Rabobank

Country report

SLOVAKIA

Summary
The small open economy of Slovakia rebounded comparatively well from the 2009 recession, posting 4% economic growth in 2010 on the back of strongly recovering exports. Domestic demand, however, did not yet contribute to economic growth and its contribution in the coming years will be limited by the government's austerity measures. This will make the economic fate of the country highly dependent on developments in external demand for its products. With a budget deficit of 7.9% of GDP in 2010, the newly elected government has made fiscal consolidation its key policy priority and strives to reduce the budget deficit to less than 3% to meet the Maastricht criteria by 2013. However, timely progress on budgetary consolidation will crucially depend on government stability, which had been at constant risk recently, as the governing coalition lacks unity and only enjoys a minuscule parliamentary majority. Still, Slovakia's relatively low public debt levels and its comparatively strong economic growth performance should shield it from increased financial market scrutiny in the near term.

Things to watch:

- Progress in fiscal consolidation
- Government stability
- Perception on international capital markets

Author: **Fabian Briegel**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64053
F.Briegel@rn.rabobank.nl

Slovakia

National facts	
Type of government	Parliamentary democracy
Capital	Bratislava
Surface area (thousand sq km)	49
Population (millions)	5.4
Main languages	Slovak (84%)
	Hungarian (11%)
Main religions	Roman Catholic (69%)
	Protestant (11%)
	Greek Catholic (4%)
Head of State (president)	Ivan Gašparovič
Head of Government (prime-minister)	Iveta Radičová
Monetary unit	euro (EUR)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	87	0.14
Nominal GDP at PPP	120	0.16
Export value of goods and services	74	0.40
IMF quotum (in mln SDR)	358	0.16
Economic structure	*2010*	*5-year av.*
Real GDP growth	4.0	5.3
Agriculture (% of GDP)	4	4
Industry (% of GDP)	35	38
Services (% of GDP)	62	59
Standards of living	*USD*	*% world av.*
Nominal GDP per head	16042	163
Nominal GDP per head at PPP	22069	188
Real GDP per head	14174	177

Social and governance indicators	rank / total
Human Development Index (rank)	31 / 169
Ease of doing business (rank)	41 / 183
Economic freedom index (rank)	37 / 179
Corruption perceptions index (rank)	52 / 180
Press freedom index (rank)	35 / 178
Gini index (income distribution)	25.8
Population below $1 per day (PPP)	n.a.

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Germany	19	Germany	20
Czech Republic	13	Czech Republic	17
France	7	Russia	10
Poland	6	Hungary	7

Main export products (%)	
Machinery & transport equipment	56
Intermediate manufactured products	19
Miscellaneous manufactured goods	11
Chemicals	5
Main import products (%)	
Machinery & transport equipment	42
Intermediate manufactured products	15
Fuel	12
Chemicals	10
Openness of the economy	
Export value of G&S (% of GDP)	85
Import value of G&S (% of GDP)	86
Inward FDI (% of GDP)	0.6

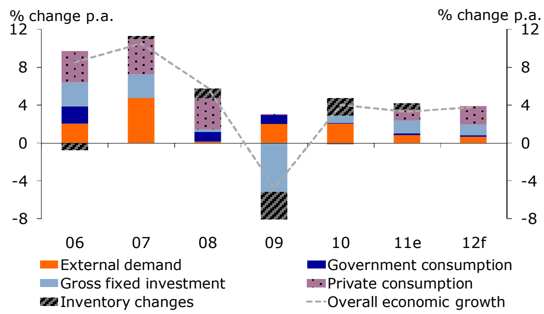
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

The small economy of Slovakia is relatively open and highly dependent on economic developments in the European Union. With a nominal GDP of USD 87bn, its economy is about half the size of its north-western neighbor, the Czech Republic. The Slovak economy is dominated by the automotive sector, which indirectly contributed about 25% of national income before the crisis. That made economic growth highly sensitive to changes on the European auto market. However, government efforts aimed at the diversification of the industrial base seem to bear fruit, as several Asian electronics companies increased their production capacities in Slovakia in recent years. Besides cars, vehicle parts and electronic appliances, the country also produces significant amounts of aluminum and steel. The country's exports reflect its industrial structure, with machinery and transport equipment accounting for more than half of all exports in 2009, followed by intermediary manufactured products. In line with the large extent of intra-industry trade, imports are dominated by the same goods. Most of Slovakia's foreign trade is conducted with Germany and the Czech Republic.

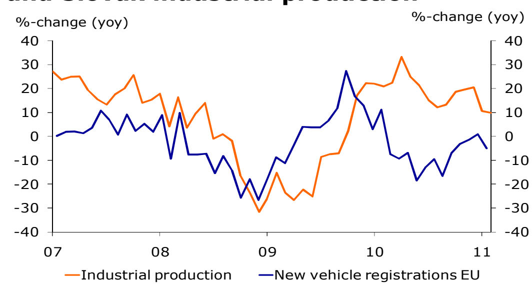
The largely foreign-owned banking sector looks relatively stable, though risks arising from augmented exposures to financially distressed European sovereigns have recently increased. In September 2010, the risk-weighted capital-adequacy ratio stood at 13.2%, up from 12.3% in the previous year. Non-performing loans amounted to 6.4% of all loans, compared to 5% in the same period of 2009. With a loan-to-deposit ratio of 79%, Slovakian banks' dependence on foreign funding is limited. Due to weak demand for corporate loans, banks increased their investments into European government bonds during the first half of 2010, also including Greek sovereign debt which had not been held by Slovak banks before. At the end of June 2010, total holdings of debt securities issued in Greece, Hungary, Spain, Portugal, Italy and Ireland amounted to EUR 1.3bn, up by EUR 0.8bn compared to the end of 2009. In addition to their direct exposure to weaker euro zone and EU countries, the Slovak banks are indirectly exposed via their respective foreign parent banks.

Graph 1: Economic growth



Source: EIU

Graph 2: New passenger car registrations and Slovak industrial production



Source: Eurostat/ACEA

The Slovakian economy has rebounded relatively strongly from the 2009 recession, when its dependence on the European car market led to a 4.8% decline of GDP. The recession might have even been worse if various European countries had not implemented substantial car scrapping schemes to stimulate car sales. In 2010, GDP increased by 4.0% on the back of improving exports and investments, as well as ongoing inventory restocking. For the next two years, we expect economic growth to decline to 3.3% in 2011 due to budgetary consolidation in Slovakia and its main export markets, before increasing to 3.8% in 2012 as Slovakian private consumption strengthens. Key risks to the Slovakia's growth outlook are formed by the shaky European economic recovery. Through direct and indirect exposures of the Slovakian banking system, an escalation of the European debt crisis could not only hurt external demand, but also limit banks' ability to provide credit.

Political and social situation

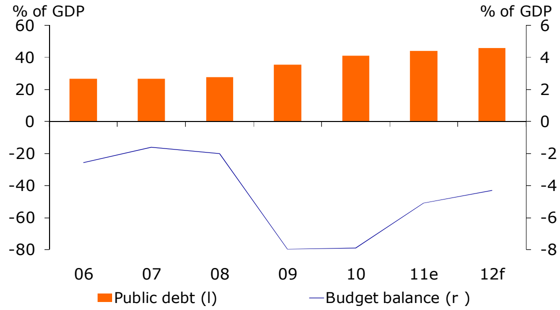
Slovakia is currently governed by a four party centre-right coalition under the leadership of Ms. Iveta Radičová of the Slovak Democratic and Christian Union –Democratic Party (SDKU-DS). Her coalition partners are Freedom and Solidarity (SaS), the Christian Democratic Movement (KDH) and the ethnic Hungarian Most-Hid (Bridge) party. The current coalition government took office after the June 2010 parliamentary elections, when the winner of the ballot, the centre-left Direction-Social Democracy (Smer-SD) of former prime minister Robert Fico, could not renew its coalition due to the poor results of its former partners. So far, the new government has presented an ambitious reform program. This plan not only intends to bring Slovakia's 2010 budget deficit of 7.9% of GDP down to less than 3% of GDP by 2013, but also comprises reforms to the country's health care, pension, and social security systems. Addressing Slovakia's minority issues is another key policy objective of the current administration. It intends to improve access to education and healthcare for the country's Roma ethnic majority, estimated at about 10% of the population, which still suffers from chronic unemployment and racial intolerance. Improving foreign relations with neighboring Hungary after the marked deterioration of bilateral relations under the previous Slovak administration also ranks high among the current government's policy goals. It is of particular importance to the coalition's Most-Hid (Bridge) party. With the current administration only enjoying a minuscule majority of 77 out of 150 seats in parliament and the coalition's Most-Hid (Bridge) party attaching particular importance to the improvement of bilateral relations, the sensitive Slovak-Hungarian issue could put the realization of the government's policy agenda at considerable risk. This problem came clearly to the fore in early 2011 when two of the coalition's members of parliament became independent after having voted against a government bill proposing to repeal last year's changes to Slovakia's citizenship legislation. The changes, which were still implemented by the previous government, led to the withdrawal of the Slovakian citizenship when Slovak citizens receive citizenship of another country. The measures were primarily intended as a response to efforts of the Hungarian government to bring together Hungarian national minorities in neighboring countries. The row over Slovakia's citizenship legislation, as well as recent lacking support of some coalition partners for a new prosecutor-general, is illustrative of the insufficient unity within the current administration, which also extends into the parties' factions in parliament. Since three additional members of parliament could possibly leave the coalition factions, the government faces increasing risks of losing its parliamentary majority. However, owing to the continuing weakness of the opposition Smer-SD's former coalition partners, early elections are neither in the interest of the government nor of the opposition. Nevertheless, if a vote of no-confidence were to be held, this could easily lead to the fall of the government.

With the exception of Hungary, Slovakia's external relations are relatively good. The country's bilateral relations with the Czech Republic are cordial and both countries have strong economic ties. In order to strengthen bilateral co-operation, both countries agreed on joint government sessions on issues of mutual interest (e.g. military cooperation or energy policies). Slovakia's relations with Hungary remain strained, however, though some improvement should be achieved through the participation of the ethnic Hungarian Most-Hid (Bridge) party in the current Slovakian administration. Slovakia's relations with the European Commission and the European Central Bank are somewhat tense currently, as the country became renowned for its critical stance on bail-outs of ailing euro members. While Slovakia currently participates in the European Financial Stability Facility (EFSF), its support for the European Stability Mechanism (ESM) remains uncertain as members of the governing Freedom and Solidarity (SaS) party object to Slovakia's participation.

Economic policy

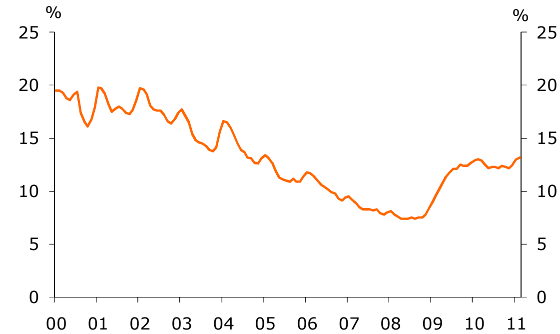
Slovakia's economic policies in the coming years will be dominated by the need to restore its government finances. Slovakia's traditionally low budget deficit had worsened drastically during the recession of 2009, as tax revenues tumbled and strongly rising unemployment levels and stimulus measures drove up expenditures. Within one year, the budget deficit deteriorated to 8% of GDP in 2009, up from 2% in the previous year. Despite the gradual recovery of the Slovak economy in 2010, the budget balance improved only marginally, still posting a hefty deficit of 7.9% of GDP, as expenditure cuts were compensated by public-spending increases for key voter groups ahead of the June 2010 parliamentary elections. Faced with the urgent task to bring down the deficit below the 3% level stipulated in the Maastricht Treaty by 2013, the government has decided to tackle the deficit by means of combining expenditure cuts and VAT hikes amidst cyclically recovering tax revenues. In order to facilitate budgetary consolidation, the current government also announced a series of structural reforms aimed at the strengthening of the business environment and the reduction of the high level of structural unemployment. Some of the proposed measures include a reduction and simplification of payroll taxes, the liberalization of the country's labour code or educational reforms to reduce mismatches between job applicants skills and employers' demands. Additionally, reforms of the country's health care, pension and social security system are anticipated. While the reform plans of the current Slovakian government are laudable, the coalition's shaky majority in parliament and increasing signs of reform fatigue among the electorate do not bode well for the implementation of these reforms. Opinion polls held in late 2010 and early 2011 show that the electorate seems to disapprove of the government's announced austerity measures, which will likely lead to slower progress on structural reforms in order to soften the pain caused by expenditure cuts. We consequently expect that the government will broadly stick to its budgetary consolidation course amidst increasing financial market scrutiny of euro zone members' public finances, but progress on structural reforms will likely be more gradual.

Graph 3: Public finances



Source: EIU

Graph 4: Unemployment rate



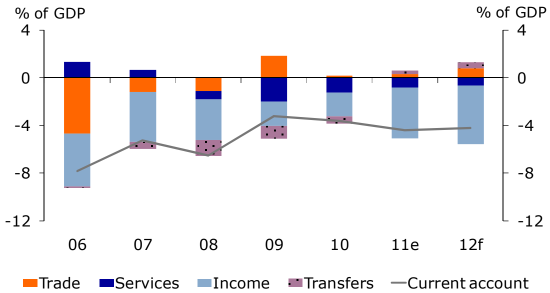
Source: EIU

While the Slovakian government intends to reduce the budget deficit in 2011 to 4.9% of GDP, we expect that the deficit will likely come in at 5.1% of GDP as the government will probably be forced to soften its expenditure cuts amidst rising public discontent. For 2012, we gauge the budget deficit at 4.3% of GDP. Public debt, which increased markedly on the back of the considerable 2009 budget deficit, as well as the pronounced decline in GDP, is expected to gradually increase to 44% of GDP in 2011 and 46% of GDP in 2012. Despite the recent budgetary worsening, Slovakia's public debt level compares favourably to the fiscal positions of various regional and euro zone peers. In combination with its comparatively strong economic growth performance, the relatively low public debt level should shield the country from increased financial market scrutiny in the near term. Nevertheless, given the considerable size of the 2009 and 2010 budget deficits, maintaining a low public debt level and keeping budget deficits in check will prove crucial if the Slovak Republic wants to avoid being associated with fiscally weaker euro zone peers.

Balance of Payments and External Position

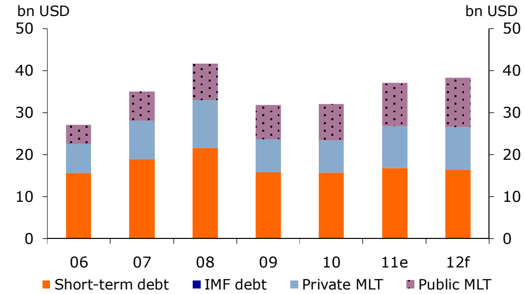
Slovakia's current account deficit widened slightly in 2010 compared to the previous year, reaching a level of 3.6% of GDP. Part of the decline can be explained by the markedly smaller trade surplus, which only amounted to 0.2% of GDP, while standing at 1.9% in the previous year. However, the trade surplus of 2009 had been exceptional since it resulted from strongly declining imports amidst the economic crisis, while car scrapping schemes introduced by various European countries in order to stimulate car sales supported Slovakia's exports. The smaller 2010 trade surplus was partly compensated, however, by a declining services balance deficit, as well as lower outbound transfers. For 2011, we expect the current account deficit to widen again, as rising profitability of Slovak companies owned by foreign investors will lead to a considerable increase in the income balance deficit. The trade surplus is expected to remain in positive territory, though with a level of 0.3% of GDP, it will not reach the levels seen in 2009.

Graph 5: Current account deficit



Source: EIU

Graph 6: Foreign debt



Source: EIU

While being lower than before the crisis, net foreign direct investment inflows will finance about 50% of the current account deficit in 2011 and about 70% in 2012. Net portfolio investment flows will remain volatile in the coming years and will thus not cover any significant part of the current account deficit in those years. Consequently, the remaining financing requirement will be financed by external debt.

In 2010, external debt stood at 37% of GDP and for 2011 and 2012, we expect it to increase slightly to a level of 39% and 40%, respectively. Most of Slovakia's external debt is denominated in euro's. Though on a downward trend since 2009, short-term debt will still account for around 45% of external debt in 2011. Consequently, upholding Slovakia's good reputation on international capital markets is imperative, stressing the need for considerable fiscal consolidation in the years to come.

Slovakia

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	8.5	10.5	5.8	-4.8	4.0	3.3	3.8
Consumer prices (average % change pa)	4.5	2.8	4.6	1.6	1.0	3.4	2.6
Current account balance (% of GDP)	-7.8	-5.3	-6.5	-3.2	-3.6	-4.4	-4.2
Total foreign exchange reserves (mln USD)	12647	18032	17854	692	719	4280	600
Economic growth							
GDP (% real change pa)	8.5	10.5	5.8	-4.8	4.0	3.3	3.8
Gross fixed investment (% real change pa)	9.3	9.1	1.0	-19.9	3.6	6.3	4.7
Private consumption (real % change pa)	5.9	6.8	6.2	0.3	-0.3	2.0	3.7
Government consumption (% real change pa)	9.7	0.1	6.1	5.6	0.1	1.0	1.2
Exports of G&S (% real change pa)	21.0	14.3	3.1	-15.9	16.4	8.0	9.5
Imports of G&S (% real change pa)	17.8	9.2	3.1	-18.6	14.9	7.7	9.7
Economic policy							
Budget balance (% of GDP)	-2.6	-1.6	-2.0	-8.0	-7.9	-5.1	-4.3
Public debt (% of GDP)	27	27	28	35	41	44	46
Money market interest rate (%)	3.1	4.3	4.6	1.2	0.8	1.2	1.7
M2 growth (% change pa)	16	12	7	5	3	7	6
Consumer prices (average % change pa)	4.5	2.8	4.6	1.6	1.0	3.4	2.6
Exchange rate LCU to USD (average)	0.8	0.7	0.7	0.7	0.8	0.7	0.8
Recorded unemployment (%)	10.4	8.4	7.7	11.4	12.5	12.3	11.2
Balance of payments (mln USD)							
Current account balance	-5423	-4431	-6430	-2819	-3173	-4120	-4000
Trade balance	-3219	-992	-1046	1653	192	320	770
Export value of goods	51376	64762	72572	55324	67966	80090	89730
Import value of goods	54595	65754	73616	53671	67774	79770	88960
Services balance	936	595	-714	-1736	-1036	-750	-570
Income balance	-3073	-3532	-3362	-1794	-1740	-4000	-4700
Transfer balance	-67	-503	-1309	-942	-588	310	500
Net direct investment flows	3800	2960	2979	-460	198	2140	2740
Net portfolio investment flows	1912	-2765	2252	-246	-2462	-700	260
Net debt flows	2173	6964	5535	-8972	959	3940	790
Other capital flows (negative is flight)	-4577	2884	-4482	-4514	4818	-2450	-3470
Change in international reserves	-2116	5612	-146	-17010	340	-1180	-3680
External position (mln USD)							
Total foreign debt	27085	34977	41624	31749	32036	37040	38250
Short-term debt	15584	18972	21600	15783	15688	16870	16460
Total debt service due, incl. short-term debt	19444	21317	27120	29863	21527	22380	25270
Total foreign exchange reserves	12647	18032	17854	692	719	4280	600
International investment position	-37792	-40042	-50663	-60859	n.a.	n.a.	n.a.
Total assets	27097	35905	36868	44402	n.a.	n.a.	n.a.
Total liabilities	64890	75947	87531	105261	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-4.7	-1.2	-1.1	1.9	0.2	0.3	0.8
Current account balance (% of GDP)	-7.8	-5.3	-6.5	-3.2	-3.6	-4.4	-4.2
Inward FDI (% of GDP)	6.0	4.0	3.3	-0.1	0.6	2.5	3.4
Foreign debt (% of GDP)	39	42	42	36	37	39	40
Foreign debt (% of XGSIT)	43	45	48	48	41	40	37
International investment position (% of GDP)	-54.6	-47.5	-51.4	-69.3	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	31	27	31	45	27	24	25
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	3	1	2	2
FX-reserves import cover (months)	2.5	3.0	2.6	0.1	0.1	0.6	0.1
FX-reserves debt service cover (%)	65	85	66	2	3	19	2
Liquidity ratio	92	100	94	74	82	87	83

Source: EIU