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Slovakia must now change its course

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Slovakia's economy – on the road to success since the 2000s

Well before joining the euro area in 2009, Slovakia developed dynamically and made rapid progress towards convergence. With annual growth averaging a good 3 %, it has been one of the fastest growing countries in the euro area since 2010. However, the convergence process has since come to a near standstill (cf. figure).

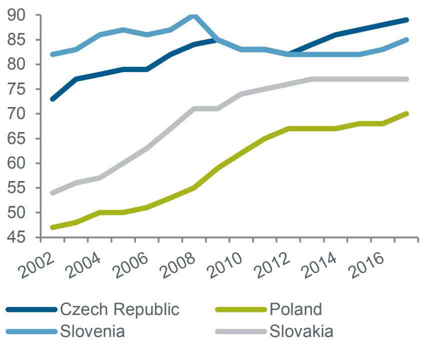
A relatively late 'catch-up' transformation conducted by Dzurinda's two pro-reform cabinets (1998–2006) laid the foundations for the catching up process. In addition to clearly affirming its alignment with the West, the government decided to liberalise the economy to a large extent. Comprehensive market-economy reforms in key areas now earned the former latecomer international recognition. The relatively low flat tax rate of 19 % on income, corporate profits and value added which was introduced in 2004 provided additional impetus to the new start, in combination with the country's simultaneous accession to the EU. The signals coming from Bratislava were answered mainly by a large number of Western European and Asian investors, especially from the automotive sector. They were able to build on highly skilled and relatively low-cost labour. The high unemployment rate gradually dropped to the current EU average in the course of the ensuing investment boom. Convergence made significant progress, and many came to regard Slovakia as 'Tatra Tiger' for its extensive reforms, industrialisation drive and export successes.

Growth has picked up noticeably …

Slovakia's economy is currently in an upturn phase, with the European Commission predicting 4.0 % growth for 2018 and as much as 4.2 % for 2019. The strong business cycle is being sustained by major EU-financed infrastructure projects and a new large-scale investment in the automotive industry that will drive exports (Jaguar Land Rover in Nitra). Although Slovakia now has a mix of competitive industries within a strengthened manufacturing sector (i.e. electronics, software, metal and wood processing, furniture, synthetics), its structure is shaped by the automotive sector unlike any other economy (44 % of industrial production and 40 % of industrial exports!). It thus contributes very significantly to Slovakia's export strength (export quota in 2017: 96.3 %).

Figure: GDP per capita in PPS* from 2002 to 2017

EU average = 100, *purchasing power standard



Source: Eurostat

... but will its potential soon be exhausted?

Its dependence on exports makes the Slovakian growth model fragile, however, and may soon reach its limits. A skills shortage has now also spread across almost all sectors between Bratislava and Košice and foreign firms are already competing for specialists. Low internal mobility resulting from high homeownership of nearly 90 % plays a role. Besides, the country has yet to fully develop the ability to keep talent within the country or attract talent from abroad.

The small domestic market will not provide significant growth impetus in future either. A hard Brexit would increase export risks and possible higher US tariffs on cars would also hit Slovakia's economy hard. By the medium term, the dilemmas of the automotive industry, which is undergoing radical changes worldwide, could spell more trouble for Slovakia.

What effective countermeasures are there?

None of this means that the economy will necessarily stagnate in the medium term. But its considerable dependence on the automotive industry should be reduced. Greater sectoral diversity, especially greater differentiation of the service sector, would place future growth on a more stable foundation. The government has addressed the acute skills shortage through the gradual introduction of a dual training system since 2015. Labour migration has recently grown from a low starting level. Simplified rules for hiring workers from third countries came into effect this year. The continuing enormous regional imbalances between the prosperous region around Bratislava and, in particular, the east of the country with its weak infrastructure should now be addressed as a priority. As the economy is now heavily based on manufacturing and relies significantly on foreign investment, another very crucial way to strengthen its growth prospects is to step up the hitherto rather low expenditure on research and development (typically less than 1 % of GDP, well below the EU average). That would prepare the ground for young, domestic research-oriented businesses with higher value creation, enabling convergence with Western European levels of income and living standards to pick up again in the most sustainable manner. ■