 2007 – 2012**

	2007	2008	2009	2010	2011	2012
Profit/loss, EUR million						
Non-financial and financial corporations, total	10 887	8 905	7 353	9 144	10 764	10 472
Financial corporations	643	-579	767	554	1 125	1 614
Non-financial corporations	10 244	9 485	6 586	8 590	9 638	8 857
of which:						
Agriculture, forestry and fishing	39	156	-104	-42	61	67
of which: Agriculture	10	130	-104	-42	32	49
Industry	5 054	3 998	2 819	3 965	4 053	4 014
of which: Manufacturing	3 171	2 355	1 026	2 153	1 983	2 284
Construction	513	678	558	584	779	557
Services total	4 638	4 652	3 315	4 083	4 745	4 219
Cost profitability, %						
Non-financial corporations	7.6	6.2	5.2	6.2	6.3	5.5
of which:						
Agriculture, forestry and fishing	1.4	5.1	-4.6	-1.9	2.4	2.8
of which: Agriculture	0.4	5.2	-5.5	-2.3	1.5	2.4
Industry	7.3	5.2	4.8	5.9	5.4	5.0
of which: Manufacturing	5.4	3.6	2.2	3.9	3.2	3.5
Construction	8.8	8.9	7.8	9.5	12.1	9.5
Services total	8.0	7.0	5.5	6.4	6.8	5.9

Source: SO SR (2013c).

In 2012, the overall deceleration of economic growth (and in some branches even a decline) had an adverse effect on the financial indicators of *non-financial corporations*. Their costs increased more rapidly than revenues, which resulted in a decline in their profit/loss almost by EUR 800 million (by 8.1%) and their cost profitability from 6.3% to 5.5% compared with 2011. Mainly construction and services and to a small extent industry affected the decline. The profit/loss of agriculture increased in 2012. The results in industry was adversely affected by the supply of electricity, gas, steam and air conditioning and positively by manufacturing.

The share of loss-making corporations with 100 and more employees in their total number reached 28.9%, which is around the 2011 level (28.3%). Total loss was recorded in the manufacture of wood and of products of wood.

Table 10 shows that non-financial corporations still have not been able to stabilize their profit/loss and cost profitability at the pre-recession levels. On the other hand, financial corporations exceeded the pre-recession levels by a large profit/loss in the last two years.

### **3. Qualitative Factors of Economic Development**

Technological development of the Slovak economy, which is currently based on the import of foreign technology, should be compensated by a more intensive development of the domestic innovation capacity, which would be based on efficient domestic research and development (R&D), educated and sophisticated labour force, and the use of information and communication technologies (ICT). These qualitative factors of economic development are a prerequisite for higher returns on national labour, economic growth and job creation.

Table 11 shows the development of selected input (R&D expenditure and R&D personnel) and output (domestic patent applications and academic papers) indicators in the Slovak R&D in 2006 – 2011.

The share of gross R&D expenditure in GDP increased steadily in 2011 and reached 0.68% GDP, which resulted from the growing share of higher education sector to 0.24% GDP. The increase in gross R&D expenditure in 2011 is attributable to the EU Structural Funds and the Cohesion Fund appropriations to the Slovak universities.

On the other hand, business enterprise sector is still underrepresented in the Slovak innovation system. Almost two thirds of R&D expenditure go to the public sector (government sector and higher education sector), which, coupled with insufficient institutional support of the transfer of public sector research results to the commercial sector, deteriorates the innovation activity in the economy.

Table 11

**Selected Indicators of Research and Development, 2006 – 2011**

	2006	2007	2008	2009	2010	2011
Gross R&D expenditure (% GDP)	0.49	0.46	0.47	0.48	0.63	0.68
Divided by sector of performance (% GDP):						
Government sector	0.16	0.16	0.15	0.16	0.19	0.19
Business enterprise sector	0.21	0.18	0.20	0.20	0.27	0.25
Higher education sector	0.12	0.11	0.11	0.12	0.17	0.24
Divided by resource of funds (% GDP):						
Government sector	0.27	0.25	0.25	0.24	0.31	0.34
Higher education sector	0	0	0	0	0	0.01
Business enterprise sector	0.17	0.16	0.16	0.17	0.22	0.23
Foreign resources	0.04	0.05	0.06	0.06	0.09	0.1
R&D personnel <sup>1</sup>	23 120	23 437	23 641	25 388	28 128	28 596
Year-on-year change (%)	3.6	1.4	0.9	6.9	9.7	1.6
Domestic patent applications <sup>2</sup>	193	240	167	176	235	223
Number of patent applications <sup>2</sup> per 1,000 R&D employees	8.3	10.2	7.1	6.9	8.4	7.8
Academic papers <sup>3</sup>	2 238	2 266	2 386	2 390	2 510	2 766
Number of academic papers per 1 000 R&D employees	96.8	97	101.2	94.1	89.2	96.72

<sup>1</sup> Head Count by 31<sup>st</sup> December.

<sup>2</sup> Domestic patent applications filed at the Industrial Property Office of the Slovak Republic.

<sup>3</sup> Academic articles listed in Current Content Connect® (by 2<sup>nd</sup> April 2013), author or at least one co-author with postal address in Slovakia.

Source: IPO (2012); ISI Web of Knowledge<sup>SM</sup> (2013); SO SR (2012c).

In terms of R&D financing, government resources were dominant in 2011 (51%) with an upward trend also in the last examined year. Business enterprise resources remain at the level of one third of total resources. In 2011, foreign resources continued to increase, reaching 15%. The low share of higher education resources (0.01% GDP in 2011) is related to their status, means of financing and lack of ability to generate their own resources (e.g. commercialisation of research results), which could be used for their own R&D.

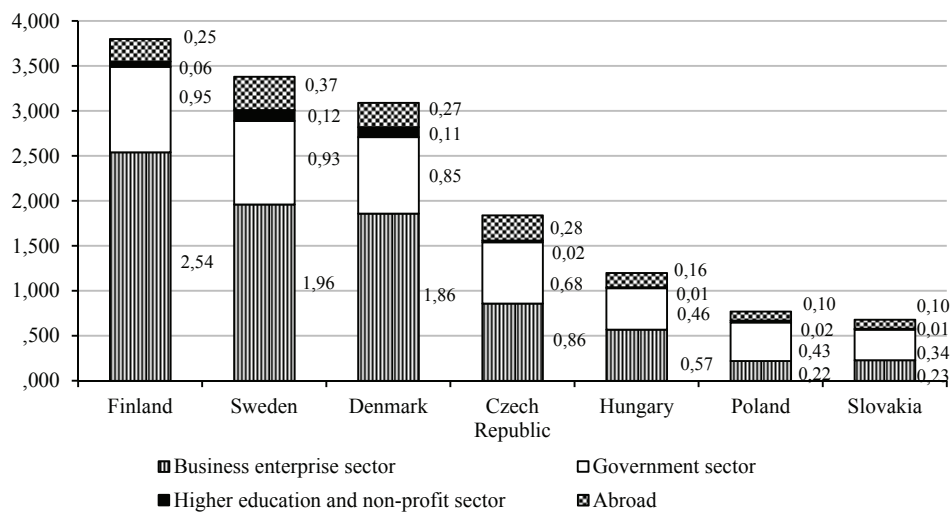
The R&D financing in Slovakia lags behind the advanced economies in terms of not only total expenditure, but also inadequate structure and under-representation of business enterprise resources.

The number of R&D personnel increased in 2009 – 2010 and also in the next year. However, employment increased year-on-year only by 1.6% in 2011 to 28,596 employees. Underinvestment in R&D as well as the low number and inadequate structure of R&D employees pose a barrier to innovation development. Figure 3.2 compares the number of R&D employees and their share in total employment. Slovakia has to deal with the low share of R&D employees in total employment, their inadequate structure and under-representation of business sector R&D employees.

Patent activity measured by the number of domestic patent applications declined slightly to 223 domestic patent applications, which translated into a decline in patent productivity (from 8.4 in 2010 to 7.8 patent applications per 1 000 R&D employees). In 2011, academic productivity (measured by the number of academic papers per 1 000 R&D employees) increased from 89 to 96.7 papers.

Figure 10

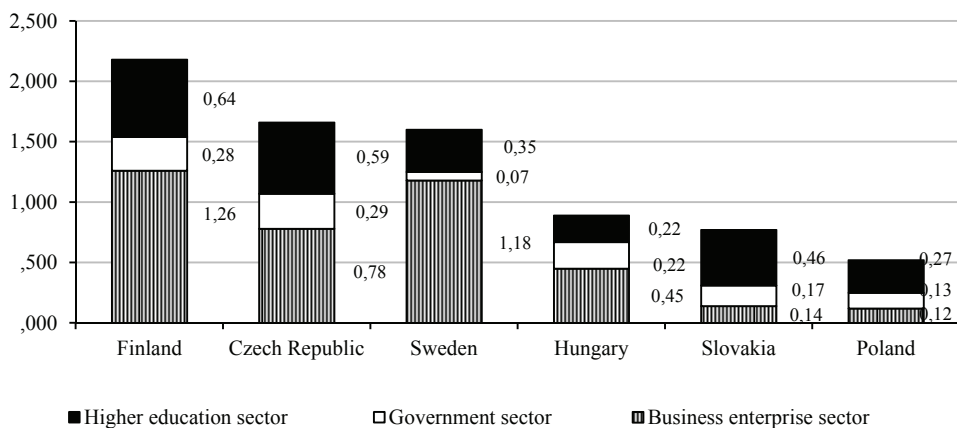
**Structure of Gross R&D Expenditure in 2011 by Resource in Slovakia and Selected EU Economies (% GDP)**



Source: Own compilation based on Eurostat data (2013a).

Figure 11

**R&D Employees in Slovakia and Selected EU Economies in 2011**  
(share in total employment)



Source: Own compilation based on Eurostat data (2013a).

Education is one of the key competitiveness factors of the economy. Especially university college education constitutes a prerequisite for high-quality human capital. After two years of relative increase in public expenditure on education in 2009 – 2010, in 2011 its share in GDP declined to 4%, which is the second worst result in the EU-27 (the last country in the list, Bulgaria, spends 3.6% of public resources on education; the first country, Denmark, 7.8%; the EU-27 average is 5.3%). In terms of resources, Slovakia has the lowest share of public resources in the EU – only 84.3% of total resources in the last examined year. The relatively high share of private resources is related to the growing number of private university colleges of social sciences and humanities after 2003.

In terms of creating the potential for innovation development and high-quality human capital, the persistently low public expenditure on university college education, which only reached 0.83% GDP in the last examined year, can be considered very negative.

In 2011, the participation in lifelong learning of the age group 25 to 64 years increased slightly to 3.9%. In Slovakia, this indicator lags behind the EU-27 average, where 8.9% of the age group 25 to 64 years participated in lifelong learning. The number of graduates in mathematics, science and technical science developed relatively positively. Slovakia ranked sixth in the EU-27 with 18.3 graduates per 1 000 of the population aged 20 – 29 years, which exceeded the EU-27 average (15.2 graduates).

Table 12

**Selected Indicators of Education**

	2004	2005	2006	2007	2008	2009	2010	2011
Total public expenditure on education (% GDP)	4.2	3.85	3.8	3.62	3.5	4.3	4.5	4.0
Share of public resources in financing of education (%)	84	83.9	85.2	86.2	82.5	83.9	84.2	x
Public expenditure on higher education (% GDP)	0.98	0.81	0.90	0.79	0.78	0.81	0.83	x
Number of graduates in mathematics, science and technology fields (per 1 000 of the population aged 20 – 29 years; ISCED 5 – 6)	9.2	10.2	10.3	11.9	15.0	17.5	18.3	x
Number of PhD graduates in mathematics, science and technical science, industrial and construction technologies (per 1 000 of the population aged 20 – 29 years; ISCED 6)	0.4	0.5	0.5	0.6	0.6	0.7	1.1	x
Participation in lifelong learning (% of the age group 25 to 64 years)	4.3	4.6	4.1	3.9	3.3	2.8	2.8	3.9

Source: Eurostat (2013a) ; x – unavailable data.

The development of knowledge-based society is largely preconditioned and propelled by the use of ICT across society. Table 13 shows some indicators of ICT penetration in the society (households, businesses and public administration). In Slovakia, the number of households with Internet access increases every year. Digital literacy, expressed as the share of citizens who regularly use the Internet (60%) and the share of citizens with medium level of PC knowledge (33%), increased in 2012. Both indicators reached a higher level in Slovakia than the EU-27 average (58% and 25%, respectively).

ICT use in the business sector, measured as the share of business revenues from e-commerce in total revenues and the share of enterprises using e-invoicing, declined in 2012 after years of relatively dynamic growth. The share of revenues from e-commerce declined to 12% of total revenues (EU-27 average is 15%) and the share of enterprises using e-invoicing stayed the same as in the previous year – 34% (EU-27 average is 21%).

Table 13

**Selected Indicators of ICT Penetration in the Society (%)**

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Share of households with Internet access	23	23	27	46	58	62	67	71	75
Share of citizens <sup>1</sup> who regularly use the Internet	20	23	26	33	44	49	58	56	60
Share of citizens <sup>1</sup> who use the Internet banking	10	10	13	15	24	26	33	34	40
Share of citizens <sup>1</sup> with medium level of PC knowledge	.	35	30	33	x	33	x	33	33
Share of business revenues from e-commerce in total revenues	.	0	0	3	8	11	11	16	12
Share of enterprises which send or receive e-invoices	.	.	.	14	23	30	34	34	x
Share of citizens <sup>1</sup> who use the Internet to interact with public administration	25	27	32	24	40	38	50	48	42
Share of enterprises which use the Internet to interact with public administration	47	57	77	85	88	91	88	96	x
Share of broadband Internet connections	0.4	1.5	4	6.9	9.6	14.3	15.5	16.4	x

<sup>1</sup> Age group 16 to 74 years.

Source: Eurostat (2012).

ICT are also used in the area of electronisation of public administration services. The demand for public administration online services is represented by the share of citizens and enterprises using the Internet to interact with public administration institutions. Enterprises recorded a more dynamic year-on-year increase and a much larger share in the last examined year compared with citizens who

used the Internet to interact with public administration. This can be explained by the fact that the supply side of the public administration online services concentrates mainly on the business sector (e.g. prioritizing online tax collection). The share of enterprises which use the Internet to interact with public administration (96%) is higher than the EU-27 average (84%). The share of citizens who use the Internet to interact with public administration declined in the last two years (to 42% in 2012). In terms of creating the ICT infrastructure, Slovakia still lags behind the EU-27 average. Broadband Internet connection penetration was only 16.4% in 2011 (the EU-27 average is 26.5%).

The development of R&D, innovations, education and ICT penetration in the society, which shows the potential of qualitative factors in the economic development of Slovakia, can be considered negative. The increase in total R&D expenditure in the last examined year 2011 is positive, but the level of financing still lags behind the EU-27 average and the V4 countries. From the point of view of innovation development, the structure of R&D sector is inadequate because of the low participation of enterprises, which are irreplaceable in the development of innovation in the national economy. From the point of view of R&D financing in Slovakia, there is a sustained increase in foreign resources, which is attributable to the EU Structural Funds appropriations (Operational Programme Research and Development, Operational Programme Competitiveness and Economic Growth, and Operational Programme Bratislava Region).

In the annual assessment of national competitiveness, the World Economic Forum (WEF, 2013) also evaluates qualitative factors of competitiveness – education, technological readiness, and innovation.<sup>11</sup> In terms of overall competitiveness, Slovakia ranked 71<sup>st</sup> out of 144 countries. It belongs among those countries whose economic development is driven by innovation. The Slovak education ranked 54<sup>th</sup>, technological readiness 45<sup>th</sup> and innovation 89<sup>th</sup>. In the Quality of education pillar, the highest-ranking indicators were Internet access in schools (29<sup>th</sup>), Local availability of specialized research and training services (49<sup>th</sup>) and Tertiary education enrolment rate (42<sup>nd</sup>). The lowest ranking indicators were Quality of the education system (120<sup>th</sup>) and Quality of management schools (111<sup>th</sup>). In the Technological readiness pillar, the highest-ranking indicators were FDI and technology transfer (9<sup>th</sup>) and Internet users (26<sup>th</sup>). The lowest ranking indicator was Internet bandwidth (76<sup>th</sup>). In the Innovation pillar, Slovakia had a relatively good international position in Utility patents (40<sup>th</sup>) and Availability of scientists and engineers (79<sup>th</sup>). The lowest ranking indicators were Government procurement of advanced technology products (127<sup>th</sup>) and University-industry collaboration in R&D (100<sup>th</sup>). With regard to the Government procurement of

<sup>11</sup> Twelve pillars of competitiveness and within them 110 indicators were evaluated.

advanced technology products, which is an active innovation policy instrument, Slovakia ranks among developing economies.

The European Commission publishes an annual study, the *Innovation Union Scoreboard* (EC, 2013b), which assesses the innovation performance (based on 25 indicators) of the EU member countries. According to the newest assessment, the Slovak economy falls into the group of moderate innovators (level below the EU average) and ranks 21<sup>st</sup> in the EU.

#### **4. Labour Market**

After the gradual recovery in 2010 – 2011, the labour market stagnated in 2012 and the results were puzzling: employment increased slightly year-on-year, but the number of unemployed increased as well, especially towards the end of the year. The conditions for small enterprises deteriorated and real wage declined slightly despite the accelerating increase in nominal wage. In 2012, extensive legislative changes were adopted, fuelling rather negative expectations in employment. The year 2012 also brought a struggle of certain groups of public sector employees for better working conditions.

##### **4.1. Development of Employment and its Structure and Related Legislative Changes**

While the product declined for one year due to the economic crisis (a recession throughout 2009), a decline in employment lasted a little longer and a recovery was not underway until the end of 2010. In 2011, employment increased at a slowing pace. In 2012, the employment growth dynamics, which was even lower than in 2011, declined steadily. In the last quarter of 2012, the year-on-year increase in employment stopped after two years of persistent growth (Figure 12).

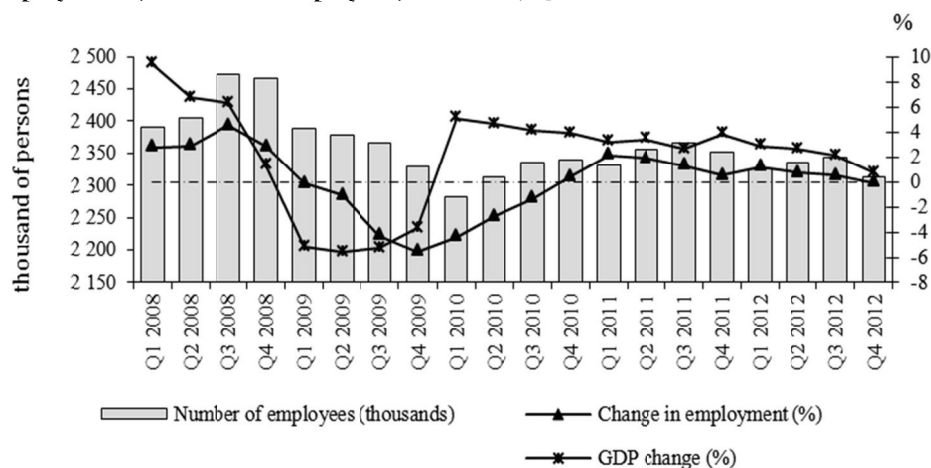
The slow recovery process, which started in 2010, halted in 2012. Employment did not even manage to reach the pre-crisis levels. The number of employed in the last quarter of 2012 declined to 2 313 thousand of persons after two years of growth. In the pre-crisis period – in the fourth quarter of 2008, it was 2 446 thousand of persons (thus, there were still 153 thousand employees less at the end of 2012). Total employment (the number of employees) based on the Labour Force Sample Survey (LFSS) increased by 0.6%<sup>12</sup> to 2 329 thousands (SO SR, 2013a; 2013b).

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<sup>12</sup> The 2012 data are calculated based on the new 2011 Population and Housing Census. The 2012 indices, whose source is the Statistical Office of the SR, are therefore calculated based on comparable data and cannot be derived directly from the previously published absolute numbers of employees and their change in 2011 – 2012.



Figure 12

**Employment (Number of Employees) and GDP, Quarters of 2008 – 2012**

*Note:* GDP based on quarterly national accounts at constant prices, reference year 2005, employment based on LFSS, change in employment in 2012 calculated from comparable data.

*Source:* Based on SO SR data.

After the 2009 recession, employment reacted to the recovery of economy and production with approximately a nine-month delay. Because of slackening product growth (or production and value added) in 2011, a subsequent slow-down in employment growth at unchanged elasticity of employment could be expected.

A more significant deterioration in employment towards the end of the year was often assigned to the negative impact of the approved legislative changes affecting labour relations and labour costs. The amendment to the Labour Code (adopted in October 2012, effective as of 1<sup>st</sup> January 2013) tightens the definition of dependent work (in order to prevent replacing employment contracts with other contractual forms), increases the employer's costs (reintroducing the concurrence of the termination notice period on the one hand and a severance payment on the other; increasing the cost of social security in conjunction with the Social Insurance Act amendment) and reduces the employer's flexibility in certain areas (abolishing the option to agree on a longer than specified probationary period, reducing the maximum time period for fixed-term employment, tightening the employment of agency employees, tightening the provisions on working time etc.). The legislative changes leading to higher hiring costs and dismissal costs and lower flexibility in labour relations should have caused the enterprises to prepare themselves and realise the planned (and unplanned) dismissals in accordance with the legislation in force in 2012.

However, a more detailed view of the employment structure reveals that in fact the decline by 38 thousand employed persons in the fourth quarter of 2012 (year-on-year, unrevised data) consisted of only 15 thousand employees and as many as 23 thousand entrepreneurs. The number of entrepreneurs (with employees) declined by more than 14% in this quarter. In comparison, the number of sole proprietors whose work had the characteristics of dependent work declined by 6.7% and the number of employees (as calculated by the 2011 Population and Housing Census conducted in May 2011)<sup>13</sup> increased by 0.8%. The new data support the following fact even more clearly: The negative situation in the labour market in the last quarter resulted in closures of enterprises belonging to natural persons rather than dismissals of employees. Year-on-year decline in the number of employees in general as well as employees in the private sector was the highest in the second quarter of 2012, while the situation of enterprises deteriorated clearly towards the end of the year. In 2012, the number of entrepreneurs declined by 2.4 % and the number of employees increased by 1.2% (SO SR, 2013c).

It can be expected that the consequences of the legislative changes related to employment in the SR will be more significant in 2013, when related acts become effective. In addition to the amendments to the Labour Code, there are also relevant changes in terms of labour costs. The Social Insurance Act amendment (adopted in August 2012) introduces a variety of changes, which will affect persons employed via agreements on work performed outside employment relationship and self-employed persons. In the case of self-employed persons, the amendment raises the minimum and maximum assessment base (AB) as well as the minimum and maximum insurance contribution. The transfers of self-employed persons to the Social Insurance Agency and health insurance companies will thus increase in 2013. Since 1<sup>st</sup> January 2013, persons working via agreements (both, work performance agreement and agreement on work activity) with a regular monthly income have the same status as regular employees for the purposes of health, sickness, pension, and unemployment insurance. Until 2013, employers only levied contributions on accident insurance (0.8% AB) and guarantee insurance (0.25% AB). Since January 2013, they carry the increased cost burden in the form of full employer's contribution.

So far, these changes caused a dramatic decline in the persons employed via agreements on work performed outside employment relationship. On 31<sup>st</sup> December 2012, the Social Insurance Agency registered 642 295 agreements, in

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<sup>13</sup> The discrepancy between absolute values and indices or year-on-year changes in employment in 2012 results from the methodology of the Statistical Office of the SR when adjusting the sample to the population based on the last census in May 2011. Some revised (absolute numbers) will be published later.

January 2013 only 297 422 (all types of agreements were included; the figure published by the Social Insurance Agency). A decline in the number of agreements on the turn of the years is a usual phenomenon, but not on such a large scale. The decline of 345 thousand represents almost 54%. For completeness' sake, in March 2013 (the newest figure) the Social Insurance Agency registered a little more than 373 000 persons working via agreements. Since March, concurrence of work via agreements and early retirement is also forbidden.

Because of the deteriorating situation in the labour market, the Social Insurance Agency budget was charged by the increasing total amount of unemployment benefits more than in the previous year. In 2012, the Slovak Insurance Agency paid out EUR 175.8 million to job seekers, compared with EUR 163.3 million in 2011, which represents a 7.6% increase. In comparison, in the pre-crisis year of 2008, the total amount of unemployment benefits was only a little more than EUR 66 million. In order to consolidate the Agency's budget, the maximum unemployment benefit was lowered (since 1<sup>st</sup> January 2013, it is EUR 775.30 and EUR 801.10, if the month has 31 days).

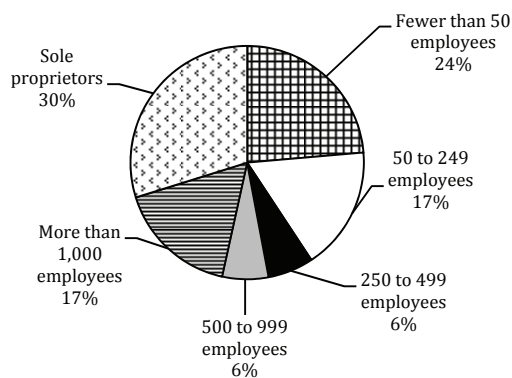
It is likely that the above-mentioned legislative changes will affect employment in small and medium-sized enterprises, especially in regions with weaker economic activity and higher unemployment rate, where work performed outside employment relationship is used more often. According to an empiric survey of employers (conducted before the adoption of the legislative changes), 77 – 86% of the questioned subjects consider the existence of various agreements on work performed outside employment relationship to be well-founded. 56% of the employers used this form to achieve more flexibility and only 16.5% to lower their costs. This reason appeared most often in small and medium-sized enterprises and in domestic privately owned enterprises (Kostolná and Olšovská, 2011). But the real consequences of the adopted legislative changes could be examined only after this year (since they are effective). In terms of employment growth in Slovakia, it is necessary to motivate (not repress) employment in small and medium-sized enterprises, because they represent the majority of local employment. Micro enterprises and small enterprises with fewer than 50 employees employ 518 thousand of persons, which is the most in terms of enterprise-size structure<sup>14</sup> (it is also the second largest group of employed persons in the SR after sole-proprietors). Small enterprises create 24% of total employment in Slovakia and medium-sized enterprises with fewer than 500 employees create a further 17%.

<sup>14</sup> Enterprise-size structure: small enterprises with under 50 employees (employ 518 thousand of persons), medium-sized enterprises with 50 to 249 employees (374 thousand of persons), large enterprises with 250 to 499 employees (139 thousand of persons), large enterprises with 500 to 999 employees (141 thousand of persons), large enterprises with over 1 000 employees (366 thousand of persons); data for 2012.

In 2012, employment declined only in enterprises with fewer than 500 employees, most substantially in small enterprises with 20 to 49 employees (by 8.7%) and medium-sized enterprises (by 4.6%). In large enterprises with more than 500 employees, which employ a little more than half a million people (507 thousand of persons), employment increased by 1%.

Figure 13

**Employment by Enterprise-size Structure**



Source: Based on SO SR data.

#### 4.2. Unemployment Development and Disadvantaged Groups in the Labour Market

In 2012, unemployment based on LFSS increased by 3.5%, most rapidly in the second and third quarters (at a year-on-year rate of 4.2% and 4.7%). In the last quarter, its growth rate slackened. On average, there were 377.5 thousand unemployed persons in Slovakia. Unemployment rate increased from 13.5% to 14.0% in 2012, culminating in the last quarter at 14.4%, which is 0.4 p. p. more than in the fourth quarter of 2011 (again, a larger increase compared with the previous year was recorded in the second and third quarters).

In 2012, the largest group of unemployed consisted of those who have never had a job (almost 95 thousand of persons). A large group of unemployed also consisted of those whose last job was in industry (83 thousand). The number of unemployed who have never had a job increased significantly in 2010 and 2011 and this trend continued in 2012 with a year-on-year increase of more than 12%. Not only did they become the largest group of unemployed; in the last quarter, their number exceeded 100 thousand for the first time since 2005.

This problem is related to the development of employment and unemployment in two disadvantaged segments of the workforce, the youngest persons entering the labour market, and low-qualified workers. In the first case, there was a strong convergence to the EU average in the past (in 2000 – 2008, unemployment rate of those under 25 declined from the highest value recorded in the EU – 36.9%, which was more than double the EU average, almost to the EU average level; Slovakia no longer ranked first, but eighth in the EU). In the case of low-qualified labour force, it is a long-term problem, the extent of which is unknown to other EU countries.<sup>15</sup> From the 377.5 thousand unemployed, no education, primary education and secondary vocational education without leaving exam were the highest achieved education levels for 208.8 thousand of persons, which is more than 55% of all unemployed.

Unemployment rate of persons with the lowest qualification<sup>16</sup> reaches around 40 – 50% on a long-term basis; Slovakia is the absolute leader in this area in Europe (the European average unemployment rate of low-qualified persons did not exceed 12% in the pre-crisis period). The scope of this problem is best illustrated by the fact that in 2000 – 2009, the average difference between the Slovak unemployment rate of low-qualified persons and the EU country with the second highest unemployment rate of low-qualified persons was unbelievable – 18.3 p. p. (The average difference between the Slovak rate and the EU average was 33.6 p. p.). In the last three years, the SR got a little closer to the EU average, which is mostly contributed to the deterioration of the situation in Lithuania and Spain. In 2012, unemployment rate of low-qualified persons reached 44.7%, widening the gap between Slovakia and the country ranking second (which has been Lithuania for three years). It is positive that in the second half of 2012, unemployment rate of low-qualified persons in Slovakia started to fall.

The question of high unemployment of low-qualified persons in Slovakia is *inter alia* related to the status of Roma population in the Slovak labour market. Based on the World Bank estimate (WB, 2012), around 165 thousand Roma in productive age are out of work, most of them (122 thousand of persons) in the eastern Slovakia. Most of them are part of economically inactive population (stopped looking for a job) or belong to the group of long-term unemployed and to the sub-group of unemployed with the longest duration of unemployment

<sup>15</sup> For completeness' sake, 75.5 thousand of those unemployed were aged under 25 (and further 64.4 thousand of those unemployed were aged 25 to 29; thus 37% unemployed were aged under 30 in 2012). Unemployment rate of those under 25 increased to 34% in 2012 (which is the highest level since 2002) and unlike the total unemployment rate did not increase most rapidly in mid-year, but in the last quarter (by 1.7 p. p.).

<sup>16</sup> Persons who achieved primary and lower secondary education, i.e. levels 0 to 2 in the International Standard Classification of Education. Source of data used in the text: Eurostat database.

(based on estimates, 53 thousand Roma have been unemployed for more than two and a half years). The extremely low employment rate in Roma women is alarming (9% compared with 20% of Roma men). In the case of both genders, the employment rates are significantly lower compared with other countries in the region (the survey was conducted in the SR, CR, Hungary, Bulgaria and Romania; e.g. in Hungary, employment rate of Roma men is 34%, in Bulgaria and Romania 42%, in the CR 43% and in the SR 20%). Even if the Roma manage to get a job in Slovakia, their average wage reaches only about a half of the average wage of the non-Roma population. The main factor is their low qualification. Roma employees usually work in low-qualified jobs in construction (25%), mining and quarrying (19%) or community service (25%). Almost 60% of Roma workers have no qualification. Employment rate increases with higher education, albeit more slowly than the employment rate of non-Roma population living in the same area. The employment rate of Roma with completed secondary and higher education is 20% compared with the employment rate of non-Roma population living in the same or neighbouring area, which is 47% (WB, 2012).

The result of this development in the case of the above-mentioned disadvantaged groups of persons, whose employability drops significantly during the economic slowdown, was the increase in long-term unemployment in the last few years. Long-term unemployment represented 64% of total unemployment in 2012, which is the same as in the previous year. The post-crisis<sup>17</sup> trend of its increase halted, because in 2012, the number of unemployed for less than one month increased the fastest. This reflects the deterioration of the situation in the labour market directly in 2012. Some changes occurred within the groups of long-term unemployed. For the second year in a row, the number of unemployed for one to two years declined, but the number of unemployed for more than two years increased to 170.4 thousand of persons, which represents 45% of total unemployment in the SR; in 2012, total increase in long-term unemployment thus resulted from the increase in unemployment two years ago.

In addition to the high youth unemployment rate, the highest unemployment of low-qualified persons in the EU, and the large share of long-term unemployment (long-term unemployment rate in the SR was the highest in the EU since 2002 and after ten years, Slovakia was replaced by Greece and Spain, but not because it declined in the SR; on the contrary, it increased from 9.2% to 9.4% of economically active population), regional disparities are another major problem of the Slovak labour market. In 2012, the highest unemployment rate was

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<sup>17</sup> During the 2009 recession, the share of long-term unemployment in total unemployment declined, because short-term unemployment increased more rapidly (as it was a direct consequence of the economic slump).

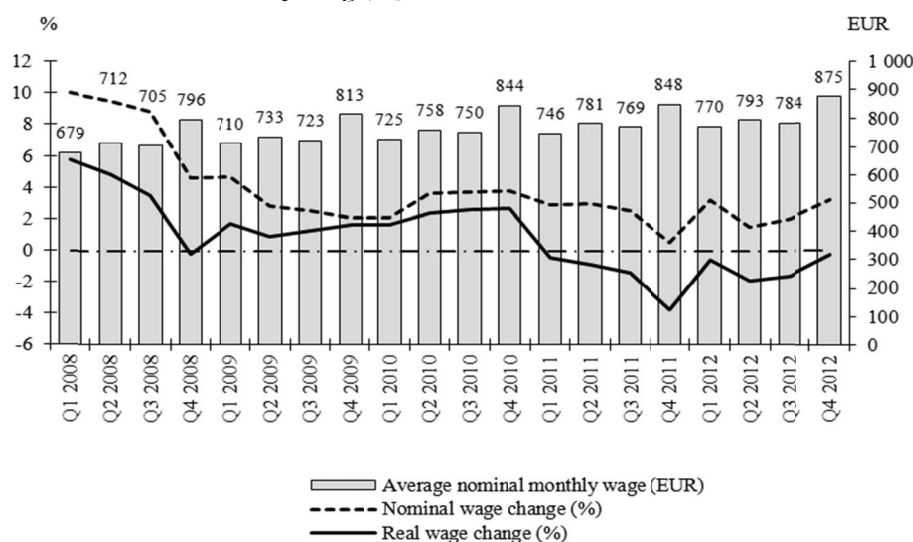
reached in Košice Region. Almost one fifth of economically active population (19.7%) was unemployed in this area. At the same time, the highest number of unemployed lived here (around 74 thousand unemployed)<sup>18</sup> compared with the other regions. A further 70 thousand unemployed live in Prešov Region (the second largest group), where there is also the second highest unemployment rate (18.3%). It is not a coincidence that both regions have the highest presence of Roma population out of work (e.g. in Central Slovakia, employment rate of Roma men is twice as high as in Eastern Slovakia). In 2012, unemployment rate and the number of unemployed declined only in Bratislava Region. Bratislava Region (unemployment rate of 5.6%) and Trenčín Region (9%) are the two regions with the lowest unemployment. The number of those working abroad increased by 4.8% in 2012 – almost 121 thousand of persons found a job in another country. It is also not surprising that Prešov Region is the region with the highest number of those working abroad.

### 4.3. Development of Average Monthly Wage

Nominal wage in the economy increased by 2.4% and reached EUR 805. The increase in nominal wage was faster than in 2011 (when it increased by 2.2%). However, because of the influence of the increase in consumer prices, real wage declined at a rate of 1.2%, which is a little slower rate compared to 2011. Figure 4.3 offers a more detailed view of the nominal and real wage development.

Figure 14

#### Nominal and Real Monthly Wage, Quarters of 2008 – 2012



Source: Based on SO SR data.



Figure 14 shows signs of improving wage development: the faster nominal wage growth in the second half of 2012 and the slower decline in real wage. The two-year continuous decline in real wage almost halted at the end of the year.

The most lucrative branches of the Slovak economy (in terms of income) were the same three branches as in the previous year, in which the monthly wage by far exceeds the Slovak average. At the same time, they represent the only branches where average monthly wage exceeds EUR 1 000: financial and insurance activities (EUR 1 658), information and communication (EUR 1 637) and supply of electricity, gas and steam (EUR 1 471). Similarly to the previous year (2011), average wage increased the most in these branches (by 7%) – however, this time with the exception of the ICT, in which the average wage declined significantly in the summer months. As a result, after three years information and communication as the branch with the highest average wage was replaced by financial and insurance activities. In terms of the wage development dynamics, the three branches with the highest year-on-year increase were the same, with the exception of ICT, which was replaced by healthcare with a 6.6% year-on-year increase in average wage. The amendment to the Act on Health Care Providers, Medical Workers and Professional Medical Associations, resulting from the memorandum signed by the previous government (of I. Radičová) and the Medical Trade Unions Association, also contributed to this increase, as it stipulated the first two stages of the increase in wages (the January and the July increase, in total by 20 – 30%). The memorandum marked the end of an acute crisis in healthcare at the end of 2011, which culminated when a large number of physicians handed in their notice. In addition, the less successful action of nurses and midwives related to the Act on the Minimum Wage Claims of Nurses and Midwives contributed to the wage increase in healthcare. The Act entered into force on 1<sup>st</sup> April 2012, but ceased to be effective in July because of the decision of the Constitutional Court based on a filing by the Slovak Medical Chamber. (However, in the facilities founded by the Ministry of Healthcare, the nurses' wages were raised on 1<sup>st</sup> April on average by 18%; the other healthcare workers' wages were raised by 8% thanks to the collective agreement; MH SR data). It is interesting to compare these results with the (un)successfulness of the education employees. The result of the biggest strike in history of the SR in November 2012 was an increase in tariff salaries of teaching and professional staff by 5% and an increase in the variable component of the salaries of non-teaching staff also by 5% (to compare, in 2012, education employees earned on average EUR 682

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<sup>18</sup> The departure of the largest employer US Steel would mean at least a temporary job loss for another eleven thousand people. Therefore, the efforts of the Slovak government to negotiate acceptable terms are understandable.



a month, healthcare and social assistance employees EUR 770). Among the branches with the lowest average wages are accommodation and food service activities (EUR 511) and construction (EUR 607). The best earning employees still earn more than thrice as much as the worst earning ones – the gap actually deepened in 2012.

Large wage differences exist not only among branches, but also among regions of the SR, especially between the Bratislava Region and the rest of Slovakia. Average wage in the Bratislava Region is almost 70% higher than in the Prešov Region. This difference is among other things caused by the different structure of job titles and has to be understood in the context of significant difference in the price levels (total cost of living), which makes income differences more relative. In 2012, average monthly wage declined only in the Nitra Region (only by EUR 1; however there was no year-on-year decline in average wages in any of the regions in the last two years), which thus became the region with the second lowest wage (taking the place of the Banská Bystrica Region). Average wage increased the most in the Trenčín Region.

The gender pay gap in 2011 (data are published by Eurostat with a one-year lag) was 20.5%. In comparison, the European average was 16.2% (the average wage of a woman in the SR constitutes less than 80% of the average wage of a man). The so-called Equal Pay Day (which was 4<sup>th</sup> April in 2013) symbolizes the fact that women in Slovakia have to work three months longer to earn the same wage man do. At the same time, women achieve a higher level of education in Slovakia.

## **5. External Economic Relations**

### **5.1. Balance of Payments**

In 2012, the external imbalance of the Slovak economy was reduced. The current account of the balance of payments reached historically the largest surplus of 2.3% GDP (Table 14). This was primarily achieved through the balance of trade, whose surplus increased substantially compared with the previous three years. This was due to new production in the automotive industry and its orientation also towards new markets, which caused a larger increase in exports compared with imports influenced by the weaker domestic demand. While the capital account of the balance of payments improved compared with the previous year, the financial account reached a deficit after several years of high surpluses.

Not only the balance of trade, but also the balance of services, which reached a surplus after several deficit years, had a positive impact on the current account

of the balance of payments. Its positive development is mainly due to the increase in income in the category of other services, caused by the higher foreign demand. Income increased especially in advertising, legal, accounting and consulting services, research and development and technical services.

Table 14

**Main Components of the Balance of Payments in the SR, 2008 – 2012**

	2008	2009	2010	2011	2012
Balance of trade (EUR million)	-758	946	779	975	3 609
Balance of services (EUR million)	-487	-1 026	-744	-371	306
Balance of income (EUR million)	-2 295	-870	-2 065	-1 680	-1 653
Current transfers (EUR million)	-893	-676	-422	-354	-649
Current account (EUR million)	-4 433	-1 627	-2 453	-1 429	1 614
Capital account (EUR million)	806	464	1 018	865	1 376
Financial account (EUR million)	5 063	2 060	2 385	2 565	-342
Current account/GDP (%)	-6.6	-2.6	-3.7	-2.1	2.3
Rate of current account deficit offset by					
Capital and financial account surplus	1.32	1.55	1.39	2.40	x

Source: NBS (2013a); SO SR (2013a); own calculations.

The negative balance of income hardly changed compared with the previous year. On one hand, the income of persons working abroad increased, but at the same time, interest payments increased too. The balance of current transfers is the only component of the current account which deteriorated year-on-year because of lower receipts from government as well as from private transfers. Revenues from the EU budget declined as well as receipts from grants, deposits, disbursements and other unilateral transfers of legal entities.

## 5.2. Foreign Trade

As mentioned above, the current account of the balance of payments improved significantly because of the balance of trade development. Despite the negative development of foreign demand, it reached a surplus of 5.1% GDP, exceeding the results of the previous years, when exports and imports increased (and in 2009 declined) almost identically (Table 15).

Export and import dynamics slackened compared with the previous year. While exports (strongly supported by the automotive industry) increased by almost 11% in 2012, imports (slowed down by the weak domestic demand) increased only by 6%. Consequently, the export performance of the Slovak economy increased more significantly (by more than 5 p. p. compared with 2011) than its import intensity (by 2 p. p.). With regard to the lower economic growth dynamics compared with the foreign trade dynamics, the openness of the economy, measured as a share of foreign trade in GDP, increased again year-on-year

and exceeded 170%. The main factor contributing to the increase was the automotive industry, which is both export-oriented and import-intensive.

Table 15

**Foreign Trade in Goods in the SR, 2008 – 2012**

	2008	2009	2010	2011	2012
Exports (EUR million, current prices)	49 522.3	39 721.2	48 272.1	56 783.2	62 833.0
Annual change (% , current prices)	4.6	–19.8	21.5	17.6	10.7
Imports (EUR million, current prices)	50 280.1	38 775.1	47 493.6	55 767.6	59 223.8
Annual change (% , current prices)	4.6	–22.9	22.5	17.4	6.2
Balance (EUR million)	–757.8	946.1	778.5	1 015.6 <sup>19</sup>	3 609.2
Balance/GDP (%)	–1.1	1.5	1.2	1.5	5.1
Export performance (% GDP)	74.1	63.3	73.3	82.2	87.9
Import intensity (% GDP)	75.2	61.7	72.1	80.7	82.9

Source: SO SR (2013a); own calculations.

While foreign trade declined in 2008 and slumped in 2009 because of the economic crisis, in the next year it recovered also thanks to the base effect of the previous year. In 2011, the export and import dynamics slackened and in 2012, it stabilized. Imports and to a lesser extent exports declined year-on-year only in December. At the same time, foreign trade was reaching a surplus in all months of 2012.

In terms of the commodity structure, machinery and transport equipment were mostly responsible for the year-on-year increase in exports. Exports increased in the sub-groups of machinery and transport equipment because of increased exports of motor vehicles related to the production of new models. However, such development will not continue in 2013 because of the weakening foreign demand. In terms of finished goods, the highest year-on-year increase was reached in exports of some types of agricultural and food products. In the group of chemical products and semi-finished goods, the semi-finished goods were exported most (e.g. copper; iron and steel products). Although the prices of petroleum and natural gas in the global market increased, the export of raw materials stagnated because of low foreign demand.

Significant year-on-year increase in exports of machinery and equipment in 2012 was connected with the strong increase in imports in the same group. In the sub-groups of transport equipment and machinery, there was an increase in imports of components for the automotive industry. In the group of final goods, agricultural, food and electrotechnical products contributed most to the increase in imports. In chemical products and semi-finished goods, the increase in imports was mainly due to plastics and copper.

<sup>19</sup> The difference in the figures of the balance of trade in 2011 in Table 14 and Table 15 is caused by different data published on the NBS and SO SR websites.

The territorial structure of the Slovak foreign trade has remained similar in the last few years. In 2012, the EU accounted for more than 83% of exports, which is a slight decline compared with the previous years. The share of the EU countries in the Slovak imports reached 64%, which confirmed the trend of gradual decline (which is faster than in the case of exports). In 2005, the EU share in imports to Slovakia was above 70%.

Slovakia has the strongest economic ties with Germany and the Czech Republic. The dependence on the German demand makes the Slovak economy particularly vulnerable, especially coupled with the current negative development in the euro area including its strongest economy. In relation to the persistent crisis in the monetary union, which concerns Slovakia because of the impact of the economic slowdown in the economies of its business partners, a deceleration of the export growth rate can be expected.

This fact confirms the need for diversification in terms of territory. The Slovak foreign trade should orient itself also towards non-euro-area and non-EU countries. Such a step is not in line with the theory of optimum currency area, according to which an increase in the share of mutual trade benefits the optimum currency area and thus its advantages for the member states. However, in times of crisis it turns out that it is a double-edged sword.

The Slovak automotive industry has already begun placing its production in the non-EU markets. The automobile manufacturer Volkswagen exports part of its production to China and Kia to Russia. PSA Peugeot Citroën has also started penetrating the Eastern markets, although its smaller cars are still being exported in the weakening euro-area markets, such as Italy, Spain, France and Germany. Although the EU countries are Slovakia's traditional and close business partners, the significance of developing markets has been increasing, which represents an opportunity for the Slovak foreign trade. The Slovak economy would benefit not only from territorial diversification, but also from the diversification of production, which could partly reduce economic slowdown in times of declining demand for automobiles.

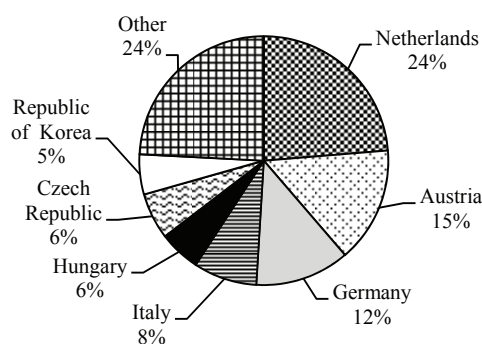
### **5.3. Foreign Capital**

In terms of capital and financial accounts of the balance of payments, the results in portfolio investment and other short-term investment were the most distinctively different in 2012 compared with the previous period. The balance of portfolio investment reached a substantial surplus because of inflows from the NBS activities in the financial market and the increase in sales of government bonds. On the other hand, the result in the capital and financial accounts declined year-on-year because of the development in the balance of other investments.

FDI inflows increased year-on-year mainly because of higher inflows of resources in the form of other capital.

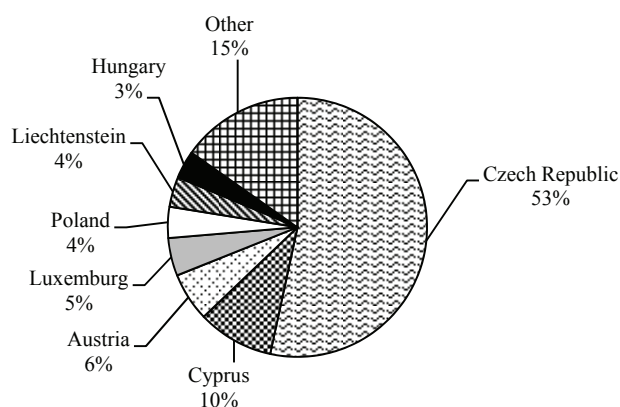
Figure 15 shows that the country with the largest FDI stock in Slovakia in 2011 was the Netherlands, followed by Austria and Germany. Important investor countries in the SR also include Italy, Hungary, the Czech Republic and the Republic of Korea. In terms of FDI outflows, the most important country is undoubtedly the Czech Republic with more than 50% share in total Slovak FDI abroad (Figure 16).

Figure 15  
FDI Stock in Slovakia, 2011 (EUR thousands)



Source: Based on NBS data (2013a), preliminary data.

Figure 16  
Slovak FDI Stock Abroad, 2011 (EUR thousands)



Source: Based on NBS data (2013a), preliminary data.

Concerning the investment conditions in Slovakia, the Slovak government approved a change of the investment aid rules at the beginning of 2013. The new law stipulates that the highest stimuli should be acquired by investment projects in branches with high value added and at the same time in the most underdeveloped regions of Slovakia. Such differentiation of investment aid should also help to restrict aid to less important branches in terms of value added creation and at the same time preserve the principle of providing higher investment aid to projects in less developed regions. This means that the amount of investment aid remains tied to the unemployment rate in the region.

In the *Manifesto of the Government of the Slovak Republic for the Years 2012 – 2016*, the government pledged to create favourable investment climate for domestic and foreign investors. Economic policy should be focused on aiding established investors in expanding their activities in Slovakia. Established investors requesting aid can be successful only if they create new jobs and expand their production at the same time.

## **6. Price Development**

In 2012, the movement of the price level was not such a controversial topic compared with the previous year.<sup>20</sup> The attractiveness of this topic in 2011 was related to the rapid increase in price level after the disinflation during the recession. A similar (even a little lower) inflation rate in 2012 did not attract as much attention.

### **6.1. Consumer Price Increase Slackened after a Jump**

The slight slowdown in the growth of consumer prices (to 3.7% based on the Harmonised Index of Consumer Prices, HICP, Figure 17) was mainly caused by:

- *The more positive development of fuel prices*, which reflects an external factor (the development of petroleum prices in the world market). Consequently, the average price of diesel increased less in 2012 (“only” by 7.5%) compared with 2011 (when it increased year-on-year by 20.3%).
- *More moderate revisions of regulated prices*. The contribution of this administrative measure declined slightly. The increase in regulated prices slowed down year-on-year by 0.7 p. p. (from 7% in 2011 to 6.3% in 2012).

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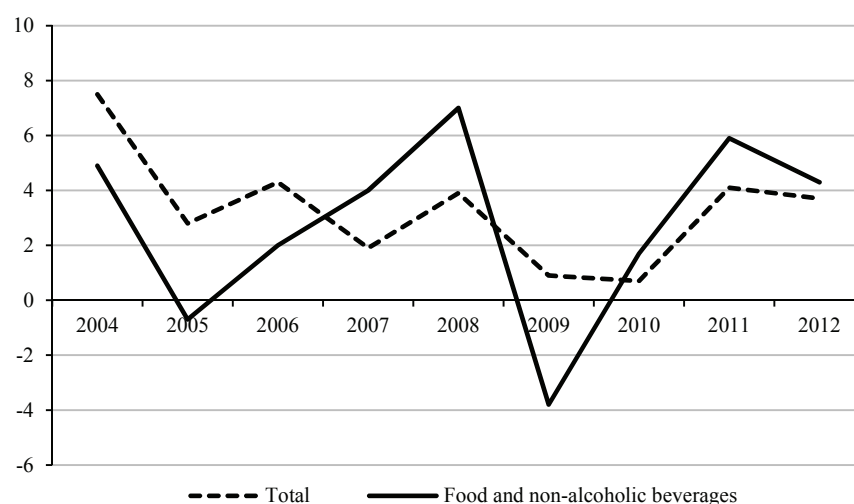
<sup>20</sup> After record low inflation rates in 2009 and 2010 (less than 1% based on HICP), the 4.1% inflation rate in 2011 seemed extremely high. However, compared with the pre-recession levels, such inflation rate does not seem extraordinary (more in Morvay et al., 2012a).

- *The negative development of domestic demand and consumption.* Domestic demand dynamics and final consumption dynamics remained low (see Chapter 1 of this publication). Final consumption at constant prices declined year-on-year (by 0.6%), creating no inflationary impulses.

- *The slowdown in agricultural commodity price growth* (these are determined by a set of specific factors). In 2011 (especially in the first half of the year), food prices were driven up by global poor harvest and significantly influenced total inflation. In 2012, this effect was also weakened.

Figure 17

Year-on-year Change in Consumer Price Level (% , HICP)



Source: SO SR.

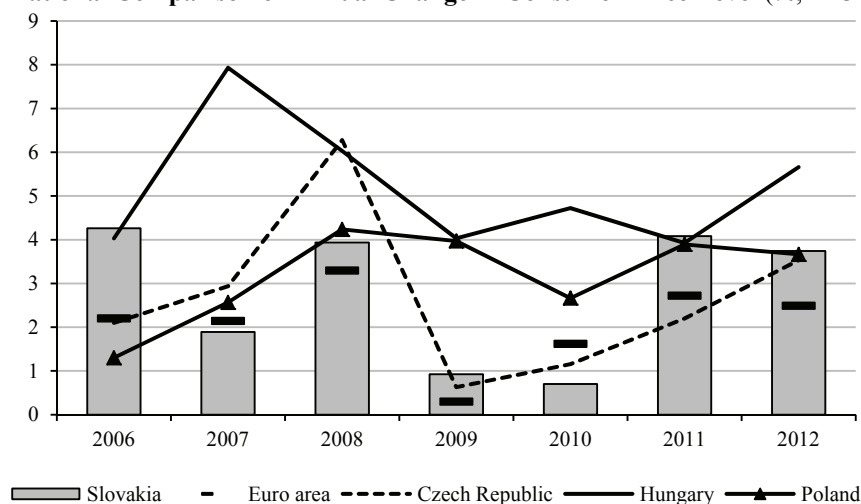
In 2012, the growth rate of consumer prices was higher than average nominal wage growth rate for the second year in a row. Real wages declined. However, in order to explain this phenomenon, it is more important to focus on the very low average wage growth and not the inflation rate (see Chapter 4).

The Slovak economy has undergone a period of disinflation and subsequent renewed inflation, similar to the development in the euro area and in the V4 countries (Figure 18). However, it is obvious that in 2010 – 2011, inflation rate rose faster in the Slovak economy than in the neighbouring countries or the euro area average (in 2010, inflation rate was the lowest among the selected countries, in 2011 the highest). Price level in the SR in this period proved to be more volatile. The rapid transition from the highest disinflation to the highest inflation is obvious. In 2012, consumer price level in the SR did not deviate from the levels of

other economies (however, results in the group of selected countries were heterogeneous – in some countries inflation accelerated, in others it decelerated<sup>21</sup>).

Figure 18

**International Comparison of Annual Change in Consumer Price Level (% , HICP)**



Source: Eurostat.

## 6.2. Producer Price Growth Slackened Considerably

When assessing price development in production, the “moderation” in agricultural product prices (related to the above-mentioned moderation in agricultural commodity price growth) attracts one’s interest. After a two-digit agricultural commodity price growth for two years in a row (2010, 2011), a price increase of 6.9% in 2012 seems quite low. However, in the past, the price dynamics of these commodities often changed rapidly.

Construction has been going through a period of severe recession for several years, which is probably the reason why producer prices in construction increased only slightly.<sup>22</sup>

The slowdown in producer price growth was more significant than the slowdown in consumer price growth. It is probable that recurrent sales problems

<sup>21</sup> The deceleration of inflation in the SR is very similar to the development in the euro area and Poland. However, in the Czech Republic and Hungary, the development was different: inflation accelerated in 2012.

<sup>22</sup> The price growth rate of construction work declined to 0.6%, the price of materials used in construction increased a little faster (1.5%). The faster increase in construction material prices complicates the situation in construction, which was hit hard by the recession.



throughout 2012 suppressed price growth, e.g. price growth in industrial production for the national territory declined to 1.3% (in 2011, it was 4.1%).

The price dynamics of goods for the domestic market and for export swapped places. In 2010 and 2011, price growth of goods for foreign markets was much higher than price growth of goods for the domestic market. In 2012, it was vice versa (Table 16).

**Table 16**  
**Year-on-year Change in Industrial Producer Prices (%)**

	2010	2011	2012
Industrial producer prices – total	0.2	4.4	2.0
Industrial producer prices – domestic	–2.8	2.7	3.9
of which: industrial production	0.0	4.1	1.3
Industrial producer prices – export	2.7	5.7	0.7

Source: SO SR.

### 6.3. Significant Shift in the Comparative Price Level

Throughout 2001 – 2011, comparative price level<sup>23</sup> in the SR approached the EU-27 price level (increasing from 44% in 2001 to 72% of the EU-27 price level in 2011). According to Eurostat (2012), the comparative price level in the SR increased significantly. Comparative price level increased (although more slowly) also in the other new EU member states, especially in the Czech Republic, Romania, Estonia and Latvia. In the above-mentioned period, the comparative price level in the SR approached the EU-27 level by 28 p. p. This represents the most significant increase among the new EU member states catching up with the EU price level (Table 17).

**Table 17**  
**Comparative Price Levels in Selected New EU Member States (EU-27 average = 100)**

EU member state	Comparative price level 2001	Comparative price level 2011
Slovakia	44	72
Czech Republic	50	77
Hungary	53	64
Poland	65	60
Slovenia	74	84
Latvia	59	74
Lithuania	54	66
Estonia	61	79
Romania	42	60
Bulgaria	41	51

Source: Eurostat.

<sup>23</sup> Comparing the price level of commodities making up the household final consumption; prices include indirect taxes. For more information please refer to Eurostat (2012).

To summarize, whereas there was a certain “compensation jump” in the price level in 2011 (after the very low inflation during the recession and shortly afterwards), in 2012, this compensation effect vanished and the price level movement was more moderate. Price growth slackened also because of the weakening economic growth, evident especially at the end of the year.

## **7. European Central Bank Monetary Policy and the Euro Area Functioning from the Point of View of Slovak Republic**

The end of the euro area crisis, including the debt crisis, the crisis of growth, employment and in many countries a social crisis, is still nowhere in sight. Countries fighting the debt crisis implement austerity measures, which contribute to the recession coupled with a rapid increase in unemployment. The European Union (EU), the European Central Bank (ECB) and the member states resort to an increasingly wider spectrum of instruments and measures. Many of the EU steps lead to a deepening of the European integration.

Such development raises contradictory reactions both in the member states and in the EU as such. The euro area periphery and France continue to demand sharing of the government debts and greater solidarity, whereas the north of the monetary union led by Germany is against a “transfer” union and believes that helping the periphery reduces the pace of the necessary reforms. France also calls for more emphasis on the economic growth and expects the ECB to stimulate the economy. However, Germany’s primary concerns are fiscal consolidation and inflation, which should be further monitored by the euro area central bank.

In this chapter, we address the ECB monetary policy in 2012 and at the beginning of 2013, as well as the current questions related to the EU and euro area functioning, accentuating Slovakia’s position. We concentrate on the indicators of macroeconomic (in)stability monitored by the EC, the participation of SR in the euro area rescue mechanisms (European Financial Stability Facility, European Stability Mechanism) and thoughts on a banking union, which could be an important part of the deepening of the European integration. Although it is difficult and maybe even impossible to predict the future of the monetary union, the direction is clear from the so far accepted and planned integration steps.

### **7.1. European Central Bank Monetary Policy**

The European central bank entered the year 2012 with the key interest rate at 1%, but the deterioration of the economic development in the euro area forced it to reduce the interest rate to a record low of 0.75%. The interest rate remained at

this level for almost a year. In May 2013, the interest rate was reduced again to a record low of 0.5%. This was done in reaction to the sharp decline in the inflation rate to a level well below the ECB target level,<sup>24</sup> the unimproved development of the real economy and increasing unemployment. The euro area central bank has supported the economy by reducing interest rates to a lesser extent than the central banks in the UK or the USA, whose interest rates were closer to zero. However, after the last cut, key interest rates of the ECB and the Bank of England (BoE) are the same (BoE's key interest rate has been 0.5% since March 2009).

At the turn of 2011 and 2012, the ECB supported the banking sector, offering low interest rate loans for three years to commercial banks through the so-called long-term refinancing operation (LTRO). Banks borrowed around EUR 1 trillion, settled their due liabilities or deposited the money in the ECB. They did not start offering more loans to enterprises and households to enhance economic growth, as the ECB anticipated. At the beginning of 2013, banks used the first opportunity to pay back part of the LTRO loans before due date (around EUR 250 billion). This can be considered an indicator of the European banking sector's health. At the same time, it was confirmed that the banking sector is imbalanced, because the first instalments were from the banks from the core of the euro area (including Germany, France and the Netherlands), which do not need the help anymore. On the other hand, most south European banks (especially Italian and Spanish) are still dependent on the ECB loans.

At the beginning of September 2012, the ECB resumed purchases of government bonds of the euro area countries,<sup>25</sup> creating a new programme – Outright Monetary Transactions (OMT). The programme enables the ECB to purchase government bonds of the troubled countries with maturity of one to three years with no quantitative limits, in order to reduce their debt service costs, provided the country concerned commits itself to strict and effective conditionality under the EFSF or ESM programme.

The OMT programme has become the most powerful weapon in the fight against the crisis and the question of the ESM capacity is no longer critical. It is enough if a country (Spain, Italy or other countries) is provided help from a rescue mechanism and the ECB can intervene. Thus, this programme enables the ECB to “save” countries based on a mere promise to implement reforms. The consent of all member states is no longer necessary. This step of the ECB calmed

<sup>24</sup> Inflation rate in the euro area declined from 1.7% in March 2013 to 1.2% in April 2013, which put pressure on the ECB to abide by its mandate to ensure price stability, i.e. an inflation rate below but close to 2%.

<sup>25</sup> The European Central Bank has so far invested primarily in the Italian, Spanish, Greek and Portuguese bonds.

the bond market. However, it can be considered a measure which insufficiently motivates the concerned countries to implement key reforms, delays solutions to problems and enhances moral hazard in the euro area. Moreover, the OMT functioning is not clear yet.

## **7.2. *Six-pack, Two-pack and the Fiscal Treaty***

The European Union has been undergoing a challenging process of elimination of the macroeconomic imbalances, which arose in the pre-crisis period and contributed to the deepening of the crisis in the euro area. At the end of 2011, the Macroeconomic Imbalance Procedure was introduced with the so-called *six-pack* legislation, with the aim to strengthen macroeconomic surveillance in the EU. The aim of the new framework is to identify and solve macroeconomic imbalances in the EU member state at an early stage. Macroeconomic surveillance forms a part of the so-called European Semester framework related to all aspects of surveillance including fiscal and structural policies.

Since 2012, the EC regularly publishes a so-called Alert Mechanism Report on macroeconomic imbalances in the member states plus a list of countries which require a further in-depth review. The first Alert Mechanism Report was published in February 2012, the second in November 2012 (EC, 2012a). The publication of the second report by the EC kicked off the second annual cycle of the Macroeconomic Imbalance Procedure 2013.

The evaluation of the member states, which takes into account their specifics and current economic development, is based on a so-called scoreboard. In the second report, one more indicator that focuses on financial sector was added to the original ten. According to the last report, it is necessary to perform an in-depth review of the development related to macroeconomic imbalances in 14 EU member states, the results of which should be published in spring 2013.<sup>26</sup>

Table 18 shows the indicators of external balance, competitive position and internal balance, their indicative thresholds and (non)fulfilment in Slovakia in 2007 – 2011. In the case of the current account deficit, the imbalance was reduced because of the impact of the crisis. However, the Slovak net international investment position deteriorated and remains above the indicative threshold. The crisis had a serious negative impact on the internal balance, especially the private sector debt, general public sector debt and unemployment rate, which remains

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<sup>26</sup> The countries concerned are: Belgium, Bulgaria, Denmark, Spain, France, Italy, Cyprus, Hungary, Malta, the Netherlands, Slovenia, Finland, Sweden and the United Kingdom. Countries which are subject to surveillance under economic adjustment programmes supported by official financing are not assessed in the Alert Mechanism Report (Ireland, Greece, Portugal and Romania).

above the indicative threshold. However, since several indicators do not exceed indicative thresholds, the second Alert Mechanism Report of the EC did not include Slovakia among the member countries which would require a more in-depth review.

After almost a year of discussions among the European institutions, the European Parliament approved a legislative package containing two proposals (a so-called *two-pack*) strengthening the fiscal surveillance mechanisms. These will enhance the powers for the EC to control national budgets. The first regulation focuses on monitoring and assessing draft budgets of the euro area members,<sup>27</sup> the second is concerned with enhanced surveillance of euro area member states receiving financial assistance or those who might potentially receive it in the future.<sup>28</sup> The *two-pack* has to be approved by the Council of the European Union and the rules should apply in the next budget period, i.e. with regard to the 2014 budgets.

In March 2012, heads of state and government of the EU countries, with the exception of the United Kingdom and the Czech Republic, signed a new fiscal treaty – the so-called Fiscal Compact or Fiscal Pact, officially the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*. The treaty aims at eliminating some of the shortcomings of the Stability and Growth Pact and at strengthening the fiscal governance framework in the euro area. In other words, it is a step towards further centralisation and integration, coupled with a significant transfer of national sovereignty in terms of fiscal issues to the European level. The treaty also includes a system of *ex ante* coordination of all major economic policy reforms planned on the national level, which will be executed in the European Semester framework.

The treaty entered into force on 1<sup>st</sup> January 2013, because the acquired minimum number of the euro area members – twelve out of seventeen – ratified it. The Slovak Republic ratified the treaty in January 2013, when the president signed it after the National Council of the Slovak Republic had approved it in December 2012.

However, in Slovakia, the constitutional Fiscal Responsibility Act was approved already in March 2012. Based on a so-called debt brake, the act introduces automatic correction mechanisms, which are activated after the public debt exceeds 50% GDP. The adoption of the fiscal treaty requires an amendment to the act, which would set the public finance deficit ceiling.

<sup>27</sup> Until 15<sup>th</sup> October, euro area member states will have to present their draft budgets to the EC, which will review their accordance with the Stability and Growth Pact. In the case deviations are exposed, it can ask the country to revise the budget draft.

<sup>28</sup> If the legislation were in force now, the regulation would concern Greece, Ireland, Portugal, Spain, Cyprus and Italy.

Table 18

**EC Scoreboard Indicators and their (Non-)fulfilment in Slovakia, 2007 – 2011**

Indicator	Indicative thresholds				
	Euro area members		Non-euro-area members		
Current account balance (% GDP) <sup>1</sup>	-4 to 6				
Net international investment position at the end of the year (% GDP)	-35				
Real effective exchange rate <sup>2</sup>	-/+5		-/+11		
World export market shares <sup>3</sup>			-6		
Nominal unit labour cost <sup>4</sup>	9		12		
Year-on-year change in house prices <sup>5</sup>	6				
Private sector credit flow (% GDP)	15				
Private sector debt (% GDP)	160				
Public sector debt (% GDP)	60				
Unemployment rate (%) <sup>1</sup>	10				
Financial sector liabilities (%)	16.5				
Indicator	2007	2008	2009	2010	2011
Current account balance (% GDP) <sup>1</sup>	-7.2	-6.4	-4.7	-4.1	-2.8
Net international investment position at the end of the year (% GDP)	-46.2	-57.4	-66.7	-63.2	-64.4
Real effective exchange rate <sup>2</sup>	19.4	26.0	27.1	11.8	4.3
World export market shares <sup>3</sup>	74.4	52.1	39.8	31.3	22.3
Nominal unit labour cost <sup>4</sup>	6.2	6.7	10.9	9.4	4.4
Year-on-year change in house prices <sup>5</sup>	25.7	12.8	-12.8	-4.9	-5.6
Private sector credit flow (% GDP)	10.3	12.4	2.8	3.3	3.3
Private sector debt (% GDP)	64.3	69.4	73.9	72.8	76.3
Public sector debt (% GDP)	29.6	27.9	35.6	41.0	43.3
Unemployment rate (%) <sup>1</sup>	13.7	11.4	11.0	12.1	13.4
Financial sector liabilities (%) <sup>6</sup>	24.8	8.9	-5.0	2.2	1.2

Notes:

<sup>1</sup> 3-year running average.<sup>2</sup> Based on HICP/CPI deflator to 35 industrial countries – 3-year percentage change.<sup>3</sup> 5-year percentage change, current prices.<sup>4</sup> 3-year percentage change.<sup>5</sup> Deflated by the household final consumption deflator.<sup>6</sup> Year-on-year change.

Source: EC (2012b); Eurostat (2013a).

**7.3. European Stability Mechanism and Further Measures Deepening the European Integration**

Slovakia's participation in the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) means significant risks in the form of higher debt burden, higher interests on government bonds and the loss of resources put in the rescue mechanisms, especially if some large European economies ask for help. Slovakia is supposed to contribute more than EUR 659 million and provide guarantees of more than EUR 5 billion.

The Ministry of Finance of the SR (2012) estimated that the SR contribution in the ESM would increase the country's public debt by 0.4% GDP in 2012 and the share of the SR in the EFSF debt by 1.9% GDP. Table 19 and the development

in the euro area suggest that these shares will increase in the following years. The prediction takes into account financial assistance provided to Ireland, Portugal and Greece. However, it does not take into account the impact of the restructuring and recapitalisation of the Spanish financial sector, because it should be funded by the ESM, i.e. transferred from EFSF to ESM, whose liabilities (contrary to those of the EFSF) should not be redirected into the public administration debt of the member states. At the same time, deposits of the SR in the ESM reduce the disposable resources of the State Treasury used to finance the state and thus contribute to the increase in public debt.

Table 19

**Share of the SR in the EFSF Debt and Contribution of the SR in the ESM as Components of the Gross Public Administration Debt, 2011 and Prediction 2012 – 2015 (% GDP)**

	2011	2012	2013	2014	2015
Share of the SR EFSF debt	0.2	1.9	2.5	2.6	2.4
Deposit of the SR in the ESM	0.0	0.4	0.7	0.8	0.8

Source: MF SR (2012a).

The implementation of a *banking union*, which would automatically involve all euro area members, is an important step in the European integration. The other EU member states can participate on a voluntary basis. As its first pillar, the *Single Supervisory Mechanism* (SSM) will be formed, i.e. banking supervision will be transferred to the ECB. Many economists consider it a key step towards the solution to the crisis.<sup>29</sup> Furthermore, a so-called resolution fund to help euro area banks and a common deposit insurance system should be formed. An agreement on the directives for both above-mentioned pillars should be reached by June 2013.

At the meeting in December 2012, the finance ministers of the EU member countries reached a compromise regarding the Single Supervisory Mechanism. The European Central Bank will have the authority to supervise banks with total assets over EUR 30 billion or over one fifth of the GDP of the country in which they are located. National regulators will supervise smaller banks and the ECB will intervene only if necessary. Each member country will have one vote on the Supervisory Board and decisions will be taken by simple majority. Single

<sup>29</sup> The hope that the EU would unite in the fight against the banking sector problems was shaken by the condition for international assistance, originally presented to Cyprus, under which the country should have taxed its citizens deposits below EUR 100 000, which are protected by law. In the end, “only” deposits above EUR 100 000 were taxed. However, after this unprecedented step, the credibility of the euro area banks declined significantly. Public confidence in the European integration can decline as well.



Supervisory Mechanism should be implemented during 2013 and fully functional in March 2014, which is later than originally planned.

In the case of Slovakia, Single Supervisory Mechanism will apply to around three quarters of all banks. Since the Slovak banks are mostly subsidiaries of west European banks (which are systemically important), surveillance over them will be transferred to the ECB. Thus, the SR will lose almost all tools to regulate banks in its territory. There is a risk that if a large foreign bank faces problems, it could transfer the capital from its subsidiary in the SR abroad (Morvay, Okáli and Šikulová, 2012). Slovakia would be saving the unsound bank through its sound subsidiary at the expense of its own banking sector stability. In extreme cases, this could lead to a collapse of the Slovak subsidiary. All this largely depends on the details in the specific proposal of the new European surveillance body and its authority.<sup>30</sup>

The functioning of the Single Supervisory Mechanism is a prerequisite to direct recapitalisation of the troubled banks by the ESM, which should break the vicious cycle between the banks and the states. This should prevent the Ireland and Spain scenario, in which the banking sector pulled down whole economies. However, countries' positions on the direct recapitalisation of banks differ. Germany, other core euro area countries and also Slovakia claim that the state, in which the bank is located, should take part in its rescue. Germany pushes for a 50% share of the country's involvement in the recapitalisation of a bank which asks for ESM assistance, Slovakia is in favour of a 20% share. The south European countries are, understandably, against. One of the risks of direct recapitalisation by the ESM is that it limits the Mechanism's ability to act. Using the ESM resources to rescue banks would reduce the lending capacity designed to assist troubled states. Since markets perceive bank recapitalisation as riskier than assistance to states, this could reflect negatively on the ESM rating.

In February 2013, the EC proposed a *Financial Transaction Tax*, on which the finance ministers had agreed a month before. Its implementation was supported by Slovakia and ten other countries,<sup>31</sup> which enabled them to engage in the procedure of *enhanced cooperation* laid down in the Treaties of the EU. An EU-wide agreement was blocked by the UK and Sweden. According to the EC, the aim of the tax is to ensure the financial sector's contribution to public revenues and strengthen the single market. However, since this tax will not be introduced by all countries, we expect it to reduce the competitiveness of countries involved.

<sup>30</sup> In this context it is necessary to add that in 1999 – 2000, Slovakia spent more than 10% GDP on the consolidation of its banking sector. However, if the banking union is formed, financially sound banks will have to bear the costs of consolidating the troubled ones.

<sup>31</sup> Austria, Belgium, Estonia, France, Greece, Germany, Italy, Portugal, Slovenia, Spain.



Thoughts on the *fiscal capacity* for the European Monetary Union (EMU) have also appeared. Fiscal capacity, essentially an additional budget for the euro area separate from the EU budget, would support structural reforms. The primary function of the fiscal capacity would not be redistributive, but countercyclical, i.e. it would serve to reduce the consequences of macroeconomic cyclical shocks and structural reforms implemented based on the binding agreements between the countries and the European institutions. The financial resources for the new fiscal capacity could be taken from national contributions, VAT and the above-mentioned financial transactions tax.

With regard to the negative impacts of the struggle against the debt crisis on the European economy, the leaders of the member states agreed on a new pact in June 2012. After the Stability and Growth Pact and Euro Plus Pact, they adopted the *Compact for Growth and Jobs*. The pact contains a general framework of measures on the level of member states, the euro area and the EU in the total amount of EUR 120 billion. It should be financed primarily from the unspent EU appropriations and by the European Investment Bank (EIB). Increasing the EIB capital by EUR 10 billion increases its lending capacity by EUR 60 billion. Loans should primarily support small and medium-sized enterprises, innovation and skill development, clean energy and modern infrastructure. The additional EIB capital will be deposited by the countries in three instalments. The SR contribution is EUR 26 million.

In the case of the banking union or fiscal capacity for the Economic and Monetary Union (EMU), many things remain unclear. The specific form of these and other mechanisms or measures and their effectiveness in the fight against the crisis and prevention of possible future crises will to a great extent impact the nature of the consequences for Slovakia. The above-mentioned measures approved at the European level emphasize a multispeed EU and a more centralized euro area, i.e. restrictions on competencies at the national level.

At the end of 2012, the European Council agreed on a plan to complete the EMU based on deeper integration and stronger solidarity of the euro area member states.<sup>32</sup> This process involves the completion, consolidation and introduction of the framework for enhanced economic governance, including the above-mentioned *six-pack*, the ensuing *two-pack* and the Fiscal Treaty. The completion of the EMU also involves a more integrated financial framework, including single banking supervision.

If, after the formation of the banking union, the euro area aims to create a fiscal union, it will mean more and more restrictions on the Slovak economic

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<sup>32</sup> It is clear from the development in the EU since the outbreak of the crisis that solidarity can be understood in different ways.

policy. Since the result of this process is not yet clear, it can be evaluated only cautiously. It can lead to greater risks for the SR, especially in the mid- to long-term horizon. It is very probable that several other countries and banking sectors in the euro area will need financial help, which could also damage the relatively stable economies with sustainable debts (Morvay, Okáli and Šikulová, 2012).

Because of the high openness of the Slovak economy, the single currency can be considered an asset for the SR. However, the deepening of the European integration includes not only opportunities, but also several risks for the member states. Therefore, despite the smallness of its economy, the Slovak Republic should take as much part as possible in the formation of the common European solutions.

## **8. Public Finance**

In 2012, the consolidation of public finance continued. Because of lower growth rates related to the persistent influence of the financial, economic and debt crises in the EU, several measures had to be taken throughout the year to keep the level of the public finance deficit planned in the originally adopted budget. Because of the economic growth structure, the volatile and uncertain development in the EU countries had a major impact on the public finance development. On one hand, the declining economic growth rate (although still one of the highest in the EU) was pulled mostly by foreign demand, which, however, does not contribute to new job creation. Increasing unemployment in turn puts pressure on public finance expenditure. On the other hand, the necessary fiscal consolidation does not allow the much-needed countercyclical fiscal stimulus, which would reduce the decline in domestic demand. As in the previous years, fiscal policy acts procyclically.

### **8.1. Development of Public Finance in 2012**

In 2012, amendments aimed at increasing public finance revenues were adopted, effective since January 2013. The amendments include changes to the personal and corporate income tax rates, changes in the social security and healthcare system (increase in the contributions of self-employed persons, employees and persons employed via agreements on work performed outside employment relationship). The Ministry of Finance of the SR anticipates that the implementation of these measures will translate into EUR 380 million in revenues. According to preliminary data, in 2012, the public finance deficit reached 4.35% GDP compared with the planned deficit of 4.7% GDP. Table 20 shows a more detailed overview of the consolidation efforts in 2007 – 2012.

Table 20

**Consolidation Efforts, 2007 – 2012 (% GDP)**

	2007	2008	2009	2010	2011	2012
1. Net lending/net borrowing	-1.8	-2.1	-8.0	-7.7	-4.9	-4.7
2. Cyclical component	0.7	1.1	-1.1	-0.4	-0.1	-0.2
3. One-time effects	0.5	-0.2	0.0	-0.2	-0.5	0.2
4. Interest costs	-1.4	-1.2	-1.4	-1.3	-1.6	-1.7
5. Motorway and expressway construction outside public budget	0.1	0.0	0.4	0.7	0.3	-0.1
– PPP project construction costs	.	.	0.4	0.7	0.4	0.1
– state payments for PPP project availability minus maintenance and service costs	.	.	.	.	0.0	-0.1
– loans accepted by the NMC	0.1	0.0	0.1	0.0	0.0	0.0
– principal repayments by the NMC	.	-0.1	-0.1	-0.1	-0.1	-0.1
6. Adjusted balance (1-2-3-4-5)	-1.8	-1.8	-5.8	-6.4	-3.1	-2.8
Consolidation efforts	-0.4	0.0	-4.0	-0.6	3.3	0.3
7. Impact of the 2 <sup>nd</sup> pension pillar	-1.3	-1.2	-1.3	-1.2	-1.2	-1.0
Consolidation efforts (adjusted for the 2 <sup>nd</sup> pension pillar)	-0.4	-0.1	-4.0	-0.6	3.3	0.1

*Note:* The data for 2012 are preliminary and will be revised based on the more favourable development of the public finance deficit; PPP – Public-private partnership projects; NMC – National Motorway Company.

*Source:* MF SR (2012c).

Table 21 shows the development of the core indicators of public administration budget in 2007 – 2012. The structural balance represents an important indicator of the implemented fiscal policy. Since 2008 and especially in 2009, it increased to 6.6% GDP (because of the crisis and the implemented fiscal policy). The observed decline is related to fiscal consolidation.

Table 21

**Core Indicators of General Government Budget, 2007 – 2012**

Indicator	2007	2008	2009	2010	2011	2012
Net lending (+) / borrowing (-) (EUR million)	-1 115	-1 397	-5 022	-5 047	-3 414	-3 354
Net loans (+) / borrowings (-) (% GDP) <sup>1</sup>	-1.8	-2.1	-8.0	-7.7	-4.9	-4.7
Primary balance (% GDP) <sup>2</sup>	-0.4	-0.8	-6.6	-6.3	-3.4	-2.9
Cyclically adjusted primary balance (% GDP) <sup>3</sup>	-1.1	-2.0	-5.5	-5.9	-3.2	-2.7
Structural balance (% GDP) <sup>4</sup>	-3.1	-3.0	-6.9	-7.1	-4.3	-4.7
Gross general government debt (EUR million)	18 198	18 624	22 331	26 998	29 911	37 399
Gross general government debt (% GDP)	29.6	27.9	35.6	41.0	43.3	52.2
Net general government debt (% GDP) <sup>5</sup>	24.5	23.6	33.0	39.1	42.1	50.0

*Note:* The data for 2012 are preliminary and will be revised based on the more favourable development of the public finance deficit.

<sup>1</sup> Net lending/borrowing include the second pension pillar costs (Eurostat definition).

<sup>2</sup> Primary balance is the public administration balance adjusted for interest paid.

<sup>3</sup> Cyclically adjusted primary balance is the primary balance adjusted for the cyclical component.

<sup>4</sup> Structural balance is the public administration balance adjusted for the cyclical component and the one-time effects.

<sup>5</sup> Net general government debt is the gross general government debt minus liquid financial assets.

*Source:* MF SR (2012c).

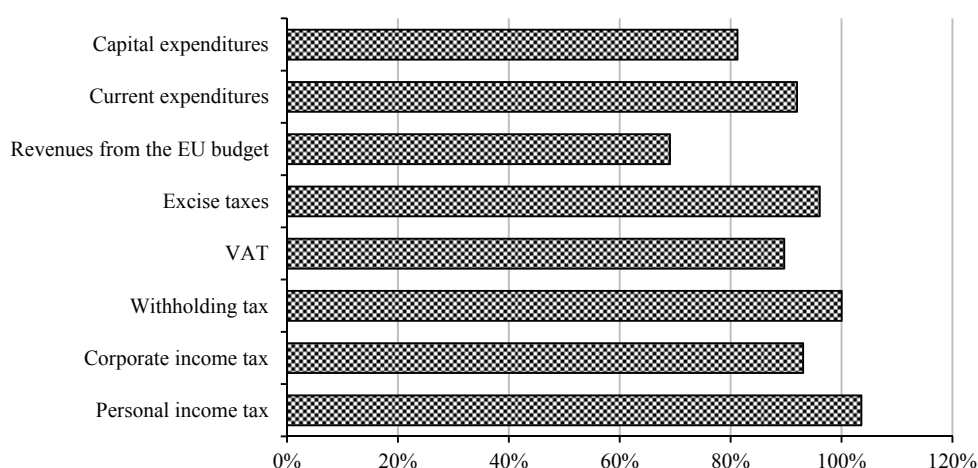
## 8.2. State Budget Development in 2012

In 2012, state budget revenues were EUR 1.7 billion lower and state budget expenditures were EUR 1.6 billion lower than planned. Closer inspection of the planned and real revenues reveals the largest gap in corporate income tax (EUR 130.5 million), but primarily in taxes on goods and services. The collected value added tax (VAT) revenues were lower by EUR 498.2 million and the excise tax revenues by EUR 81.9 million, especially because of the lower tax revenues from mineral oil and tobacco products. In terms of non-tax revenues, entrepreneurship and asset ownership revenues were lower by EUR 46 million and administrative and other fees and payments by EUR 67.2 million.

In terms of expenditures, both current and capital components were lower than originally planned – current expenditures by EUR 1.2 billion and capital expenditures by EUR 459.3 million. Current expenditures were lower mainly because of purchases of goods and services (which were lower by EUR 718 million) and current transfers (which were lower by EUR 377.8 million). Interest paid on loans was lower by EUR 138.2 million because of lower costs of public debt service. Capital expenditures were lower because of capital asset purchases (which were lower by EUR 229.3 million) and capital transfers (which were lower by EUR 230 million). In terms of the necessary investment in public infrastructure as well as quality service offered by the public administration to the citizens, reducing capital and current expenditures can create pressure to increase expenditures in the future.

Figure 19

### Fulfilment of Selected Revenue and Expenditure of the State Budget, 2012



Source: MF SR (2013b); own calculations.

Persistent implicit debts related to transport infrastructure (motorways, first- and second-class roads), environmental infrastructure, and investment in education, science, research and innovations, together with costs related to the aging of the population do not create conditions for long-term sustainable and healthy economic growth in the future.

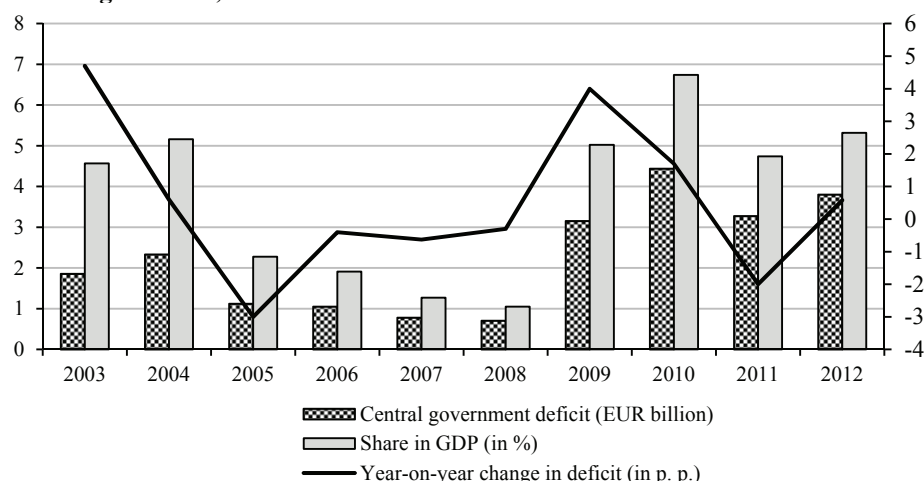
However, the need for fiscal consolidation, the accepted international commitments and the sensitive perception of the public finance development by financial markets do not provide adequate room for countercyclical expansionary policy. The nonfulfilment of the fiscal targets can be interpreted negatively by financial markets, causing an increase in the risk premium, which would have a negative impact on the refinancing of the existing public debt. However, more expansive policy would cause an increase in government debt and the new Fiscal Responsibility Act defines debt thresholds and sanctions in case they are exceeded. The situation in the world economy and especially in the European countries, marked by the volatile and mostly negative expectations, introduces elements of uncertainty into the fiscal consolidation, especially in connection with economic growth and its impact on public finance revenues and expenditures.

### 8.3. Government Budget Deficit and Central Government Debt

In 2012, state budget deficit reached EUR 3.8 billion and despite the adopted consolidation measures, it was 16.3% (EUR 135 million) higher than planned. In proportion to the GDP, it reached 5.32% after a year-on-year increase of 0.6 p. p.

Figure 20

#### State Budget Deficit, 2003 – 2012



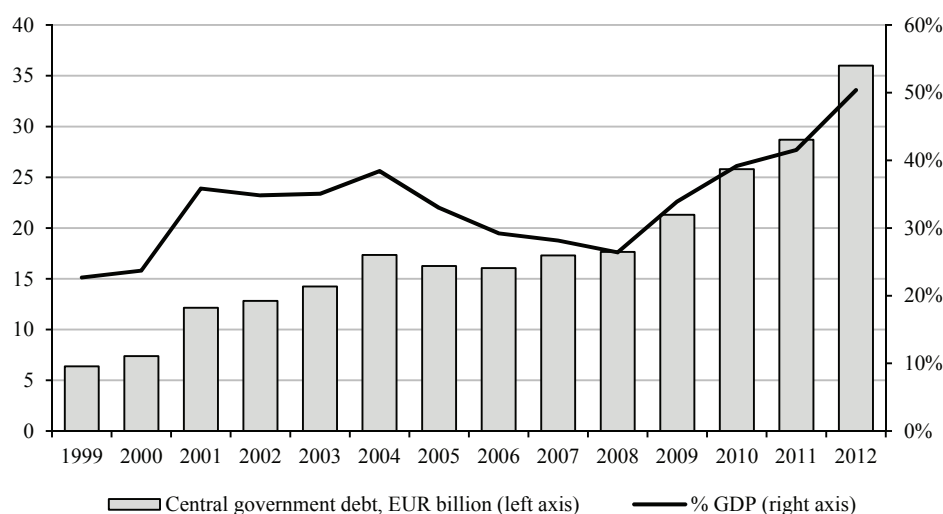
Note: SB deficit left axis; share in GDP right axis.

Source: MF SR (2013b); own calculations.

In proportion to the GDP, central government debt increased year-on-year by 8.8 p. p., reaching 50.4% GDP. This represents one of the largest central government debt increases since 2001. The main cause of the dramatic increase except for the state budget deficit was the participation of Slovakia in the EFSF and ESM, as well as decelerating GDP growth dynamics.

Figure 21

**Central Government Debt, 1999 – 2012**



Source: MF SR (2013b); own calculations.

#### 8.4. Financial Position of Slovakia vis-à-vis the EU Budget

Since becoming member of the EU, the Slovak Republic has been a net receiver of revenues from the EU budget. In 2011, the net financial position of the SR was lower by EUR 119.9 million than in the previous year because of lower appropriations under “Sustainable growth”, specifically Cohesion Fund appropriations. Cohesion Fund appropriations were EUR 342 million lower compared with the previous year. This was caused mainly by the delays related to public procurement of infrastructure projects. The rest of the expenditure increased on a year-on-year basis. The Cohesion policy expenditure grew by EUR 283.9 million, due to increasing financial implementation in some operational programmes.

The year-on-year decline in the net position vis-à-vis the EU budget does not signalize a stable increase in the absorption capacity of the Slovak economy (Figure 22). The negative development in 2011 and 2012 indicates persistent problems on the side of the managing authorities, as well as the final beneficiaries.

With regard to the new budget period 2014 – 2020 and the necessity to implement the resources allocated for 2007 – 2013 by 2015, there is a real threat that the allocated resources will not be absorbed. In the absence of national (domestic) resources, cohesion policy appropriations represent unique financial resources, which, if used well, could help to realize structural changes in the Slovak economy. However, the pressure to absorb the whole financial allocation for 2007 – 2013 can lead to allocation in less productive areas with lower multiplier effects in the Slovak economy.

Table 22

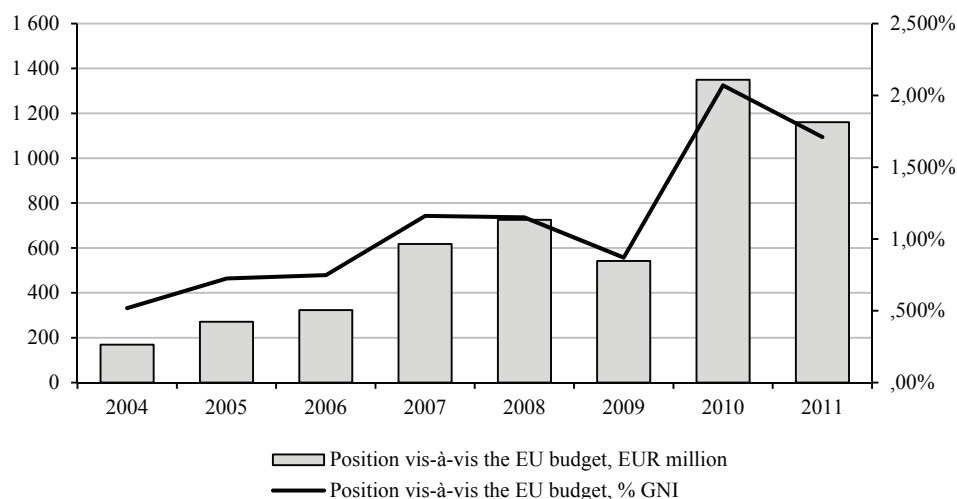
**EU Budget Expenditures in the SR, 2007 – 2011 (EUR million)**

	2007	2008	2009	2010	2011
1. Sustainable growth	669	852.8	633.5	1 208	1 096.8
1.1 Competitiveness for growth and employment	33.7	43.3	48.7	11.8	40.9
1.2 Cohesion for growth and employment	635.2	809.5	548.8	1 096.1	1 056
1.2.1 Structural funds	451.9	510.1	385.9	633.7	917.6
1.2.2 Cohesion fund	183.3	299.4	198.8	462.4	138.2
2. Preservation and management of natural resources	380.5	357	513	676.5	647.9
3. Citizenship, freedom, security and justice	13.7	11.1	8.5	8.7	29.2
4. EU as global partner	9.9	11.5	26.6	0.3	0.5
5. Administration	9.6	9.4	10.8	11.5	10.7
6. Compensations	0	0	0	0	0
<b>Total</b>	<b>1 082.7</b>	<b>1 241.8</b>	<b>1 192.4</b>	<b>1 905</b>	<b>1 785.1</b>

Note: 2012 data are published with a time lag and were not available at the time of writing.

Source: European Commission DG ECFIN (2012).

Figure 22

**Net Financial Position of the SR vis-à-vis the EU Budget, 2004 – 2011**

Source: European Commission DG ECFIN (2013); own calculations.

### **8.5. EU Structural Support Implementation in the 2007 – 2013 Programming Period**

In 2012, the pace of the financial implementation of the operational programmes increased year-on-year by 13.5 p. p. and reached 38.57%. However, because of the approaching end of the programming period, this cannot be described as satisfactory.

The largest year-on-year increase was reached in the operational programmes (OP) Healthcare (24.6 p. p.), Regional OP (19.9 p. p.), Informatisation of Society (18.3 p. p.), Employment and Social Inclusion (16.03 p. p.), Education (12.7 p. p.) and Research and Development (12.1 p. p.). The most successful operational programmes in terms of disbursement are OP Healthcare, Regional OP, OP Employment and Social Inclusion, OP Competitiveness and Economic Growth and OP Bratislava Region. Low levels of allocation are reached in OP Informatisation of Society, OP Research and Development and OP Transport. These programmes focus on those areas, which represent long-term barriers to regional accessibility development (construction of transport infrastructure) as well as knowledge economy and effective public administration. Increased activity of governing bodies in eliminating the barriers to allocation and particularly the institutional stabilisation of the cohesion policy management represent key challenges for the remaining year of the current programming period.

## **9. Overview of Selected Legislative and Economic Policy Measures**

The new government of Robert Fico, constituted in spring 2012, brought a change in the view on the role of state in the economy, which was demonstrated by the nature of the implemented economic policies and legislative measures. The medium-term vision of the economic policy of the new government was formulated in the *Manifesto of the Government of the Slovak Republic for the Years 2012 – 2016*, where the consolidation of public finances, the labour market (especially unemployment of young persons and regional unemployment), the support for economic growth and price stability, the enforceability of the law and the systematic eradication of corruption at all levels of society, were selected by the government as its priorities.

The government adopted an updated version of the *National Reform Programme of the Slovak Republic 2013*, in which it specified five main priorities of its economic policy for the year: (1) continuous fiscal consolidation focused on economic growth (with the aim to lower the 2012 deficit to 4.6% GDP and with two priorities with regard to expenditures: transport infrastructure and the educational system); (2) promoting economic growth and competitiveness (by



supporting human capital growth, innovations, business environment, green growth and energetics); (3) tackling unemployment and the social consequences of the crisis (tackling unemployment of young people, reform of the active labour market policies); (4) modernizing public administration (the ESO programme, elektronisation of public administration, more effective healthcare, transparent conditions and law enforcement); (5) restoring normal lending to the economy. In the first year, the economic policy of the new government was primarily focused on stabilizing public finances.

Although 2012 was the election year, the new parliament managed to approve a number of legislative changes, which have had a significant impact on the business environment, the labour market, the social policy and the state budget revenues. The adopted measures focused primarily on the public budget revenues, which led to several tax law amendments.

*The amendment to the Income Tax Act* (No. 595/2003 Coll.) changed the tax rate, lump sum expenses, restricted the possibility to utilize the annual tax allowance per spouse, and abolished the option to postpone tax returns for the year 2013. The corporate income tax rate was increased from 19% to 23%. A new personal income tax rate of 25% for natural persons with an annual income exceeding 176.8-times the applicable subsistence minimum was introduced alongside the existing 19% tax rate (which applies to income not exceeding 176.8-times the applicable subsistence minimum – which is EUR 34 401.74 for the year 2013). The re-establishment of progressive personal income tax represented an end to the so-called flat tax, which is one of the symbols of the economic reforms from the previous decade. The amendment also restricted the possibility to utilize the annual tax allowance per spouse. An additional tax rate of 5% was introduced for selected constitutional officers. Tax advances shall be paid by those taxable parties whose last known tax liability was higher than EUR 2 500 (previously EUR 1 660). The amendment also abolishes the option to postpone the filing of tax returns. The government introduced a special 15% tax rate on shares of profits (dividends) with the aim to motivate legal entities to pay out dividends from before the year 2004 (which would provide additional state budget revenues). The lump sum expenses were also limited to EUR 5 040 per year and the option to utilize them for income from lease was abolished, limiting the possibilities of tax optimisation especially for self-employed persons.

*The amendment to the Act on Excise Duty on Tobacco Products* (No. 104/2004 Coll.) increased the tax rate on tobacco products. The specific part of the excise tax on cigarettes was increased by 2.59% to EUR 59.50 per thousand pieces. The minimal tax rate on cigarettes was increased by 2.82% to EUR 91 per thousand pieces.

*The amendment to the Act on Administrative Fees* (No. 145/1995 Coll.) introduced several new administrative fees and increased some of the existing ones. A new fee – the so-called registration tax on vehicles – was introduced. The first owner of a motor vehicle in the categories L, M1 and N1 has to pay this fee when entering the vehicle into the vehicle registration records in the Slovak Republic. Other newly introduced fees are related e.g. to the registration of entrepreneurs by the Office for Public Procurement.

*The Commercial Code* (No. 513/1991 Coll.) was amended to help to fight tax evasion.<sup>33</sup> The changes deal with transfer and distribution of the majority ownership interest in limited liability companies. The new law requires the tax administrator's consent in both cases. Tax fraud should be prevented thanks to the *amendment to the Act on Value Added Tax* (No. 222/2004 Coll.) which i.e. regulates registration, its cancellation, and invoicing and tax security. *The Act on Restrictions of the Cash Payments* (No. 394/2012 Coll.) introduces the obligation to carry out payments above a certain limit via cashless transactions. Any payment above EUR 5 000 must be carried out through a cashless transaction. The only exception is a payment between natural persons (non-entrepreneurs), where the law allows cash payments up to EUR 15 000.

The newly adopted *Act on a Special Corporate Levy in Regulated Industries* (No. 235/2012 Coll.) should aid the consolidation of public finances. This act introduces an additional form of corporate tax for businesses with at least 50% of their revenues from regulated industries "in the field of energetics, insurance and reinsurance, electronic communication, pharmaceuticals, health care provision, rail transportation, air transportation, public sewage collection and disposal and public water supply".<sup>34</sup> The specific levy rate for a calendar month is 0.363% on profits exceeding EUR 3 million. The expected revenue is EUR 25 million in 2012 and EUR 100 million in 2013.

*The Social Insurance Act* (No. 461/2003 Coll.) was modified significantly. The first amendment (effective as of 1<sup>st</sup> September 2012) changed the insurance contribution of self-employed persons, but some changes also amended the first and second pension pillars. This amendment increased the insurance contribution of self-employed persons (from the current 44.2% of the average wage to 50% of the average wage in Slovakia from two years ago; this increased the minimum health and social contributions from EUR 160.24 to EUR 185.3). Since the beginning of 2013, persons working via agreements are also required to deduct insurance contributions from their wages. In the case of regular income of persons working via agreements, health and social insurance contributions are set at 48.6%;

<sup>33</sup> The Commercial Code provisions were changed through the VAT amendment.

<sup>34</sup> <<http://www.zakonypreludi.sk/zz/2012-235>>.

in the case of irregular income, the rate is 43.8% (persons working via agreements with irregular income are not required to deduct sickness and unemployment insurance). Lower rates of insurance contributions are set for students and the beneficiaries of old age and disability pension, and the pension for years of service. The amendment to the Social Insurance Act also changed state pension policy.

Between 2013 and 2017, pensions will increase by a fixed amount, which will depend on the year-to-year increase in consumer prices and the year-to-year increase in the average wage in the national economy. From 2018 forward, pensions will increase by a percentage based on year-to-year pensioner household inflation. From 2017, retirement age will be linked to the average life expectancy, which should translate into a gradual increase in the retirement age. The amendment strengthened the principle of solidarity and weakened the principle of merit. The conditions in the second pension pillar were also changed. The most important changes include: a decline in contributions from the current 9% to 4% of the gross wage (from September 2012 to the end of 2016); the saver will be able to contribute an additional 2% of their own net wage; from 1<sup>st</sup> September 2012 until 31<sup>st</sup> January 2013, the pension insurance system will be open to those wanting to leave; the principle of automatic entry for young people was abolished and the amendment introduced an option to leave the system within a period of two years from their inclusion.

Social policy was also influenced by the *amendment to the Social Services Act* (No. 448/2008 Coll.), whose aim was to solve the unsatisfactory situation in the financing of social services and the critical situation of social service providers. The amendment introduced financing of non-public providers of social services or providers founded by the local municipality via a special purpose grant from the state budget. *The amendment to the Act on Banks* (No. 483/2001 Coll.) can also be considered part of social policy measures, as its intent was to make current accounts and basic payment services accessible to socially disadvantaged citizens. The amendment introduces the so-called basic bank product, which can only be used by consumers whose monthly income is lower than the minimum wage.

*The amendment to the Labour Code* (No. 311/2001 Coll.) introduced several changes in the labour relations. The position of persons working via agreement was equalized, as they gained several new rights which previously belonged only to regular employees (such as the right to rest, wage surcharge for night work, wage compensation for public holiday, maternity and parental leave, protection against arbitrary dismissal etc.). The amendment reintroduced the *concurrence* of the termination notice *period* and a *severance* payment (only if the employee has worked at their job for a period of at least two years; if not, they only have the right to the termination notice period). Higher severance pay was introduced for

workers who have worked at their current place of work for at least twenty years. From the employers' perspective, the costs of dismissing employees increased also because of the obligation to pay severance pay even if the termination of employment relationship is based on a mutual agreement with the employee.

The employers' option to use contract chaining was also limited. The amendment lowers the maximum length of fixed-term employment from three to two years and the employer can only renew such employment agreement twice in a row (previously three times). Apart from the above-mentioned changes, the amendment to the Labour Code brought about the following changes: the option to extend the probationary period by another three months was abolished; night work was extended by an hour; the position of trade unions was reinforced (they no longer have to prove their membership base; union members are, again, provided with time off with wage compensation; the obligation to inform about union membership was abolished); the definition of dependent work was tightened with the aim to restrict forced self-employment; working time account can now only be implemented based on a collective agreement or agreement with employee representatives.

In connection with the scandals related to the import of food to Slovakia, the government passed several regulatory measures. *The Act on Inappropriate Conditions in Business Relations Related to Food Products* (No. 362/2012) is expected to restrict the misuse of economic position of chain stores in relation to local food producers and to increase the share of local food in the domestic market. *The amendment to the Act on Foodstuffs* (No. 152/1995 Coll.) also dealt with the protection of the local food market and its aim was to increase the health protection of citizens and consumers by restricting imports of dangerous food products and food inadequate for human consumption from some EU member states. The amendment changes the responsibilities of food sellers and it strengthens food control.

*The amendment to the Act on Health Insurance* (No. 580/2004 Coll.) introduced the provision of health insurance for work via agreements on work performed outside employment relationship (Work performance agreement, Agreement on work activity, Agreement on temporary job of a student), increased the minimum and maximum assessment bases and changed the assessment base for advance payments on health insurance.

\* \* \*

In 2012, the key priority of economic policy was the need to consolidate public finances, which had an impact on the nature of the adopted measures, especially with regard to taxes (specifically the amendment to the Income Tax Act, the introduction of a specific levy, the increase in administrative fees and the

introduction of new ones) and the government pension policy. In terms of inadequate tax collection and low tax discipline, part of the measures focused on the necessary changes in this field. The Labour Code was significantly amended for the second time in a short period. The previous amendment aimed at increasing labour market flexibility was adopted in 2011 by the government of Iveta Radičová, while the amendment of the new government in 2012 aimed at enhancing the rights of employees.

## **10. Outlook for 2013 and 2014**

After the unexpectedly severe recession (2009) and equally unexpected recovery (2010), the Slovak economy balanced between recovery and a second recession for two years (2011 and 2012). Since the second half of 2011, the second wave of recession was expected. However, at the time of writing, the Slovak economy still has not experienced a downturn in any of the quarters. As mentioned in the earlier outlook, the Slovak economy was more resilient against “the second wave of the crisis” than previously expected. Although the euro area was in recession in 2012, the Slovak economy grew (albeit slightly). However, after the significant deceleration of economic growth in the last quarter of 2012, the expectations of a recession have returned.

Some of the causes of the above-mentioned resiliency of the Slovak economy against the second wave of the recession include: the change in the regional structure of exports (towards markets unaffected by the crisis), the successful correction of the production programs in the automotive industry (reorientation on smaller, high-quality cars), the continuing increase in the so-called more demanding services, as well as the fact that the Slovak manufacturing enterprises in the automotive industry are the top branches of their parent companies, and therefore better protected against production cuts.

### **10.1. Outlook Background**

The previous chapters focused on the ex-post analysis and contain information relevant for the outlook. Some of it (which is considered the most important with regard to the outlook) is summarised here:

- The significant increases in export performance and functional openness of the economy in the previous period increased the already high sensitivity of the economy to external disturbances.
- Two thirds of the European countries (of the EU-27 plus Island, Norway and Switzerland) were in recession in 2012. The second wave of recession did not result in such large decline in the real GDP as the first wave in 2009. Since

the second half of 2008 until (probably) the end of 2013, the European economy has been experiencing one crisis period with two dips – one deeper (2009) and one shallower (2012/2013).

- Wage restraints and fiscal consolidation take on the role of primary stability factors in saving the single currency (excluding the possibility of its devaluation). However, the recovery of competitiveness protracted and currently also coupled with deterioration of the factors of economic growth, stalling the recovery in the countries worst hit by the crisis and thus of the euro area economy.

- Slovakia is one of the nine EU-27 countries which exceeded their 2008 economic level. Although the SR ranks among the more successful countries in the euro area with regard to overcoming the crisis, the Slovak results in the labour market are among the worst.

- The key production and export branch (the automotive industry) has undergone a so-far successful reorientation of production and change in the territorial structure of exports. The high level of technology, low labour costs, reorientation on smaller cars and penetration of the Eastern markets represented a successful mix of factors, allowing expansion at a time of European economic turmoil.

- In 2008 – 2012, there was a significant increase in the Slovak manufacturing revenues in the non-euro-area markets. This is contrary to what is desirable to strengthen the so-called optimum currency area, but it increased the Slovak economic resiliency in the event of a crisis.

- The necessary fiscal consolidation does not allow the much-needed countercyclical fiscal stimulus. Fiscal policy acts pro-cyclically and represents one of the barriers to growth. Non-fulfilment of fiscal targets can be perceived sensitively and cause an increase in the public debt service costs. However, a more expansionary policy would be in contradiction with the rules set in the domestic environment (by the Fiscal Responsibility Act).

## **10.2. Determinants from the External Economic Environment**

The Slovak economy is exceptionally vulnerable to external determinants (because of the high share of both exports and imports in the GDP). Therefore, the outlook is based on a review of external determinants, followed by internal determinants. Finally, the outlook parameters are quantified.

When reviewing the external determinants, we deal mainly with the euro area and Germany (because of the country's ties with the Slovak economy). For five years in a row, the external environment has had a negative impact on the Slovak economy. However, the fact that export performance of Slovakia has increased significantly is not completely in line with this statement. Therefore, it is necessary to be more specific with regard to the negative external environment. Although

the development in the euro area is generally negative because of the chronic debt crisis, a combination of factors offers some branches of the Slovak economy more room to expand in external markets even in such conditions.

Available projections (see Table 23) imply that the recession in the euro area will not deepen any further. These projections allow for declining real GDP in the euro area also in 2013, but the decline should be more moderate than in 2012. Three diverse institutions (IMF, the European Commission, Projektgruppe Gemeinschaftsdiagnose)<sup>35</sup> have reached a consensus in their projections in several areas:

- In 2013, real GDP of the euro area will probably fall by a few tenths of a percent. This represents a lower decline than in 2012.
- In 2014, economic growth in the euro area is anticipated (albeit relatively low, around 1%).
- In both years, the development in Germany should be more positive than in the euro area. In 2013, the German GDP should not decline, and in 2014, it should increase by almost 2%.

The April 2013 Gemeinschaftsdiagnose projection (Projektgruppe Gemeinschaftsdiagnose, 2013) introduces three fundamental facts:

1. In spring 2013, global economic growth recovered slightly.
2. In spring 2013, the German economy expanded.
3. “The institutes expect the economy to pick up over the course of this year. Concerns related to elections in Italy and the banking crisis in Cyprus show that a risk of the crisis intensifying remains, although it is not as great as last year” (p. 5).

Table 23

**Expected Real GDP Change in the Euro Area and Germany**

	2012		2013 projection	2014 projection
<b>Euro area</b>				
Real GDP, year-on-year change, %	-0.6	Gemeinschaftsdiagnose	-0.4	0.9
		EC	-0.4	1.2
		IMF	-0.3	1.1
<b>Germany</b>				
Real GDP, year-on-year change, %	0.7	Gemeinschaftsdiagnose	0.8	1.9
		EC	0.4	1.8
		IMF	0.6	1.5

Source: Projektgruppe Gemeinschaftsdiagnose<sup>36</sup> (2013), April; EC (2013a), May 2013; IMF (2013), April.

<sup>35</sup> These institutions are considered “diverse” because we selected institutions with differing fields of interest and activity: a leading financial institution in the form of the IMF, a leading political institution in the form of the EC, and a leading research institution in the form of the German Projektgruppe Gemeinschaftsdiagnose, composed of several renowned research institutes.

<sup>36</sup> This research group consists of the following research institutes: Ifo, München; IfW, Kiel; IWH, Halle; RWI, Essen.



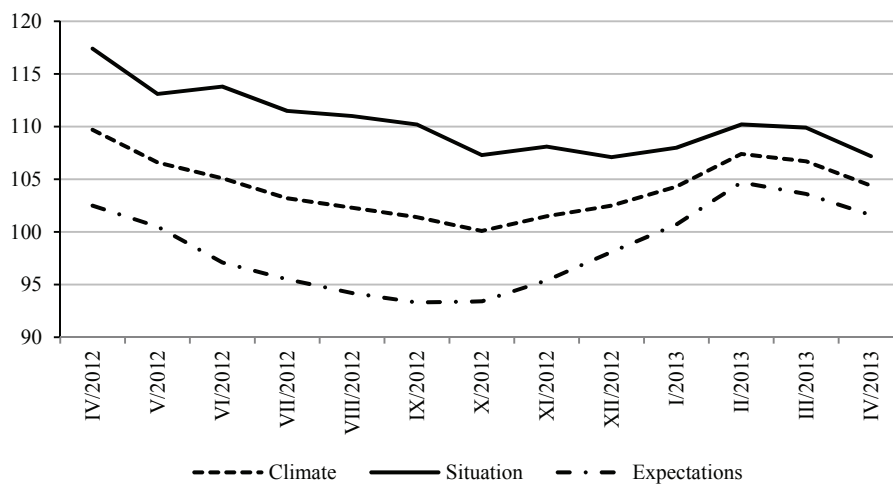
The International Monetary Fund projection (IMF, 2013) also acknowledges that in spring 2013, financial stress in the euro area moderated compared with autumn 2012 (at the time of publication of the previous IMF projection). This moderation is in response to policy actions at both the national and European levels. “But economic activity remains weak, and growth projections for 2013 have been lowered because weakness has spilled over from the periphery to the core” (p. 46).

The following views show that on one hand, a moderate improvement of stability in the euro area can be expected. On the other hand, it is still only minimally reflected in the performance indicators of the euro area economy.

The Business Climate Index (Geschäftsklimaindex)<sup>37</sup> is a useful indicator of the economic climate, demonstrating the expectations in Germany. During the last year (Q4 2012 to Q4 2013, Figure 23), the value of the index declined and then increased (the reversal point was in October 2012). Since October 2012, business climate has been improving in Germany. However, this should not be overemphasized: the April 2013 level shows an interruption in the improvement. Since it is a very volatile indicator, it should be viewed with caution (as indeed any climate indicator).

Figure 23

**Business Climate Indicator in Industry and Trade (Geschäftsklimaindex) in Germany (index, 2005 = 100)**



Source: IFO (2013).

<sup>37</sup> This index is a composite of both the current situation in business and the expectations in a six-month horizon. For more details see IFO (2013).  
<http://www.cesifo-group.de/portal/page/portal/ifoHome/a-winfo/d1index/10indexgsk>.



### 10.3. Determinants from the Internal Economic Environment

The primary factor determining the development of the Slovak economy is the development in the euro area. Thus, internal determinants are secondary. Both the process of fiscal consolidation and the overall domestic economic policy are important domestic determinants. The February 2013 tax projection of the Institute for Financial Policy (IFP, 2013) quantified more shortfalls in tax revenues (EUR 361 million in 2013 and EUR 708 million in 2014), which further complicate fiscal consolidation. It is therefore possible that the government would have to implement further restrictive measures.

On the other hand, at the time of writing, the government published its intention to enhance the so-called pro-growth measures<sup>38</sup> and perhaps to change the process of fiscal consolidation after 2014 (which is beyond this outlook). Since there were no further details, we consider this information as a factor, which could reduce the restrictive effect of the domestic economic policy, but without the possibility to review or quantify it.

It is highly probable that for the left-wing government, declaring “certainties for the people”, the negative employment development recorded in 2012 and at the beginning of 2013 is unacceptable. Therefore, the government might attempt to change the economic policy in order to consolidate public finances and at the same time improve the labour market parameters. It will be a great challenge for the political elites to combine fiscal consolidation with economic growth and lowering unemployment (for more information please refer to OECD, 2012). At the same time, some 2012 measures have even increased administrative or financial costs of employment.

Macroeconomic parameters are strongly influenced by the absence of regulated price and indirect tax adjustments. This is one of the explanations of the significant decline in the inflation rate at the beginning of 2013.

One of the few means of supporting the weak domestic demand is the use of the EU funds. Greater use of this instrument would reduce the restrictive impact of the fiscal policy. Mobilisation in this area is therefore expected.

### 10.4. Expected Development of Basic Macroeconomic Parameters

Both external and internal determinants will probably function as two complementary barriers to growth in the near future: the recession in the euro area will limit the increase in foreign demand; domestic fiscal consolidation coupled with low wage growth will limit domestic demand.

<sup>38</sup> The government declared it would create tens of thousands of jobs through unspecified pro-growth measures. See e.g. HNonline 16. 4. 2013.  
<<http://hnonline.sk/ekonomika/c1-59704010-fico-slubuje-ze-vytvori-60-tisic-miest>>.

We have already asserted that at the end of 2012, the period of surprising resiliency of the Slovak economy against the euro area recession came to an end. It is highly probable that a continuing recession in the euro area will hit the Slovak economy more seriously.

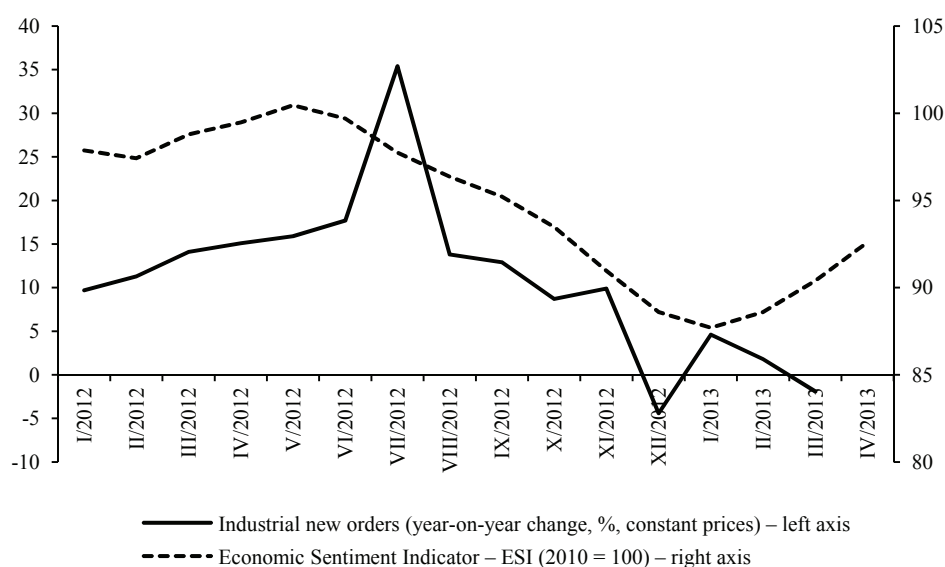
The automotive industry, which is the driving force of the Slovak economy, has experienced a significant expansion, which will translate into weak economic growth in 2013 (however, it is positive that we are still talking about growth).<sup>39</sup>

Several indicators suggest that at the beginning of 2013, the Slovak economy slowed down significantly. In some branches the hitherto positive development deteriorated (which is the case of industry), in others the long-term negative trend continued (construction).

At the beginning of 2013, inflation was extremely low in Slovakia. The CPI shows a very low inflationary impact of the regulated prices. The economic slowdown and the long-term negative development of domestic demand have also acted as barriers to inflation.

Figure 24

**Selected Leading Indicators in the SR: Industrial New orders and Economic Sentiment Indicator**



Source: SO SR.

<sup>39</sup> For more information please refer to e.g. Slovenské automobilky: Milión nie, rekord áno. <<http://auto.etrend.sk/auto-biznis/slovenske-automobilky-milion-nie-rekord-ano.html>>.

Figure 24 combines the values of two leading indicators in the SR. The *Economic Sentiment Indicator (ESI)* based on subjective statements is inevitably affected by people's mood or immediate subjective experiences (as it measures them). *Industrial new orders* is the second indicator used to predict future development. The dynamics of new orders (contrary to climate indicators) is the measure of projected future production not affected by immediate subjective experiences. Since mid-2012, both indicators have suggested deterioration in the future development. The bottom was reached at the turn of 2012 and 2013 and since then, there have been signs of improvement (or at least signs of an interruption in continuous deterioration) in the ESI, albeit without a positive turning point in the development of industrial new orders.

Table 24

**Projections for Selected Macroeconomic Parameters (in %)**

Parameter	2011 (s) 2011 (r)	2012 (r)	2013 (p)		2014 (p)
			Autumn projection (October 2012)	Current projection	Current projection
Real GDP, year-on-year change	3.2	2.0	2.2 to 2.8	0.8 to 1.5	2.5 to 3.2
GDP, year-on-year change, current prices	4.9	3.4	3.7 to 4.3	2.4 to 3.1	4.7 to 5.5
Number of employees, year-on-year change based on LFSS	1.5	0.6	0 to 0.5	-0.5 to 0.3	0.5 to 1.1
Unemployment rate based on LFSS	13.5	14.0	13.7 to 14.2	13.9 to 14.4	13.7 to 14.2
Average annual inflation rate (CPI)	3.9	3.6	2.7 to 3.3	2.3 to 2.8	2.5 to 3.1

Source: Reality (r) in 2011 and 2012 based on SO SR; projection (p) by the authors.

The following trends in the development of selected macroeconomic parameters are predicted (Table 24):

- In 2013, economic growth will probably decelerate. However, the annual average of the year-on-year real GDP growth rate will remain positive. The decline in real GDP cannot be ruled out, but if it appears, it should be only short-term (not present throughout the year). According to the May 2013 projection (the so-called flash estimate of the SO SR), the economy did not decline in the first quarter (although the growth was very weak), which is in line with our expectations. In 2014, we project the economic growth rate at around 3%.
- Inflation rate will probably be significantly lower in this period compared with the previous year because of the absence of adjustments of regulated prices and indirect taxes as well as the relatively weak domestic demand.

- Labour market indicators will be monitored most meticulously in the projection period. Weak economic growth cannot create more jobs without the help of specific instruments. It is probable that the unemployment rate will increase a little in 2013 and could fall a little in 2014.

To summarize, in 2013 we do not project an economic recession, although the economic slowdown can be quite significant. The dynamics of the economy should remain more positive compared with the EU average.

### 10.5. Confrontation with other Projections

Projections of domestic and foreign institutions agree that economic growth in the SR will slacken considerably in 2013, but the economy should not decline (which should be the major difference between the development in the SR and the euro area). Projections for 2014 are also relatively consensual: the economic growth rate should more than double compared with 2013 (Table 25). Our economic growth projection is in line with the above-mentioned domestic and foreign projections. It is a little more optimistic than the NBS projection. Our prognosis is, in general, close (although not intentionally or necessarily) to the prognoses of some selected institutions.

Table 25

#### Projected Real GDP Change in the SR

	2012		2013 projection	2014 projection
Real GDP, year-on-year change, %	2.0	Foreign institutions		
		EC	1.0	2.8
		IMF	1.4	2.7
		Gemeinschaftsdiagnose	1.3	2.5
		Domestic institutions		
		IFP	1.2	2.9
		NBS	0.7	2.8
		Selected banks	0.9	3.0

Source: EC (2013a), May 2013; IMF (2013), April; Projektgruppe Gemeinschaftsdiagnose (2013), April; IFP (2013), January 2013; NBS (2013c), P1Q 2013; Macroeconomic projections of selected banks (NBS, 2013b), April 2013.

\* \* \*

After approximately one and a half year of waiting, the Slovak economy will be fully confronted with the second wave of the crisis. The economy cannot resist the second wave of the recession (which has already hit the euro area) forever. Significant slowdown hits the economy at a time when the euro area economy has started to improve gradually. This could mean that the significant decline in economic growth could be coupled with a possible alleviation of the difficulties.

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