Elena Kohutikova: Slovakia - perspective place for investments

Speech by Ms Elena Kohutikova, Deputy Governor of the National Bank of Slovakia, at the Conference "Middle and East Europe – region of the future", Salzburg, 15 October 2003.

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Slovakia has been disregarded as a reasonable country to place an investment in, for a long time. This trend has been showing on the results of total foreign direct investments made in Slovakia until 1999 compared to the other countries acceding to the European Union in May 2004. After the changes of general economic policy (economic reforms, legislative changes, making institutions more transparent…) with the new government seizing power in 1998, this FDI per capita gap shrinked to minimum. At present, overall environment is very much competitive for new investments within the area; it still ranks fourth behind Czech rep., Hungary and Poland, however capacity to invest, experience of the foreign companies that invested already and overall conditions created by government motivation to attract new investments makes Slovakia a very interesting market.

This contribution aims to view some of the attributes of Slovak environment and features of the country that have a vast importance in the course of decision-making process on placement of an investment.

1. Location and infrastructure

Slovakia is a small open economy (with exports plus imports ratio to GDP amounting to 155 %). Therefore, development of external relations is of high importance for the country.

Thanks to location, Slovakia, near European markets as well as near eastern European emerging markets may represent a bridge between East and West. European market of 350 million people is accessible within one-day truck drive (more than U.S. and Canada combined).

Despite relatively hilly surface, major roads infrastructure is fairly well developed. Moreover, government highway construction program aims to conclude main corridors connecting North and South, and East and West in the medium resp. long run perspective.

2. External stability

Slovakia became a member of OECD in 2000. This membership invitation declared stable environment, transparency and clear path in economic development based on the premises of the World Trade Organization. OECD membership itself helped to certain extent to ensure exponential growth of investments in 2000-2002. Slovakia will enter European Union in May 2004 and soon will become a member of NATO as well (ratification process in member countries is running in the moment). Economy has been stabilized and Maastricht criteria should be reached and fulfilled until 2006. According to the strategy, Slovakia plans to adopt euro as soon as possible, on the horizon of years 2008-2010.

3. Internal stability A) Reforms

All necessary economic reforms were/are to be introduced before fulfilling Maastricht criteria that the least possible disturbing factors may appear once given up own monetary tools. Pension reform is under the process of final discussion in the Parliament, new Labor Act has been introduced recently, major tax reform is to be introduced soon and health care reform and public administration reform is underway as well.

Another major reform, *tax reform*, aims to make the tax system more transparent and simple. This unique and radical reform based on fiscal neutrality introduces unified flat tax rate of 19% for VAT and rise of other indirect taxes on the one hand and introduces the same, decreased, direct tax rate of 19% for individual income tax as well as corporate tax on the other hand. This reform will change the situation of both companies and households dramatically. It also counts with gradual delegation of minor taxes and fees to the lower level, to communities, which will collect these to relocate resources for projects developing local infrastructure and solution of the ecology related problems.

Pension reform introduces three-pillar system. The first pay-as-you-go pillar fulfils the role of full merit and the second capitalization pillar fulfills the role of pension savings; both of which will be obligatory. The third supplementary pillar fulfills the role of additional pension insurance choice. The objective of this reform is to adjust the system to demographic changes and to changing features of the society. This reform is assumed to bring more effective management of the social system in future.

Healthcare reform aims to solve two main issues. These are introduction of deductibles for health care services. Two functions of this measure shall prevent misuse of free healthcare services and collect resources in order to support financial stability of the system. Moreover, the reform includes other stabilization measures, which aim to slow down or even stop the sector indebtedness.

Public finances reform aims to make public finances more transparent as well, introduces strategic planned budgeting and more effective allocation of resources. This reform includes introduction of forecasting systems for stable medium-term framework of public finances.

All these and other introduced and planned reforms are structured in detail, timed and co-organized with all other important economic interventions as well as with ability to comply with Maastricht criteria, especially budget deficit.

3. Internal Stability B) Fiscal and monetary consolidation

In 2002, the general government deficit amounted to 7.2% of GDP, which was well above the reference value set for EMU admission. Slovakia had also failed to meet this particular criterion in the previous years. The largest deficit had been recorded in 2000, surging largely on the back of costs incurred in restructuring the banking sector, with after-effects of the restructuring campaign still affecting the deficit through interest expenses.

Based on the draft assumptions of the state budget of following years, the Slovak government is bent on slashing the deficit down to 5.0% of GDP in 2003 and 3.9% of GDP in 2004, In 2005, the deficit is supposed to reach 3.4 percent. In 2006, the criterion regarding the general government deficit should be met with a small margin to spare (0.1%).

The fiscal criterion on public debt is currently met. Slovakia had not exceeded the reference value (60% of GDP) in the previous years either. After a gradual increase in public debt in the period of 1999-2001, in 2002 the government moved to reduce it, in particular by using privatisation revenues.

The inflation was above the reference value throughout the entire period reviewed, but shows a downtrend in the last years. At the end of 2002, Slovakia's HICP exceeded the reference value of 2.9% by a mere 0.4%.

However, massive price deregulations implemented in 2003 leaded to a substantial increase in inflation, which currently exceeds 8%. Deregulation effects will be present also in 2004, but their share should slowly decrease and in 2006 total inflation will not exceed 3%. This will lead to fulfillment of inflation criterion for our eurozone entry.

Considering the fact that there is only a limited amount of bond issues in Slovakia with long term maturity, it is useful to look at the development on the yield till maturity on the traded long term bonds. These have been falling in the recent years, with the yield till maturity below 5 per cent to meet the Maastricht criteria.

The SKK/EUR exchange rate was relatively stable during the period reviewed, namely from early 2001 until now. It spent most of the time in a ±3% corridor off the mean value of SKK/EUR 42.63 (average for the period from 1 January 2001 until now). It recorded a period low in July 2002 amid pre-election doubts, and is currently (September 2003) attacking its highs as the Slovak currency is considered the most stable and attractive in the Central European region.

4. Dynamics of the growth

Based on a comparison of real GDP growth in Slovakia and in the EU, we can find a more distinct convergence of economic levels in the last two years. In 2002, real GDP growth in Slovakia outpaced real GDP growth in the EU by more than 3 percentage points.

In GDP growth, Slovakia is one of the most dynamic economies and this should persist also in the following years.

In 2002, Slovakia has absorbed the highest inflow of foreign direct investments in its entire history; the total inflow amounted to 185.8 billion SKK, i.e. almost 4.5 billion EUR. In other words the inflow of foreign direct investments was two times higher than in 2000 and more than 20 times higher than in 1997.

Following results of a recent survey done by Forbes magazine, 91% of current foreign investors in Slovakia intend to increase their stakes. The group of present and satisfied investors is getting bigger, the group covers names like: Alcatel, Coca-Cola, Fujitsu, Heineken, IBM, Johnson Controls, Kraft, MOL, Samsung, Siemens, Sony, Tesco, US Steel, VW, etc..

Taking into account current and future VW investments and lately confirmed PSA Peugeot-Citroen investment plans, Slovakia is on its way to become one of the leading automobile producers. Industrial production absorbed more than 36 % of total foreign direct investments and another significant amount (24.5%) came into financial intermediation.

5. Labour force

A steadily growing economy, solid growth in labor productivity and the expansion of investor activity in Slovakia are positive signals both for the economic development as well as for investment climate for new players to arrive. Besides, Slovakia possesses relatively high quality of education system and the skills of its labor force. Businesses operating in Slovakia have discovered that the work force has in general strong work ethic, is skilled and educated. Slovakia’s school system ensures that almost 90% of the population has secondary or university education.

With wages lower than Hungary, Poland or the Czech Republic, employee costs even lower that in European Union; Slovakia becomes even more attractive for investments.

As candidate countries try to catch up with the EU, it is critical that GDP growths to be supported by rising productivity of labour, while factors of costs are kept under control. During last 10 years Slovakia achieved 4% growth in the real productivity of labour and 2% growth in the real wage.

Past development in the real unit labour costs is even more favourable for foreign investments. Slovakia offers the lowest labour and production costs among V4 countries.

This low labor and production costs have roots mainly in the character of labor market and features of unemployment, which is still, in spite of down-sloping trend, one of the highest in the region. However, availability of this workforce, which is relatively skilled, represents another advantage. Industrial restructuring and transformation have led to a high level of redundancy of skilled labor force. State-owned heavy industry and weaponry, running before 1990, were liquidated or went bankrupt. After the period of low foreign investments until 1999, job creation dropped into red numbers. This trend has been reverted after 2000; however still large numbers of industry oriented skilled workers mainly in central and eastern parts of the country are searching for job opportunities.

6. Legislative investment incentives

The trend of introducing legislation that favors foreign direct investments has been gradually approved since 1999. The Parliament had approved several major acts; the main goal of is to stimulate foreign direct investments to Slovak economy. The main acts, as follows, create the baseline to the motivation of foreign direct investments be placed in Slovakia.

The Investment Incentive Act no. 565/2001 deals with state support in forms of:

- initial investments to tangible and intangible assets
- subsidies for newly created job opportunities (up to USD 4.000)
- subsidies for re-qualification of employees hired to newly created job opportunities (up to 230 USD)

Industrial Park Development Support Act no. 193/2001 is another important basic investment incentive, which deals with community subsidies for:

- technical facilities and infrastructure up to 70% of total costs
- land purchase costs up to 70% of total costs

- land rental costs up to 70% within next 10 years

to the community ownership or community disposal to the use of the developer.

All customs and import duties on new machinery employed in production have been canceled, well before the adoption of free movement of good, when this issue will become automatic. All these and other allowances even more support all the points that make an investment in Slovakia even more attractive.

7. Rating improvement

All the features discussed and measures taken in the scope of Slovak economic development mirror in the continuous improvement of rating by all major rating agencies.

Standard & Poor's			**Moody's**			**FITCH**		
Assignment date	**Rating (FCY/LCY)**	**Outlook**	**Assignment date**	**Rating (FCY/LCY)**	**Outlook**	**Assignment date**	**Rating (FCY/LCY)**	**Outlook**
Current rating			**Current rating**			**Current rating**		
(October 03)	**BBB/A-**	**positive**	**(October 03)**	**A3/A3**	**stable**	**(October 03)**	**BBB/A-**	**stable**
December 02	BBB/A-	positive	November 02	A3/A3	stable	March 03	**BBB/A-**	stable
October 01	BBB/A-	positive	October 02	Baa3/A3	positive	November 02	**BBB-/BBB+**	positive
November 00	BB+/BBB+	positive	November 01	Baa3/A3	stable	February 01	**BB+/BBB+**	positive
November 99	BB+/BBB+	stable	November 00	Ba1/Baa2	positive	September 00	**BB+/BBB+**	stable
September 98	BB+/BBB+	negative	October 99	Ba1/Baa2	stable	December 98	**BB+/BBB+**	-
June 97	BBB-/A	stable	March 98	Ba1/Baa2	negative	October 98	**BBB-/A-**	negative
April 95	BB+/	stable	November 97	Baa3	negative	August 96	**BBB-/A-**	-
February 94	BB-/	stable	May 95	Baa3	stable	*	*****	*

8. Conclusion

Slovakia has taken many steps in order to become more attractive place to make an investment, mainly in the recent years. Moreover, it is obvious that economy is on the path to stabilization, both external and internal. All major reforms are timed in the way to be introduced before 2005 and more importantly before joining ERM2. Legislation favoring foreign investments has been applied to a large extent. Labor and production costs are one of the lowest in the region. Vast majority of investors are satisfied and confident about future. Besides, Slovakia experiences one of the highest dynamics in the region. All these features make Slovakia a more perspective country to invest day by day.