

Assessment and recommendations

Economic performance has been impressive ...

The Slovak Republic enjoyed several years of very strong growth and has made significant progress in catching-up to the income levels of the more advanced economies. In 2006 and 2007, GDP growth was the highest among OECD countries and the unemployment rate fell substantially. Nevertheless, notwithstanding the stellar economic performance at the national level, the benefits of higher growth remain fairly concentrated in those geographical areas where FDI inflows have been strongest, leaving large regional economic dispersions. Mirroring the progress in catch up, the exchange rate has appreciated by around 20% since 2006. Growth has been underpinned by significant structural reforms. The introduction of a flat tax raised the attractiveness of the Slovak Republic as a business location for domestic and foreign investors and, together with welfare reforms, has raised work incentives. On the fiscal side, the pension reform reduced the future fiscal costs of ageing, while raising the short-term deficit of the defined benefit system. However, recent measures will contribute to increasing future fiscal costs.

Following the successful efforts in meeting the Maastricht criteria, the Slovak Republic adopted the euro at the start of 2009. This marks a major achievement and will be beneficial for the country going forward, not least in light of the current global financial crisis. At the same time, structural reform and a strong fiscal policy framework will be needed to fully reap these benefits. This *Survey* addresses the following main challenges associated with maintaining high trend growth while being a member of the euro area:

- Increasing the flexibility of labour and product markets in order to improve the potential of the economy to adjust to shocks and facilitate structural change.
- Ensuring the working of the automatic fiscal stabilisers and the sustainability of public finances in the face of ageing pressures.
- Reducing distortions in the housing market in order to improve regional mobility and contain risks to financial stability.

... but the global headwinds will slow growth in 2009

The economy is set to enter a rougher period. Growth is projected to slow down significantly although given high potential growth the economy will be significantly stronger than elsewhere in Europe. The euro will partially shelter the economy against disturbances from the currency markets. As a small open economy with strong trade links, the Slovak Republic cannot escape the adverse effects of the global economic downturn.

Both inflows of foreign direct investment and exports will suffer as global demand falls, in particular in Western Europe and the neighbouring Central and Eastern European countries. The economy's specialisation in car manufacturing, which has contributed to its past high growth, is a downside risk in the current circumstances. There are already signs that the automobile industry will be particularly badly hit by the global slowdown. In addition, the credit crisis will affect the economy directly as the foreign-owned banks are likely to tighten their lending standards given the downturn in the global credit cycle. These developments may end the upswing in house prices, which have almost doubled since 2005.

The main policy challenge is to sustain high trend growth...

Looking beyond this cyclical downturn, sustaining the high trend growth rates of past years is the main policy challenge. Although the gap in GDP *per capita* relative to the pre-2004-accession EU countries is still around 40%, strong growth has reduced it by about 16 percentage points since 1999, more than in many other Central and Eastern European economies. This strong performance is mainly due to substantial growth in labour productivity, notably in manufacturing, also helped by significant FDI inflows. In contrast, labour utilisation has not contributed to the catch up since 1999. This reflects a smaller increase in participation rates compared to other countries which more than offset the fall in unemployment and the more favourable demographic development in the Slovak Republic. In addition, the relative number of hours worked per employee declined somewhat.

A key to sustaining rapid catch up will be measures to foster further increases in productivity, notably in service sectors and network industries as well as in public administration. Regarding labour utilisation, the priorities are to raise participation, in particular of women and older workers, and to reduce further the large share of long-term unemployment. Overall, these challenges require more flexibility of both product and labour markets, which should also strengthen the potential of the economy to adjust to shocks. In addition, improving education outcomes is a key determinant of long-term growth prospects, as argued in the previous *Survey*.

... while adjusting to life in the euro area

With euro adoption the economic environment will change substantially. On the one hand, the absence of exchange rate risk lowers transaction costs, leading to more trade integration, and enhances access to the large and liquid euro area financial markets, which will foster financial development. On the other hand, the Slovak Republic will face the same constraints as other members in a monetary union, namely the absence of an independent monetary policy and the lack of exchange rate adjustment. This situation poses macroeconomic policy challenges in the event of asymmetric shocks, such as the global downturn in the automobile industry affecting in particular Slovak car production, or asymmetric economic responses to common shocks.

Being a catch-up country adds to the challenge of euro area membership, above all because income differentials are larger for the Slovak Republic than for any other country that has

adopted the euro. Further changes in the economic structure from the industrial sector to services will occur in the course of the convergence process. In addition, experience from other catch-up countries that entered the euro area suggests that financial deepening evolves rapidly, raising risks of asset cycles. Closer financial integration with the euro financial markets will contribute to this, as more cross-border competition in financial services will broaden the supply and likely lower the level of retail interest rates for borrowers. Easier financial conditions are also likely to be induced by a decline in risk premia embedded in real interest rates as exchange rate uncertainty is removed. Furthermore, euro area membership may reduce liquidity premia and possibly also sovereign risk premia.

Equilibrium inflation will likely be higher than in the euro area as convergence proceeds. The appreciation of the real exchange rate, which had previously mainly occurred through nominal appreciation, will now show up in higher inflation as the Slovak price level converges towards that of the euro area. In part this is due to the Balassa-Samuelson effect, which reflects differences in productivity growth between the traded and the non-traded sectors. The nominal convergence process is likely to continue for several years to come and therefore real interest rates will tend to be lower in the Slovak Republic than the euro area.

Experience from other countries suggests that this catch-up process of rapid increases in income, strong financial development, and relatively higher transitional inflation can lead to overconsumption and overinvestment. This may be due to speculative capital inflows as the real exchange rate appreciates or as households seek to consume presumed future income gains via an increasingly sophisticated financial sector. Policies should strive to ensure, to the degree possible, that the transition takes place smoothly. The best contribution that structural reforms can make in such an environment is to ensure flexibility in product and labour markets. In more flexible markets, prices and wages adjust more quickly to shocks and thus minimise the real output losses. In addition, a strong fiscal policy framework is essential in order to allow for an appropriate cyclical variation of the policy stance.

Wage flexibility needs to be maintained

Wage flexibility across regions and sectors enhances the economy's ability to adjust to cyclical shocks and promotes smooth adaptation to changes in economic structures. In 2007, the Slovak government abolished the consent of the employer as a condition for legal extension of wage settlements to firms which do not participate in collective wage bargaining. Although firms can apply for exoneration under certain conditions and the number of extensions has been low, this measure may hinder sufficient wage flexibility and may be damaging to employment. *Legal extension should therefore be abolished. Alternatively, the conditions for exoneration should be eased and the authorities should make generous use of their powers to grant exoneration.* Another way to safeguard wage flexibility is to ensure that the minimum wage is not set too high relative to the median wage. Although minimum wages in the Slovak Republic – which are set by agreement among the social partners – are still low by international standards and a high share of employees has earnings below the average wage, they have tended to increase relative to median wages. *Further increases in the minimum wage should be implemented only insofar as they do not have negative impacts on employment opportunities. Moreover, decisions on the minimum wage level*

should take into account advice from an independent expert commission, as happens in several other OECD countries.

Productivity growth in services needs to be raised

The level of labour productivity is well below the euro area average in most service sectors, suggesting a large catch-up potential, but productivity growth has been rather limited or even negative in recent years. Despite notable progress in making the regulatory framework more competition-friendly, further action is needed in this area to raise growth and facilitate adjustment to shocks. The government has acknowledged the need for further reforms and has made improving the regulatory framework and the entrepreneurial environment a priority in its *Modernisation Programme Slovakia* 21. To strengthen competition in the liberal professions, *entry conditions should be eased and conduct regulation should be liberalised, but required standards of professional qualification should be maintained. In addition, the government should extend the points of single contact that exist for other small enterprises also to entrepreneurs of the liberal professions.* Furthermore, a wider use of ICT could lead to important productivity gains. *Removing obstacles to the spread of e-business and swiftly implementing e-government services would have high returns.* Such moves would also have important spill-over effects on other sectors by improving the quality and cost effectiveness of public services.

The fiscal policy framework should be made more effective

Government finances have improved markedly over the past years, with the debt-to-GDP ratio falling by almost half since 2000, not the least because of consolidation efforts to meet the Maastricht criteria for euro area entry. However, the current fiscal framework does not allow for sufficient cyclical flexibility. Notably, current rules require expenditures to be cut when revenues fall short of the original budget plan, potentially exacerbating a cyclical downturn. In addition, cyclical revenue windfalls tend to provoke additional structural expenditure. Thus, more needs to be done to avoid discretionary adjustments and ensure the full working of the automatic stabilizers.

Euro area entry calls for more flexibility to deal with cyclical shocks that cannot be dealt with by the common euro area monetary policy, whilst at the same time ensuring continued consolidation efforts to reach the medium-term objective of a small structural deficit and fostering long-term fiscal sustainability in the face of population ageing. Given these challenges, *a deficit rule consistent with the Stability and Growth Pact could be embedded into the constitution to demonstrate that the government is firmly committed to fiscal consolidation. The deficit rule should be complemented by multi-year expenditure ceilings, reinforced by a strong reporting system and ex post assessments to increase transparency and the political costs of exceeding the ceilings.* OECD experience shows that this considerably enhances the effectiveness of the fiscal framework in achieving and maintaining fiscal sustainability. *Cyclical expenditure items such as unemployment benefits could be excluded from the ceilings to ensure that the automatic stabilizers can work fully. As output gaps in a rapidly growing catch-up economy can be estimated only with considerable error, the authorities should consider introducing an adjustment mechanism to claw back accumulated deviations from the rule that arise from inevitable projection errors.*

The pension system should be kept on the right track

The size and age structure of the Slovak population will change considerably over the next decades due to low fertility rates and continuous increases in life expectancy, leading to substantial pressures to raise public spending on pensions. Past reforms of the pension system that combined parametric changes to the pay-as-you-go, defined benefit (DB) scheme (the so-called first pillar) with the introduction of a fully-funded defined contribution (DC) scheme (the second pillar) have led to significant improvements in the long-term balance of the DB pillar, while at the same time considerably reducing the redistributive elements of the system. This reform has had larger short-term costs for the general government budget than originally expected. Recently, a number of modifications were introduced to the pension system, which will increase future pension costs somewhat. Those currently in the system have been given two opportunities to shift between the pillars, while for new labour market entrants participation in the DC pillar was changed from compulsory to voluntary. The result is likely to be movement out of the DC pillar and into the DB one. These measures, along with an increase in the ceilings for pension contributions, have led to a rise in revenues of the DB pillar.

Frequent ad-hoc changes to pension legislation reduce transparency and potentially undermine the financial viability of the system. *The authorities should avoid such changes and, in particular, refrain from measures that tend to undermine the sustainability of the DB pillar.* In this regard, several of the recent measures should be reconsidered. *The government should consider making participation in the DC pillar mandatory for new labour market entrants or, at the very least, participation should be made the default option, allowing participants to opt out of the DC pillar. For current workers, no switching between pillars should be allowed. To further strengthen the DB pillar, consideration will need to be given to measures such as raising the retirement age in line with gains in life expectancy and reducing unsustainable components of the pension formula while strengthening solidarity. The increased pension contributions to the DB pillar from recently introduced modifications of the pension system should be used to reduce government debt.*

Low real interest rates and a small stock market make it difficult for pension funds to achieve returns that are sufficient for the value of pension savings to rise in line with real wages. Nonetheless, simulations suggest that the returns that can be achieved over the longer term on the capital market should be higher than those provided by the Slovak DB pillar assuming constant contribution rates and declining replacement rates to reflect the impact of ageing. Whilst ensuring sufficient investor protection, it is essential that pension fund regulation does not adversely affect returns by being unduly restrictive. As such, the elimination of the requirement to invest at least 30% of the capital into entities domiciled in the Slovak Republic is welcome. Currently, pension fund management companies are judged against the average of the rates of return achieved by all pension funds of a certain type, which complicates investment decisions due to low transparency and risks this benchmark, which is meant to be a minimum, becoming a low target return. *The authorities should therefore shift the responsibility for setting the benchmark to the pension fund level, and require funds to regularly publish information about their performance against an absolute benchmark.*

Developments in mortgage borrowing need careful monitoring

Many challenges related to euro area entry, such as the need for flexibility and the effects of easier financial conditions, manifest themselves in the Slovak housing market. House prices have risen substantially in recent years, driven by higher household incomes, lower real interest rates (partly in anticipation of euro area entry) and a slow supply response in the construction sector. In line with this development, mortgage borrowing has increased rapidly and banks have been easing lending standards. Even though rapid credit growth is a natural consequence of financial deepening, the authorities should monitor developments closely to limit risks to the financial system, in particular the risk of an unsustainable bubble. *Given this background the Slovak authorities should not hesitate to tighten regulation, such as lowering loan to value ratios, if there are indications of overheating in the housing market.* That said, it is clear that their scope for action is limited by the possibility that the essentially foreign owned banking system could escape Slovakian supervision by switching from a subsidiary to a branch structure. *For this reason, the Slovak supervisors should enhance cooperation with foreign supervisors.*

Make the housing market more flexible

The housing market is crucial in improving the adjustment potential of the economy through the labour market. The current market structure is characterized by a dominance of owner-occupation and a small share of rental housing, almost all of which is publicly provided. This structure significantly hampers the geographic mobility of labour, which is amongst the lowest in the OECD and one factor behind the persistently high rate of long-term unemployment. A more flexible housing market – notably the deeper development of a private rental segment – will be essential to better cope with the structural change that the economy will go through as well as to lower the wide dispersion of unemployment rates across the country.

The rental market should be strengthened

One factor behind the lack of a private rental market is the right-to-buy legislation, which allows tenants in the municipal housing flats built before 1998 to purchase their home under very favourable conditions. *This legislation should be phased out or, at least, sales prices should be raised to market values.* A further factor hindering the expansion of a private rental market is the fiscal treatment of housing, which is heavily skewed towards supporting owner-occupation. The real estate tax rate, which is set by municipalities, is very low and based on out-of-date housing values. This favours investment in owner-occupied housing over other assets and is pro-cyclical in that the effective tax rate falls as house prices rise. *The real estate tax rate should be raised to neutral levels and should be based on a measure of actual market values for real estate.*

Investment in owner-occupied housing is also supported through various schemes providing mortgage loan interest subsidies, premia for deposits in home savings bank accounts and the granting of loans at favourable interest rates through the *State Fund for*

Housing Development. Even though these subsidies have been reduced in recent years, the government should continue to cut subsidies for owner-occupied housing.

Housing support should be more flexible

State housing support for low-income households is currently mainly provided through the public rental housing sector at regulated low rents (where rents are less than a third of private ones). Although access to public housing is means-tested, income controls are weak and many households often remain in their flats after they have surpassed the eligibility criteria. This lowers labour mobility and leads to an inefficient allocation of the housing stock as it crowds out private rentals. In contrast, housing allowances are quite small as eligibility is very strict (only recipients of social assistance receive them) and benefits are low. As recipients lose eligibility when they take up work, the current scheme implies serious work disincentives.

To better target housing support and make it more effective, *the government should consider raising public housing rents closer to market levels; at least, tenants who no longer fulfil the eligibility criteria should pay market rents.* More generally, public housing should be made more targeted and housing allowances should be expanded in order to raise labour mobility. *Housing allowances should be available to those who work (but who are poor) and the allowance should reflect local housing costs* in order to encourage movement to rapidly growing (and high cost) areas of the country.

A further impediment for private rentals is the excessive tenant protection for rental contracts of indefinite duration, which locks in tenants enjoying such protection. For these contracts, the landlord must provide the tenant with alternative accommodation if the lease is terminated. *The current tenant protection regulation should be phased out.*

A stronger housing supply response could be encouraged

The flexibility of the housing market would be further increased if the supply of new dwellings were to be more responsive to demand, thereby also helping to dampen housing cycles. During the current upswing of house prices, construction has reacted only with long lags (which in itself contributed to the rise in prices) and the new dwellings that have been constructed mainly serve the upper end of the housing market. *Addressing inefficiencies in the land planning process and monitoring whether the construction sector is sufficiently competitive would be useful initiatives in trying to increase the housing stock.*

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BASIC STATISTICS OF THE SLOVAK REPUBLIC (2007)

THE LAND

Area (km ²)	49 034	Inhabitants in major cities (end-2004)	
Agricultural area (km ²)	24 330	Bratislava	425 155
		Kosice	235 006
		Presov	163 743
		Nitra	163 764

THE PEOPLE

Population (thousands)	5 398	Life expectancy at birth: Males	70.5
Inhabitants per km ²	110	Females	78.1
Average annual population growth (1997-2007, %)	0.0	Registered unemployment rate (% of the labour force)	8.4
Infant mortality (per thousand live-births)	6.14	LFS unemployment rate (% of the labour force)	11.0
		Employment (thousands, <i>Labour Force Survey</i>)	2 357

PRODUCTION

Gross domestic product		Gross fixed capital formation	
In billion SKK	1 852	In % of GDP	25.7
Per head (in \$, PPP exchange rate)	20 199	Per head (in \$, PPP exchange rate)	5 195

THE GOVERNMENT

Per cent of GDP		Composition of the National Council of the Slovak Republic (June 2006)	Number of seats
General government revenue	34.7	Christian Democrat movement (KDH)	14
General government expenditure	36.9	Hungarian Coalition Party (SMK)	20
Gross public debt (Maastricht definition)	29.4	Movement for a Democratic Slovakia (HZDS)	15
		Slovak Democratic and Christian Union (SOKU)	31
		SMER	50
		Slovak National movement	69
		Total	150

FOREIGN TRADE

Exports of goods and services, % of GDP	86.4	Imports of goods and services, % of GDP	86.8
Main exports of goods (% of total, 2006):		Main imports of goods (% of total, 2006):	
Machinery and transport equipment	48.7	Machinery and transport equipment	38.8
Manufactured goods	23.6	Manufactured goods	17.2
Miscellaneous manufactured articles	9.4	Mineral fuels, lubricants and related materials	13.6
Others	18.3	Others	30.4

THE CURRENCY

Monetary unit: Slovak koruna; euro from January 2009			
Slovak koruna per \$ (period average):		Slovak koruna per € (period average):	
Year 2007	24.7	Year 2007	33.8
September 2008	21.1	August 2008	30.3