

The Automotive Industry in Slovakia: Recent Developments and Impact on Growth¹

Abstract

This report analyses recent automotive investment in the Slovak Republic and shows how the development of the automotive industry has influenced growth in productivity and output in the broader economy. The study also discusses the motivations for automotive investment in Slovakia, with the country evolving from a relative laggard in reform implementation and foreign direct investment in the late 1990s to one of the region's top performers and one of the fastest growing economies.

It is argued that strong reform implementation, together with continued and credible commitment to reforms were both preconditions for attracting automotive investments and the key factors that enabled these investments to flourish. The reform efforts were made possible by strong political consensus on accelerating EU accession and boosting living standards. Taking into account the specificity of the industry, other aspects related to factor endowments have also played a role. Generous investment incentives appear to have played an important role in swaying foreign investors in selecting Slovakia within the broader region of central Europe. Once investment in automotive production started, they contributed to additional investment by suppliers that has helped generate locally-owned suppliers. These, in turn, are beginning to supply car producers in neighbouring countries. All told, the full impact of the original automotive investments will be felt only over several years, but even in the early years it has been substantial. With output at the existing three producers set to reach capacity only by 2010, the impact is likely to be more substantial still.

¹ The principal authors of this study are Malgorzata Jakubiak (Malgorzata.Jakubiak@case.com.pl) and Peter Kolesar (pkolesar@gmail.com), with Ivailo Izvorski editing the final report. The study has benefited from detailed comments by Homi Karas and other participants at the growth seminar held in Washington DC in April 2007.

1. INTRODUCTION

1.1 This report analyses recent automotive investments in the Slovak Republic and analyzes how these developments have affected growth in productivity and output. The report presents conclusions on the motivations of investing in the Slovak Republic.

1.2 To date, there have been three major foreign investments in the car industry in Slovakia. Two of these started operations in 2003-2004 and the third only in 2006. The full impact of these investments will be felt only in the coming years, as output is planned to reach currently installed capacity only by 2010. Even today, though, the contribution of the automotive industry is large: it has accounted for more than 40 percent of the increase in manufacturing employment during 2000-2006 and for about one-third of total Slovak exports in 2006.

1.3 The example of Slovakia is worth studying because the country was regarded as a regional laggard in reform implementation and economic performance until 1997. Following the 1998 elections that brought a pro-reform government coalition to power, the country embarked on a path of economic reforms, with ambitious efforts in advancing privatisation, corporate restructuring, improvement of public service delivery. Building on these reforms the government advanced reforms of pensions and taxes, the labour code, social protection and health care. All this took place together with a much-needed consolidation in public finances and the reduction in inflation to low levels. At the same time, Slovakia advanced European integration and acceded to the European Union (EU) in 2004. The government is likely to succeed in its plan to join the eurozone in 2009, earlier than its immediate neighbours.

1.4 The report argues that strong implementation and commitment to reforms, together with favourable initial conditions, have played a crucial role in attracting automotive investments to Slovakia and made it possible for the investments to flourish. Generous investment incentives have clearly helped sway investor's hands once a decision to invest regionally was made.

1.5 As a background on the automotive investments in Central and Eastern Europe, the study starts with the description of major developments since the early 1980s. Section 2 discusses Slovak reforms, industry-specific policies and factor endowments. Section 3 assesses effects of the development of the automotive industry in Slovakia for the domestic economy. Section 4 summarises the key findings of the report.

2. AUTOMOTIVE PRODUCTION IN CENTRAL AND EASTERN EUROPE SINCE EARLY 1990S

Developments before 1989

2.1 The countries of central and eastern Europe (CEE)² have a long history of production of motor vehicles. Czechoslovakia had the strongest tradition in automobile production in the CEE, with Škoda, the largest and oldest car manufacturer in the region, dating back to the 19th century. Škoda was the first automobile manufacturer in the region to specialize in the design of cars (Werner 2003: 2). Other smaller producers of motor vehicles in Czechoslovakia included Tatra (heavy trucks), TAZ (vans), and BAZ with Škoda licensed models. The yearly output of the Czechoslovak car industry before 1989 was 193,000 units (Dobosiewicz 1992: 74), most of it produced in Škoda's plants in Mladá Boleslav, Kvasiny and Vrchlabí. In 1989, Škoda exported 45,500 cars to western Europe (Dobosiewicz 1992: 74).

2.2 As part of the industrial policy under the Council for Mutual Economic Assistance (CMEA), Hungary specialized in manufacturing of Ikarus buses and in the production of car components (Havas 2000: 98). At the peak of its production, the Ikarus company manufactured 15,000 buses and was one of the largest bus manufacturing companies in Europe (Havas 2000: 98 and Automotive Industry Association of Hungary MGSZ). Two indigenous car-manufacturing companies (FSO and FSM) were established in Poland in the 1980s producing automobiles using Fiat licenses. Overall, the CEE countries produced 1 million cars in 1990 (Dobosiewicz 1992: 76). The exact products manufactured in each of the CEE countries differed, but factor endowments were similar with abundance of skilled labour. Production facilities, by contrast, were relatively obsolete.

Major investments since 1990

2.3 It was the industrial tradition in the automotive sector and other heavy industry sectors, skilled labour and the growth potential of the emerging CEE markets that lured substantial investments into the manufacturing industry in the early 1990s. Foreign investment in the car industry accounted for a large share of the inflows of foreign direct investment (FDI) into CEE, with several large deals at the start of transition (Doerr and Kessel 1999: 9).

2.4 In 1991, Volkswagen (VW) acquired a stake in Škoda in a bidding contest of 24 foreign companies.³ VW proposed investing more than \$5 billion and planned to run Škoda as a separate brand within the VW group besides Audi, Seat and VW (Legard 2005: 6-7 and Dobosiewicz 1992: 74-75). VW acquired a 31 percent share in 1991 for

² In this report CEE stands for Czech Republic, Hungary, Poland and Slovakia.

³ Renault's offer was also seriously considered by the Czech government in the final stages of the privatisation process. The French automaker offered a complete modernization of the plant (capital investment of \$2.5 billion) and production of its low-end Twingo model in the Škoda factories.

\$416 million, rising to 70 percent in 1995 for an additional \$520 million (Legard 2005: 7) and full ownership in the late 1990s. The privatisation of Škoda turned out to be one of the largest foreign investments in CEE in the early 1990s (Dobosiewicz 1992: 74). Škoda Auto employs 22,000 workers in the Czech Republic and produces more than half a million automobiles a year, almost 90 percent of which are exported.

2.5 Besides the Škoda investment, Volkswagen acquired a 80 percent stake in Bratislavské automobilové závody (BAZ) in Slovakia also in 1991.⁴ Volkswagen won the contest and became a strategic partner of BAZ.⁵ According to the then Slovak Prime Minister Vladimír Mečiar, the GM offer obliged the government to pay subsidies for infrastructure building and training, while VW's did not. Mečiar stated that there were 10 important indicators, according to which the government was deciding: "GM was leading in two: the company's name and faster start. VW was leading in everything else" (Slovak National Council 1991). VW used BAZ's facilities and buildings near Bratislava, but invested in completely new equipment and technology. After a slow start in 1994-1996, the factory eventually exceeded the original production expectations, producing 238,000 cars in 2006, and has become one of the most modern plants in the VW group (see Section 4.3). VW has invested EUR 1.5 billion in the Bratislava plant thus far.⁶

2.6 VW has also invested in the Polish city of Poznan, where it first set up a joint-venture with the Polish Tarpan in 1993, becoming a full owner in 1996. The plant produced Škoda models for the local market until 2002 and currently manufactures VW T5 and Caddy vans and employs over 2,500 people (Global Auto Index).

2.7 Audi, another VW subsidiary, founded a factory in Győr, Hungary in 1992 for the manufacturing of engines and invested €0.7 billion by 2000. The plant quickly expanded and became the biggest manufacturer of Audi engines in the world, Audi Group's third biggest operation (producing not only engines, but assembling Audi TT sports cars as well) and Hungary's biggest exporter (FDI Magazine and MGSZ).

2.8 Hungary is also the primary European production site for Suzuki of Japan. Suzuki's production commenced in 1992 and the company invested \$260 million in the country by 1997 (Havas 2000: 100-101). The plant capacity is planned to reach 300,000 cars a year by the end of 2007, manufacturing Suzuki Swift, Ignis and SX 4 models, as well as Fiat Sedici (SX4's sister model; Global Auto Index).

2.9 Besides VW, Fiat was another European car manufacturer that adopted a fast and ambitious strategy in CEE (Van Tulder and Ruigrok 1998: 13). By the end of 2000, Fiat invested more than \$2 billion in its two Polish facilities (10 percent owned by FSM), making it the second largest foreign investor in Poland (Dunin-Wasowicz, Gorzyski and

⁴ Of the six companies interested in a joint-venture with BAZ, three were selected for final consideration (Renault, GM/Opel and Volkswagen) and talks were eventually started with GM/Opel and VW. Despite the initial good position of GM/Opel in the negotiations (the company was granted exclusive negotiating rights for 6 weeks), VW was ultimately selected as a partner.

⁵ Interview with Jozef Uhrík, the president of the Automotive Industry Association of Slovak Republic and a former CEO of Volkswagen Slovakia, 14 March 2007

⁶ Interview with Jozef Uhrík

Woodward 2002: 11). The carmaker has produced primarily low-end cars either for domestic production (Fiat 126 until 2000) or mostly for export (Cinquecento, later Seicento and Panda; Global Auto Index). Fiat is currently planning to double its production in the country to 530,000 by 2008 to produce a new Fiat 500 and a sister model Ford Ka. When Fiat's plans of becoming a strategic investor in the Polish FSO plant did not materialize,⁷ Daewoo struck the deal with Polish government in 1996 and offered to invest \$1.1 billion. After the Korean parent company came under financial pressure, the FSO was sold to the Ukrainian company Ukr-Avto in 2005, which has continued to produce Daewoo models and plans to produce Chevrolet licensed cars and export them to Ukraine.

Table 1. Major Car Manufacturing Investments in Central Europe

Country	Investor	Location	Start Date	Type of investment/activity	Products	Volume
Czech Republic	Volkswagen/Škoda	Mladá Boleslav, Kvasnice, Vrchlabí	1991	Brownfield	Octavia Fabia Roomster Superb	450,000*
	TPCA	Kolín	2002	Greenfield	Peugeot 107 Toyota Aygo Citroen C1	300,000*
	Hyundai	Nošovice	2006	Greenfield	i30	300,000*
Hungary	Suzuki	Esztergom	1992	Greenfield	Ignis Justy Swift SX4 Fiat Sedici	300,000*
	Audi (VW)	Gyor	1992	Greenfield	TT	40,000*
Poland	Fiat	Bielsko-Biala	1991	Brownfield	Seicento Panda	250,000*
	Volkswagen	Poznan	1993	N/A	Transporter Caddy	50,000*
	Daewoo/FSO	Warsaw	1996	Brownfield	Nubira Matiz	35,000
	Opel (GM)	Gliwice	1998	Greenfield	Agila Astra Zafira Wagon R+	120,000*
Slovakia	Volkswagen	Bratislava	1991	Brownfield	Polo Touareg Audi Q7 Porsche Cayenne (assembled in Leipzig)	300,000*
	PSA	Trnava	2003	Greenfield	207	450,000*
	Kia	Žilina	2004	Greenfield	Cee'd Sportage	300,000*

Source: based on Deloitte (2006) and Global Auto Index

Note: * - planned

⁷ The main reason being the unwillingness of the Polish government to allow such a concentration in the automotive sector in Poland with Fiat controlling both of the biggest car producers in the country – FSO and FSM. GM was another serious contender in the FSO negotiations (Van Tulder and Ruigrok 1998: 16).

2.10 General Motors was unsuccessful in acquiring BAZ in Slovakia and FSO in Poland and later decided to invest over \$600 million in a major greenfield manufacturing plant in the southern Polish city of Gliwice. Opel also had a car assembly in Hungary, but the plant ceased assembly in 1998 and now only manufactures engines (Havas, 2000: 101-102).

2.11 All the greenfield investments in the automotive industry in the region after 2000 were in Slovakia and the Czech Republic. Once the new plants go into operation, the two countries will become two of the largest producers of cars per capita in the world. TPCA (Toyota Peugeot Citroën) selected Kolín in the Czech Republic as its new production location for manufacturing of small cars in 2001 with the annual capacity of 300,000 cars and Hyundai pledged to invest in a new factory also in the Czech Republic in 2006. PSA Peugeot Citroën and Kia Motors plant have invested in Slovakia, with each of the investment worth between €700 million to €1 billion. Section 4 analyses these investments in greater detail. Table 1 summarizes all major automotive investments in CEE since 1989.

Motivations for automotive investments in CEE

2.12 The motivations of large car manufacturers to invest in CEE were driven by a combination of factors. These included cheap, productive and skilled labor (resource-seeking and efficiency-seeking according to Dunning 1993) and the opportunity to gain access to local markets in the region (market-seeking).⁸ Clear prospects for EU accession also held the promise of integration into the wider EU market (Sturgeon and Florida 1999 as cited in Radosevic and Rozeic 2005: 6). In addition, tariff-substituting motivations for car investors were particularly important in the case of Poland. Restrictive trade policies in the 1990s and high import duties are repeatedly cited as the main reasons for investors to establish their assemblies in Poland (Van Tulder and Ruigrok 1998: 43 and Dunin-Waswicz, Gorzynski and Woodward 1998: 11).⁹

2.13 Investors have a strong tendency to invest in safer markets to reduce the potential of market failure stemming from asymmetric information. The presence of foreign investors and their successful operation thus served as a positive signal for other investors to invest in locations where foreign operations are already established in the same or similar industries (Charlton 2003: 10). This follow-the-leader pattern has evolved further in recent years, with investors preferring to invest in places that have already attracted suppliers and, overall, benefit from the externalities of the agglomeration.

2.14 The emergence of central Europe as a major car-manufacturing hub is compatible with global trends in the automotive industry. New manufacturing plants in CEE serving the EU market are evidence of the new 'network-led' model of industry (firms producing

⁸ As a result of gradual phasing out of tariffs on imports in EU-CEECs trade on the basis of Europe Agreements signed in early 1990s, as well as elimination of intra CEE tariffs within Central European Free Trade Agreement CEFTA.

⁹ Import of EU-produced cars to Poland was protected with quotas relatively long, until the year 2002, although quantitative restrictions on other manufacturing products in bilateral trade started to be phased out in 1992.

within every large market). The need for just-in-time delivery, which characterizes vertically integrated production, made the Visegrad region (the Czech Republic, Slovakia, Poland and Hungary) even more attractive for automotive investment. Car production in central Europe tends to use the most modern equipment and have usually become the most advanced of their kind,¹⁰ which is very different from the way factories in the region operated two decades ago – using old manufacturing equipment and production technologies.

3. REGULATORY POLICIES AND FACTOR ENDOWMENTS IN SLOVAKIA¹¹

This section examines Slovakia's economic development since the start of transition in the early 1990s and identifies the factors that have contributed to stronger economic growth and helped improve its attractiveness for automotive investors.

Overview of Slovak economic development

3.1 Over the last several years, Slovakia has emerged as one of the leading reformers and fastest growing countries in central and eastern Europe. Achieving the Maastricht criteria seems within reach and should enable Slovakia to join the eurozone as targeted by the government in 2009.

3.2 The transition to the current status of a strong reformer and a fast growing country has not been easy. Slovakia started transition with a very low level of foreign debt and with no previous experience in market reforms. Soon after the split of Czechoslovakia in 1993,¹² the Slovak economy experienced a deep transition recession. Growth resumed thereafter, thanks in part to orthodox macroeconomic policies (EIU 1998: 19) despite incomplete structural reforms. Inflation remained under 10 percent during 1994-98. Slovakia reported the highest growth among the transition countries in 1996 and the country's success started to be dubbed 'Mečiar's economic miracle.' Although officially claiming transatlantic integration as its top priority, the Slovak government (consisting of Mečiar's HZDS, the nationalist SNS and the leftist ZRS parties), had clear nationalist tendencies. Dissatisfaction with the development of democracy was voiced by foreign embassies as well as international organizations. After Slovakia's lagging behind in the

¹⁰ Perhaps with the exception of Fiat. However, for example PSA Peugeot Citroën in Trnava was specifically planned to be the "show-case" of the French automaker. According to the PSA president, Jean Martin Folz, "this will be a new type of factory, where we will utilize all our capabilities. Trnava will be a demonstration of PSA's know-how."

¹¹ We are grateful to Lucia Kurekova, Central European University, who co-authored this chapter.

¹² The split of Czechoslovakia was caused by multiple factors. Political motivations of the Czech and Slovak leaders dominated the negotiations on the re-evaluation of the competences within the federation after 1989. The decision to split Czechoslovakia was made among political leaders. This decision was not based on a popular referendum – opinion polls were showing that the population tended to be slightly more pro-federal at the time of separation. The first elections in independent Slovakia in 1994 were won by Mečiar's HZDS.

integration process became evident and the country was not invited to join NATO in 1997, Madeleine Albright called Slovakia “a hole in the map of Europe.”¹³

3.3 From 1996 onwards, the situation started to gradually deteriorate economically as well. Fiscal expansion and widening external trade imbalances, resulting from a failure to improve the business environment, led to a sharp increase in indebtedness. Currency depreciation followed, with the koruna falling by 19 percent in October 1998 (Jurzyca et al 1999: 200). Unemployment grew from 12.8 percent in 1996 to 15.6 percent in 1998, becoming a major social issue (EBRD 2000: 193).

3.4 Economic difficulties reflected deep rooted problems. Firstly, the process of privatization in Slovakia was viewed as corrupt. Under the guise of creating a national entrepreneurial business class capable of ‘sustaining Slovak independence,’ foreign as well as domestic investors were discouraged from participating in privatisation deals after 1994 to the benefit of vested interests (Appel and Gould 2000: 114, see also Vachudova 2005: 51-52). Secondly, insolvency became an oversized problem in the industrial sector despite, or rather because of, generous government subsidies.¹⁴ The poor performance of Slovak enterprises was accompanied by difficulties in the banking sector, dominated by ineffective state-owned banks (Beblavý 1998) and reflecting also the Russian and Asian financial crises (Jurzyca et al 1999: 202-204; *The Slovak Spectator* 1998). Low transparency and rampant corruption were two of the key characteristics of the Slovak economy in 1998 (Jurzyca et al 1999: 204).

3.5 The 1998 elections resulted in the demise of the Mečiar’s government. The elections were not necessarily indicative of a radical change in voters’ sentiments – HZDS still won the elections with 27 percent of the votes – but rather a reflection of a united anti-Mečiar movement. Also, Mečiar’s authoritarian style in policy making and the democratic deficit were perceived as more important by voters than the economic hardship in uniting the opposition. “Return to Europe” was quite symptomatically the main slogan of the new pro-Western (albeit ideologically hybrid) Dzurinda government.

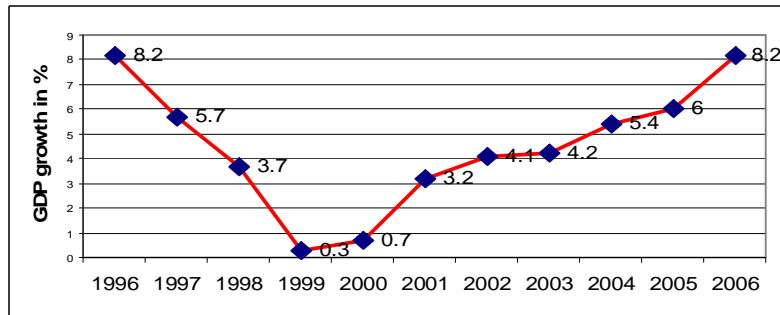
3.6 Initially, the new government brought modest macroeconomic improvement. Real GDP growth, after slowing to 0.3 percent in 1999 from about 8 percent in 1996, picked up to 0.7 percent in 2000 (Figure 1). The fiscal deficit rose to 12.3 percent in 2000 and external debt increased. Progress became more evident only towards the end of the first term of the Dzurinda government. Growth picked up to about 4 percent by 2002 and after several years of declining real wages, increasing unemployment and debt, the trend was finally reversed in 2002. The coalition was successful at implementing several key reforms, including banking sector restructuring, improvement of the general business environment, revamping state regulation of the financial sector and restructuring and privatisation of state-owned enterprises (Vachudova 2005: 201, see also Slovakia. Country Report 2000: 32-33). Most importantly, trust in policy-makers improved and

¹³ “Slovakia: TASR Reports Albright, Kovac Remarks at Washington Lunch,” Foreign Broadcast Information Service, 29 January 1998 as cited in K. D. Krause, April 2003, “Slovakia’s Second Transition,” *Journal of Democracy*, Vol. 14, No.2.

¹⁴ In March 1999, Slovak enterprises accounted for 80% of the debt out of which government had guaranteed 60%.

fear was removed from the Slovak political and public life.¹⁵ Several corruption affairs, nonetheless, tested the popularity of the Dzurinda coalition (Vachudova 2005: 202).

Figure 1. Slovakia: Real GDP growth (In percent)



Source: Statistical office, SME

3.7 The reforms, which were put off during the first Dzurinda government (of the pension system, tax, labour law, social protection and reorganization of health care), were tackled during his second term that started in 2002. The main reasons for Dzurinda's second term were related to overwhelming popular support for EU and NATO accession, with the government during his first term seen as having made critical progress. Moreover, the need to catch up with the Visegrad neighbors on the road to EU accession was an important factor. The second government was much more homogenous and had a stronger popular mandate for reform.

3.8 As part of social welfare reform, the government introduced a three-pillar pension system.¹⁶ The structure of social security contributions was changed significantly as part of a wider set of measures to tackle unemployment and liberalise the labour market.¹⁷ Corporate and personal income tax rates were set at a flat 19 percent, harmonized with a single VAT rate, helping boost the country's image as one of the 'world leading reformers.'

3.9 The government reform efforts paid off. The transition to market economy was accelerated rapidly, underpinned by stable macroeconomic policies and much-improved business environment. Fiscal prudence, together with significant currency appreciation – in line with labor productivity - kept inflation low. After acceding to the EU in 2004, Slovakia joined the ERM II with the ambition to join the eurozone in 2009, most likely before the other Visegrad countries.

3.10 The Dzurinda government focused less on communicating the long-term positive effect of the ambitious reforms and the likelihood that economic hardship some of the population experienced will be temporary. Even though social protest has not manifested

¹⁵ Opinion polls from that time reveal that while in 1998 66% of population viewed crime and personal safety as a pressing problem, in 2001 this was significantly less - 46%. Similarly, perception of crime and organized crime as a problem decreased from 36% in 1999 to 24% in 2001.

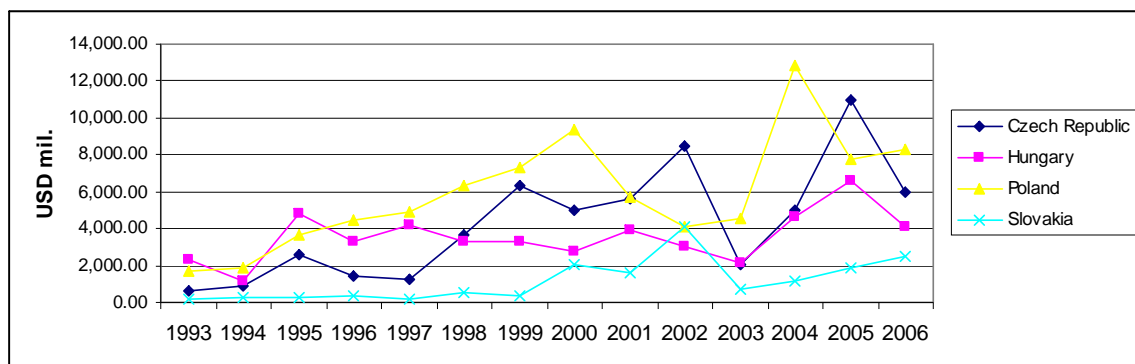
¹⁶ For more see for example Jurzyca and Goliáš 2005: 7- 10.

¹⁷ For more see: Beblavý 2005: 4-7.

through significant public unrest during the cabinet's tenure, the negative social impacts and public perception of Dzurinda's reforms¹⁸ helped the opposition parties led by SMER to win the June 2006 parliamentary elections. Following the elections, SMER's Robert Fico formed a new government with the nationalist SNS and HZDS. Despite the initial promises of the populist government, there has been a significant gap between the proposed systemic rolling back of reforms and the actual implementation. The government has opted for targeted revisions of some reforms, leaving the broad reforms little changed.¹⁹ The government has maintained euro adoption as one of its key priorities.

3.11 Political developments and reform implementation have had a profound impact on inflows of FDI. FDI inflows remained low even immediately after the 1998 elections (Figure 2). Only in 2000 inflows began picking up.²⁰

Figure 2. CEE: Inflows of FDI inflows, 1993-2006 (In millions of US dollars)



Source: EIU

Slovakia as a destination for automotive FDI: factor endowments and policies

3.12 Slovakia has become a key destination for automotive FDI in recent years. This section analyzes the factors and policies that contributed to Slovakia's attractiveness for foreign investors. While it is recognized that investors take into account a number of factors in the decision-making process and analyse all aspects of the investment environment, there is evidence that some factors and policies were more prominent in locational decisions of strategic automotive investors. Still, identifying the key factors is complicated by discrepancies between stated and underlying reasons. We first briefly outline a general position of the Slovak governments towards the automotive sector. We

¹⁸ According to the poll from April 2006 (IVO) assessing popular perception of the policies of the Dzurinda government, only 11 percent of the population fully supported public administration reform, 12 percent tax reform, 7 percent pension and welfare reforms and 3 percent health-care reform.

According to another poll from 2005 (IVO), only 11 percent of the people considered living standard of their family to have improved since the last elections in 2002.

¹⁹ Typical examples of such measures were the introduction of progressive reduction of the tax-exempt amount instead of abolishment of flat tax, paying out Christmas bonuses to pensioners or lowering VAT for medicines.

²⁰ Since 2000, Slovakia has occupied first or second position among V4 countries in FDI inflows as share of GDP (see Figure 8A in the Appendix). See also Jakoby, Kováč and Morvay 2004: 506.

then look at indicators comparing skills and costs of labour in the four CEE countries, rank the countries according to the state of infrastructure development, compare tax rates (and overall labour costs) and finally analyse the role of incentive policies in investors' locational decisions.

3.13 The analysis assumes that strategic investment decisions are made in several stages. In the first stage of the selection process, the company's top management selects a general region that fits within its objectives to invest; in the second stage the corporation short-lists two or three countries (or regions within a country) and negotiates specific terms and conditions of the investment; in the last stage, the final investment site is selected (see Oman 2000). We therefore suggest that investors in most cases first considered the four Central European countries as a general 'cluster' and only then analysed country-specific factors/endowments/policies. The analysis in this paper considers mainly this last step of the decision process, i.e., why Slovakia emerged as the regional leader in attracting automotive FDI.

Government policy towards the automotive sector in the 1990s

3.14 Slovakia's specialisation in the automotive sector should not be seen as directly resulting from a targeted and coherent government approach from the very beginning. Production of VW in Slovakia grew modestly in the first years of operation of the Bratislava plant. According to Jozef Uhrík, the then-CEO of the plant, the company's management focused on large investments into training and improvement of the quality of the workforce. The principal goal was to convince VW's headquarters to locate a more complex and sophisticated production in the Bratislava factory.²¹

3.15 The government started to play an active role only with VW's announcement of its expansion of production. A network of suppliers subsequently expressed interest in investing in Slovakia. In June 1997, Mečiar's cabinet established a position of a government's plenipotentiary for the development of the automotive sector in Slovakia, whose task was to coordinate the activities of various state institutions. A year later, the government adopted a *Program for the development of the automotive industry in Slovakia*, which defined a general strategy and stipulated the goals and the measures to be implemented. At the same time, the cabinet approved a government decree no. 192/1998,²² on the basis of which VW was granted tax incentives (The company received EUR 31.2 million in tax allowance in 1999.)

3.16 The rapid expansion of VW's operations attracted a number of large foreign suppliers, many of them (e.g. Johnson Controls and the Lear Corporation) located in the industrial park in Lozorno, which was also heavily subsidized by the government. The positive experience of VW had a demonstration effect on other car producers and appears to have played an important role in their locational decisions in subsequent years.

²¹ Interview with Jozef Uhrík.

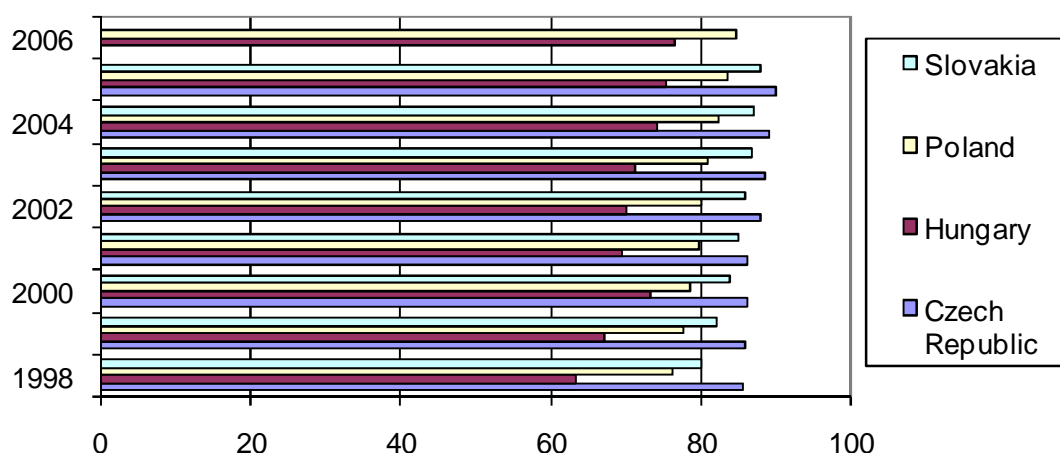
²² See "The State Aid Office as a Tool for Draining Public Funds"

Labor and human capital

3.17 Skilled and abundant labour is commonly understood to be an important factor for attracting FDI in manufacturing. Slovakia was heavily industrialized before transition, with major producers of steel (Vychodoslovenske zeleziarne Kosice, Zeleziarne Podbrezova), arms (Zbrojovka Martin), machinery (ZTS Martin, VSS Kosice) and automobiles (BAZ, TAZ). The legacy of this structure of the workforce and the educational system have been important factors in the success of production sites set up by foreign investors at the very early period of transition and thereafter. In addition to the generally high skill level, the infrequent occurrence of strikes and labor disputes has also been mentioned as a factor in assessing the Slovak labour force.

3.18 First, in terms of labour quality, Figure 3 demonstrates that more than 80 percent of the working age population in 1998 had at least upper secondary education with the figure rising to over 87 percent in 2004. Within the EU, only the Czech Republic scores slightly higher.²³ In terms of university education, however, Slovakia lagged behind with only 12 percent of the population with a university degree in 2003. Although the figures in the region are roughly similar, this ratio represents only about half of the OECD average (Table 5A in the Appendix; Kiss and Siskovic 2006). Regarding technical education, more than 23 percent of university students were enrolled in engineering, manufacturing and construction fields in the late 1990s (Figure 4), with comparable levels in the EU again only found in the Czech Republic.²⁴

Figure 3. Percentage of Population Aged 25-64 with at Least Upper Secondary Education

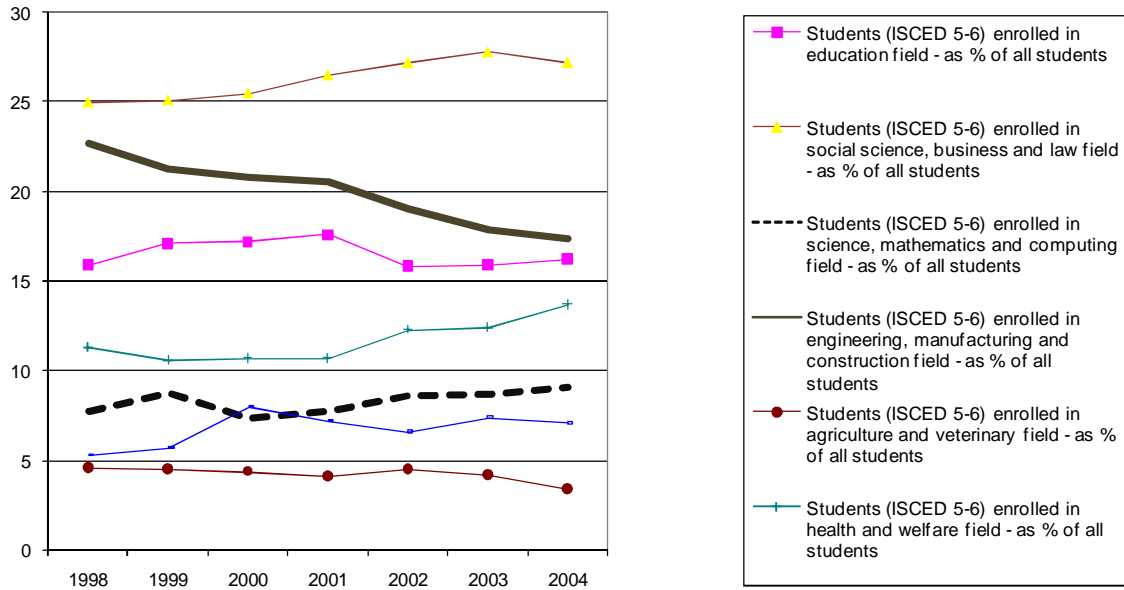


Source: Eurostat.

²³ The common communist history between the two countries of former Czechoslovakia can be clearly detected via educational structure although divergence has been appearing as the transition progressed.

²⁴ The percentage decrease in this particular field as shown in Figure 4 is due to the overall rise in the university students throughout the transition as the net figure of students enrolled in this field has remained relatively unchanged.

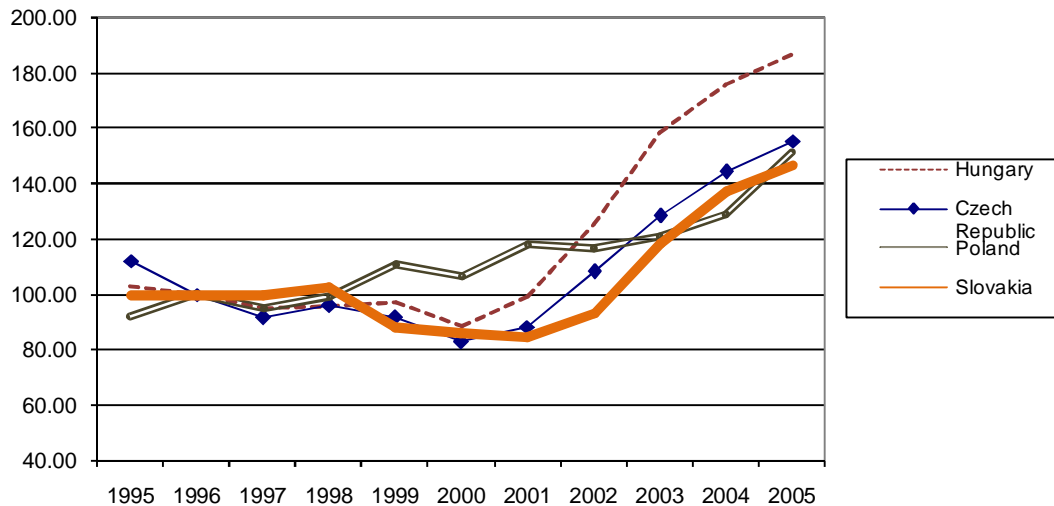
Figure 4. Field of Study (In percent of total tertiary education, ISCED 5-6)



Source: Eurostat

3.19 Second, unit labour costs in Slovakia have been rising at the slowest rate in the region. Even more, at the turn of the century when the major investment decisions were taken, unit labour costs in Slovakia were falling and until 2003 remained the lowest among the Visegrad countries (Figure 5). The minimal and average wage in the country was the lowest in the region (Table 2).

Figure 5. Unit labour costs (1996=100)



Source: EIU

Table 2. CEE: Labour costs, 2004

Labour issues	Czech Republic		Hungary		Poland		Slovakia	
	2004	2006	2004	2006	2004	2006	2004	2006
Minimum monthly wage (EUR)	212	280	209	230	180	223	152	181
Average gross monthly wage (USD)/(national currencies)	694	CZK 20,211	724	HUF 171,239	503	zł 2464.66 (QIII)	467	SKK 18,817
Average hourly cost of labour (EUR, 2005)	5.78	6.56	5.72	6.57	4.92	5.78	4.23	4.59
Social security costs	Approx. 12.5% for employees and 35% for employers.		Approx. 13.5% for employees and 33.5% for employers.		Approx. 48% for employers.		Approx. 28.7% for employers (depending on the type of employment) and 12.4% for employees.	
Harmonized unemployment rate (%)	8.3	7.1	6.1	7.5	19.0	13.8	18.2	13.4

Source: Eurostat, Allen&Overy, KPMG

3.20 Wage disparities between the CEE and the EU15 are substantial and likely to remain large for the years to come. At present, the production of a mid-size car is on average 23 percent cheaper in eastern Europe than in Germany according to estimates by the German Institut für Automobilwirtschaft (Automobil Industrie).

3.21 Third, the tendency of the Slovak labour force to go on strike has been significantly lower than in the neighbouring Poland or in Hungary (Table 3), which might have also played a role in investors' decisions.

Table 3. Strikes and lockouts in CEE

	Czech Republic	Hungary	Poland	Slovakia
Strikes and lockouts (1994-2005)	7	77	1574	9

Source: ILO.

3.22 In sum, abundance of skilled labour has been a very important factor for the entry of car manufacturing investors. According to Jozef Uhrík, the ex-CEO of Volkswagen Slovakia and the current president of the Slovak automotive association VW's Bratislava plant has prided itself with the quality human capital and significant company investments into enhancing the quality of the plant's workforce.²⁵ Moreover, according to Uhrík, the quality of VW's labour force and the complexity of its products might have persuaded the management of PSA to invest in Slovakia, since the French top managers had visited the VW plant just days before the final decision to invest in Slovakia.²⁶

3.23 Importantly, however, labour shortages have lately been reported in the country. In spite of the remaining relatively high unemployment (13.3 percent in 2006 according to the Labour Force Survey), the arrival of large investors to Slovakia has uncovered

²⁵ Interview with Jozef Uhrík

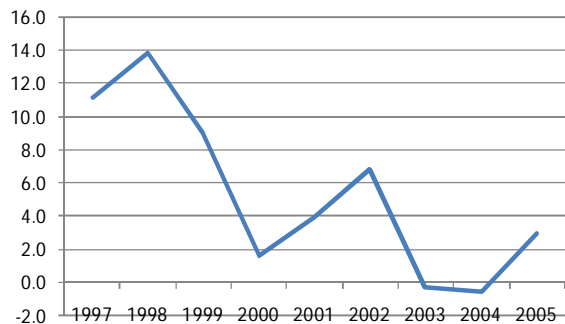
²⁶ Interview with Jozef Uhrík

shortage of adequately qualified labour in the country.²⁷ The long-term unemployed share a common characteristic: very low education levels (80 percent of all unemployed), meaning that they can hardly serve as a pool of labour for the incoming higher-end investments where job creation is skilled biased (Beblavy and Senaj: 21-22). Moreover, also a significant number of persons without work experience have difficulties finding a job in the country (20 percent of the unemployed; in Beblavy and Senaj: 22-23). Clearly, a skill mismatch due to the vast restructuring of the economies and a much less altered structure of labour pool and nearly unreformed educational system seems to be the current labour market problem in the country (Beblavy and Senaj, Arratibel et al., WB 2006). This manifests not only the rapid growth of the manufacturing sector, but also adverse demographic trends and labour migration to the EU-15 area, which has become a wide phenomenon after the accession (WB 2007). At the same time, Slovak labour force has been unwilling to migrate within the country (Paci et al 2007).

Financial intermediation

3.24 The cost of borrowing capital in Slovakia has fallen over recent years, similarly as in other transition countries. It has been reflected in the falling real lending rates (see Figure 6). The level of financial intermediation increased. Credit to the private sector increased from around 24 percent of GDP in 2002 to 27 percent of GDP in 2006 (EBRD data)²⁸. And spreads between lending and deposit rates fell. These are signs of more stable financial system, sufficient degree of competition among commercial banks and the development of the country.

Figure 6. Real lending rates in Slovakia, 1997-2005 (In percent)



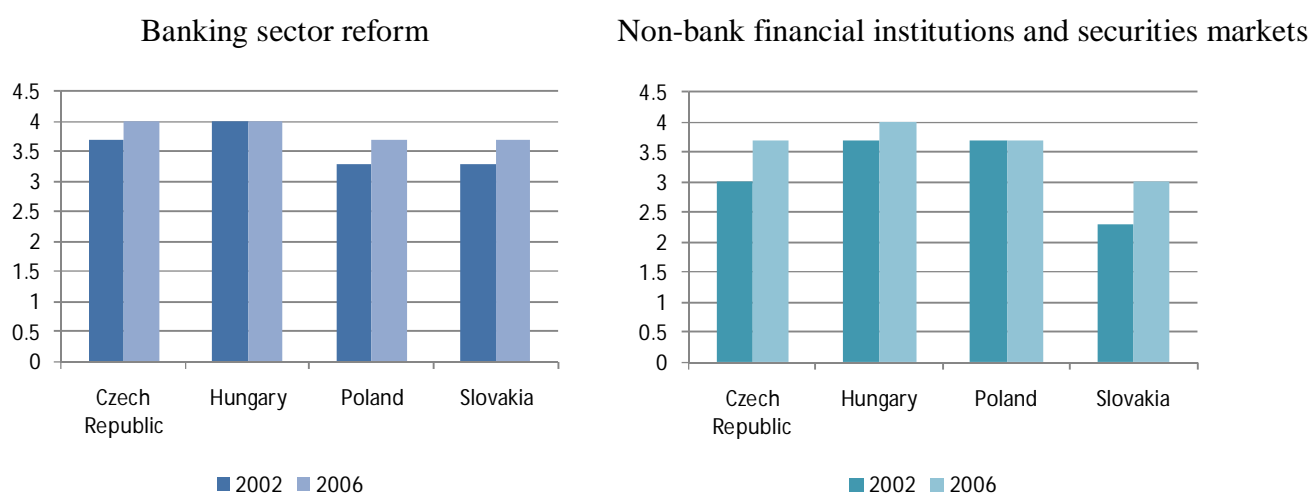
Note: real lending rates were obtained as a difference between short-term nominal rates and CPI inflation
Source: National Bank of Slovakia (nominal short-term rates) and OECD MEI (CPI inflation)

²⁷ The Ministry of Labour has lately reported long-term lack of qualified labour force in the following sectors and industries: machinery (welders, metal workers), construction (builders, artisans, carpenters), transportation (international lorry drivers, intra-city transport drivers), light industries (sewers), and seasonal shortages in services (waiters, cooks). See: Monitoring of registered deficit of labor force in some professions on the labor market in Slovakia in 2006. (Monitoring registrovaného deficitu pracovnej sily v niektorých profesiách na trhu práce v SR v roku 2006). Material recieved upon request from the Ministry of Labor in December 2006. Also: “Firms face labor shortages even in ‘hunger valleys.’ (Firmy zápasia s nedostatkom ľudí aj v hladových dolinách), 20.11.2006, www.sme.sk. Mira Sojkova, “Slovakia should be saved by foreigners.” (Slovensko maju zachranit cudzinci), 13.12.2006, www.hnonline.sk.

²⁸ Credit to the private sector was even higher in 1997-2000. But this reflected bad loans portfolio.

3.25 Positive changes at the Slovak financial market have also been captured by the EBRD transition indicators. Reforms of the Slovak banking system led to the score of 3+ in 2002 (with scores ranging from 1 to 4 and 4 being a standard of an industrialised market economy, see Figure 7). While in 2006, the result was higher and comparable with other countries in the region. Slovak economy has also progressed in the development of the non-bank financial institutions and securities market in 2002-2006. However, here the score in 2006 was lower than for any other Visegrad country (see Figure 7). Generally, Slovak financial system is now in a healthy state and resilient to shocks (IMF 2007).

Figure 7. CEE: Indicators of financial system reforms, 2002 and 2006



Note: Note: indicators range from 1 to 4+, with 4+ representing standards of an industrialised market economy.

Source: EBRD Transition Reports

Taxation

3.26 Slovakia advanced tax reform in 2004 by introducing a flat personal and corporate income tax rate, set at 19 percent, unified with the VAT rate.²⁹ With the exception of Hungary, differences among the Visegrad countries on the CIT rate are minor if the effective rate is considered (Table 5). The general VAT rate is also broadly similar across the countries. Nonetheless, the advantage of the Slovak tax system is not necessarily in lower rates, but in the simplification and transparency of the system. The new tax reform eliminated 21 different types of taxation of direct income (Slovak Ministry of Finance 2005). Slovakia's tax system has been assessed as motivating work and investment (see for example Moore 2005).

Table 4. CEE: Tax rates (In percent)

²⁹ A lower VAT rate applicable only to medicines was introduced in November 2006.

Taxation	Czech Republic	Hungary	Poland	Slovakia
Statutory corporate income tax	24	16	19	19
Effective corporate income tax rate	17.1	14.0	17.5	16.8
VAT (general rate)	19	20	22	19
Personal income tax rate	15-32	18-38	19-40	19

Source: Allen&Overy.

Investment incentives

3.27 The above-reviewed evidence notwithstanding, there is strong evidence of ‘incentive-based competition’ among the CEE countries for investments of ‘strategic’ nature, particularly in the last five years. Investors were granted subsidy packages and tax exemptions throughout the 1990s³⁰ (for example, VW Slovakia was granted tax breaks in 1998 on the basis of a government decree.) Nevertheless, it is highly probable that an intense competition for strategic investments in the Visegrad region did not start until the turn of this century. This reflected the introduction of an investment incentive scheme by the Czech government in 1998 and Slovakia’s vigorous effort to catch up with its neighbours in attracting FDI.

3.28 With the EU accession, the CEE countries had to comply with the EU rules on the provision of state aid. In general, state aid is prohibited by the European Commission as causing distortions to the single market. Nevertheless, exemptions can be granted to large investment projects, mostly when such projects significantly contribute to regional development and are based on Commission’s cohesion policy.

3.29 The EU provides a multisectoral framework on regional aid for large investment projects, with an upper ceiling of the total amount of incentives that can be granted to foreign investor in the automotive industry. This level is 15 percent of the total value of investment and applies to the ‘motor vehicle industry’ as defined by the European Commission (EC 1997). The EC has to approve the amount of investment incentives proposed by the member states for a strategic investor. The structure of investment incentives, however, is not defined or restricted by the EC, which gives the members flexibility and ample opportunities for competition. It is, however, very difficult to calculate the exact value of the financial benefits of a specific incentive package (Charlton 2003: 30). In order for an incentive to be excluded from the 15-percent rule (a so-called ‘indirect’ incentive), it has to qualify as a public good. It is also important to note that the nature of the investment agreement itself can be part of the bidding process as well, as the EU needs to approve only the amount, but not the details of the agreement.

³⁰ Suzuki, for instance, was offered by the Hungarian government “grants towards the cost of investment as well as a ten-year tax holiday and other tax concessions which gave Suzuki 22% customs preference over other vehicle importers. In sum, Suzuki Motor Corp. provided just 16.6% of the joint venture’s start up capital,” Swain 1998: 10.

3.30 In addition to the EC limits on state aid, every CEE country has its own rules for the provision of investment incentives.³¹ It suffices to note that the general reasons for adopting national rules for the provision of investment incentives include transparency and credibility towards foreign investors. Negotiations with individual investors about the amount of investment incentives without any general guidelines limiting state aid are not sustainable both politically and economically. Slovakia was the last country to adopt an investment scheme in 2005 as a result of pressure following the generous treatment of KIA Motors (and Hankook Tire) a year earlier. According to the former advisor to the state secretary of the Slovak Ministry of Finance, Marek Jakoby, it was a ‘moral hazard’ not to have an incentive scheme. Well-defined rules are an important sign for both investors and government institutions, since an incentive scheme clearly defines expectations for the negotiating process with investors.³² In general, national incentive schemes in the CEE limit state aid offered to investors based on regional characteristics (e.g., unemployment rate) and type of industry (e.g., manufacturing, R&D, technological centers and others). Nevertheless, no matter how detailed an incentive scheme, the CEE states usually allow for a ‘special treatment’ of investors of ‘strategic importance,’ which gives governments flexibility in negotiations with big investors.

3.31 All in all, the EU accession of the CEE states has not meant uniformity in incentive rules and the end of competition among the CEE countries based on investment incentives. Table 3A in the Appendix summarizes investment incentives granted to the four largest automotive investments in the region over the past 6 years.

Case study: PSA Peugeot Citroen

3.32 The investments by PSA Peugeot Citroen and KIA Motors have been the largest greenfield investments in the Slovak automotive sector. This study focuses on the first and the next study on the latter investor. Both studies should help understand the complexity of TNC-host government relationships and shed light on the importance of specific factor endowments and policies used for attracting foreign investors.

3.33 Shortly after PSA Peugeot Citroen from France, together with Toyota from Japan, decided to invest in a joint manufacturing plant in Kolín, the Czech Republic, the PSA commenced negotiations about its investment in another operation in CEE. In October 2002, the company announced it had decided to invest €700 million in the region in a new factory for the production of small cars, because the region offered “many advantages in labour skills and labour costs.”³³ The candidates for the investment were initially all four Visegrad countries, but the most frequently mentioned sites were Žatec in the Czech Republic, Radomsko in Poland and Trnava in Slovakia. Only Poland and

³¹ For a comprehensive account of the European Union limits on state aid as well as national rules for the provision of investment incentives, see “Foreign Direct Investment in Central and Eastern Europe,” Allen and Overy

³² Interview with Marek Jakoby, Advisor to the State secretary of the Slovak Ministry of Finance, Bratislava, 19 May 2006

³³ MF Dnes, 30 October 2002

Slovakia were subsequently short-listed, since building two plants (TPCA and PSA) in one country – the Czech Republic – was considered too risky.³⁴

3.34 On January 15th 2003, the company officially selected Slovakia for its new manufacturing operation in central Europe. The most often cited reasons for the decision were advantageous geographical position and proximity of large markets, skilled labour force, railway and highway accessibility of the site and the country's tradition in car manufacturing. The PSA stated that "the manufacturing facility will enable the group to get closer to the market, in which it is strengthening its position."³⁵ The Slovak Investment and Trade Development Agency declared that "Slovakia was not even a candidate half a year ago, but we managed to bring the project to a successful finish."³⁶ The overall financial incentives granted to the French investor amounted to more than €160 million.

3.35 The investment was of crucial importance for Slovakia and the planned factory was termed "the investment of the decade" by the Minister of Economy and "another Slovak locomotive" by prime minister Dzurinda.³⁷ The Slovak government could thus present the country as a reforming and rapidly developing Central European nation, which was increasingly attractive for foreign investors. This media effect of the PSA plant was also stressed by analysts, who expressed that the new investment would "draw attention of the whole Europe and it is thus probable that various investors deciding to invest in Eastern Europe will focus on Slovakia more."³⁸

3.36 It is clear that the government was mindful of the need to attract foreign investment following the 1998 elections that brought to power a reformist coalition. Other factors were also helping. Firstly, PSA was already building a plant in the Czech Republic (Kolín) and the proposed site in Žatec was in close proximity to the factory. Secondly, there were indications that the other sites did not have adequate infrastructure. There were also indications that the plots were not well prepared for the investment. Slovakia's proposed site seemed to offer an advantageous geographical location and proper infrastructure. Overall, it is difficult to assess which factors were crucial in PSA's locational decision because the process was highly confidential.

Case study: KIA Motors

3.37 Expanding production to Europe was an obvious step in KIA's expansion strategy, following buoyant growth in sales in western Europe and substantial improvements in perceptions of quality of the brand.

3.38 As in the case of the PSA, all four Visegrad countries were initially considered for the KIA investment as well. In early September 2003, the head of KIA in Hungary,

³⁴ MF Dnes, 30 November 2002

³⁵ Sme, 16 January 2003

³⁶ Sme, 15 January 2003

³⁷ Sme, 16 January 2003

³⁸ SME, 16 January 2003

Tibor Királyi, declared that only the Czech Republic and Hungary were henceforth candidates for the investment. According to a statement by the Korean press agency Jonhap from early-October, the Czech Republic was the main and favourite candidate. However, the company itself refused to comment (SME 2003).³⁹ At that stage, Slovakia was no longer considered a credible candidate, according to a Ministry of Economy official. Nevertheless, Pavol Rusko, Minister of Economy, visited South Korea and is reported to have made ‘a very attractive subsidy offer’ to the KIA management and Slovakia ‘got back in the game.’⁴⁰ Minister Rusko officially declared at a press conference on November 25 that Slovakia and Poland had made it to the final round of the selection process.⁴¹

3.39 Mixed reports, misinformation and confusion were typical of the first stage of the selection process. According to available information, the whole process was not dissimilar to price bidding – whichever two countries offered the most incentives to the investor made it to the shortlist. A representative of Czechinvest commented on Hyundai’s decision: “We are sorry, but we had to refuse requests for above standard investment stimuli that are in conflict with Czech laws and EU directives.”⁴²

3.40 Despite the fact that both Poland and Slovakia had to comply with the 15 percent EU limit on state aid, there were important differences in the competing offers. Some of the “trump-cards” (term used by Zilina’s mayor Ján Slota) of the Slovak offer were the provision of an English-language education for employees’ children; hospital; support by the Technical University in Zilina specializing in transport; construction of a railway terminal; completion of the highway to Zilina and a reconstruction of the nearby airport in Dolny Hricov.⁴³ The amount of investment incentives offered by Slovakia was officially more than the 15 percent limit (more than €170 million) of the total sum to be invested by KIA. The limit, however, covers only direct state assistance. Additional resources were dedicated to the highway construction (reported at about €700 million), airport reconstruction and others. Further incentives included the promise to build housing for the Korean management not far from the KIA factory, and construct additional housing near Bratislava. The two housing facilities were estimated to have cost more than €40 million.⁴⁴ Tax breaks were not part of the offer and the investor had not asked for them.⁴⁵

3.41 In early march 2004 KIA decided to build its first European plant in Slovakia. The reasons varied, but those most commonly mentioned include cheap and skilled labour, lack of labor actions (strikes), lower taxes and commitment to develop infrastructure in the region (SME 2004, TREND 2004).⁴⁶ Slovak government officials further stressed Slovakia’s improving economic policies, successful reforms and

³⁹ SME, 12 October 2003

⁴⁰ Interview with a former high Ministry official, who did not wish to disclose his identity, 30 March 2007

⁴¹ SME, 25 November 2003 and 25 November 2003

⁴² Korzar, 03 May 2004

⁴³ SME, 14 December 2003

⁴⁴ SME, 03 February 2006 and 30 May 2005

⁴⁵ SME, 17 January 2004. Another commitment included the promise for incentives to sub-contractors. This was not included in the investment agreement, however (SME 2006).

⁴⁶ SME, 03 March 2004 and TREND, 15 March 2004

favourable business environment. According to the Slovak Minister of the Economy Rusko, the offer to Hyundai changed five times only in the last week of negotiations: “The agreement was worked on in parallel with the prolonging of the decision-making process.” Rusko further stated that if the government were to negotiate more favourable conditions for Slovakia, there would be a real threat that KIA would not come (SME 2004).⁴⁷ All in all, it was not only the lower taxes that attracted KIA to the country, but the government incentives package played an important, if not a key, part in the selection process. The mayor of Zilina, Jan Slota, stated shortly after KIA’s decision that “the Poles could not compete with our offer... no investor could resist our offers” (TREND 2004).⁴⁸

3.42 There was public criticism of the investment agreement between KIA Motors and the government because, as critics alleged, KIA was not obliged to invest any minimum sum in the project or employ a minimum number of people and even if the project was not carried out at all, it would not be considered a breach of the agreement.⁴⁹ Furthermore, even in case KIA did not carry out all investments as described in the investment plan, it would not have to refund any state aid or other assistance provided by the government of the Zilina.⁵⁰ Or as one analyst put it, Slovakia’s competitors did not succeed, because “they did not cross the threshold of decency towards their own citizens and dignity of the state” (Zachar 2005: 74). Clearly, as this case study indicates, investment incentives played a prominent role in attracting KIA to invest in Slovakia.⁵¹

Summary: An assessment of Slovakia’s FDI-related factors and policies

3.43 Slovakia has attracted a sizable share of automotive investment inflows in recent years. The key factors underpinning this outcome reflect include, firstly, favourable initial conditions, including the BAZ factory that operated in communist times and was acquired by VW in the early 1990s. The expansion of VW Slovakia and the high quality and complexity of its products prompted other car manufacturers to take notice. The existing supply network – if modest in the late 1990s - was also of great importance for investors that followed this century. The abundance of skilled labour employed in manufacturing was also a key pre-condition.

3.44 Secondly, Slovakia underwent a significant change in economic policies after 1998, embarking on ambitious fiscal and structural reforms that created a world-class business environment. Slovakia was branded a top reformer and one of the most investor-friendly countries in central Europe.

⁴⁷ SME, 06 March 2004

⁴⁸ TREND, 02 March 2004

⁴⁹ “Investičná zmluva týkajúca sa navrhovanej výstavby závodu na montáž automobilov v Žiline, Slovenská republika”

⁵⁰ “Investičná zmluva týkajúca sa navrhovanej výstavby závodu na montáž automobilov v Žiline, Slovenská republika”

⁵¹ It needs to be noted, however, that personal political ambitions of Pavol Rusko played a very important role in the whole process. Some of field interviewees of the co-author of this study confirmed that it was Rusko’s ambitions and his failure to communicate with other ministers that contributed to the weaker position of the government vis-à-vis the investor.

3.45 Last but by no means least, Slovakia was particularly generous in offering investment incentives to strategic automotive investors. The two case studies presented above illuminate the principal role of state aid played in the competition for automotive FDI among the Visegrad countries.

4. THE CURRENT CONDITION OF THE AUTOMOTIVE SECTOR IN SLOVAKIA

4.1 The automotive industry is the single most important industrial sector in the economy and will, according to analysts, soon account for as much as one-third of country's GDP.⁵² The importance of the sector for the economy is not only underlined by the employment of more than 10 percent of the Slovak labour force in manufacturing, but more importantly by the high propensity for linkages with local suppliers. Moreover, it is projected that the industry will produce 800,000 cars a year by 2010, elevating Slovakia as one of the world's leading car producers as measured on a per capita basis.

4.2 This chapter analyses current condition of the automotive sector in Slovakia and outlines the most important characteristics such as geographical concentration, foreign ownership, production, export, profitability, linkages with local suppliers and labour productivity. Perspectives for the automotive sector in Slovakia and its future challenges are also outlined.

Geographical concentration

4.3 The automotive industry in Central Europe is concentrated in southern Poland, the eastern Czech Republic, western Slovakia and northern Hungary. Most of the production is located within a circle with a diameter of about 400 km (Figure 1A in the Appendix).

4.4 According to the Slovak Ministry of Economy, the automotive production in Slovakia is concentrated in three regional clusters (see Figure 8). The first and the strongest cluster is in the western part of the country, where both the Volkswagen and the PSA factories are located. The second regional cluster is in the northern and central part of Slovakia, centered on Kia Motors' plant. The third cluster is in eastern Slovakia, with the Kechnec industrial park in Kosice housing several key suppliers, including Gertrag Ford transmissions and Molex.

⁵² Information given by Business and Innovation Centre Bratislava

Figure 8. Slovakia: Geographical concentration of automotive production



Source: Excerpted from Ministry of Economy of Slovakia (2005), p. 7.

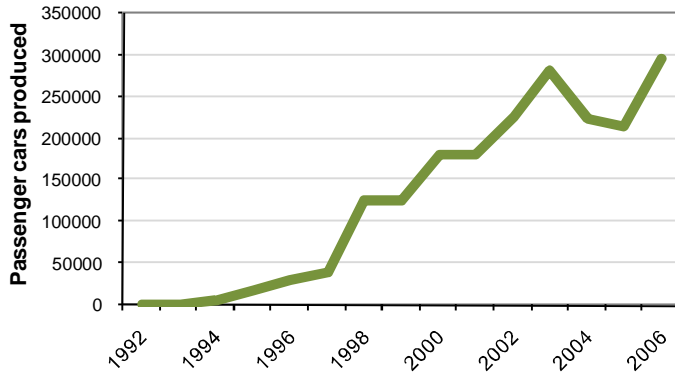
Production

4.5 The four Visegrad countries account for 12.2 percent of the total EU-27 production of passenger cars, or 2 million cars.⁵³ Slovakia's production amounted to 300,000 motor vehicles in 2006. With two of the three manufacturers starting producing only in 2006 (PSA in July 2006 and KIA in December 2006), these numbers are only part of the fuller picture. Production is set to rise substantially in the coming years, and reach capacity of about 800,000 by 2010.

4.6 Until 2006, car output reflected solely production at VW Slovakia (Figure 9). Production capacity of the factory did not meet the initial expectations until 1997. Heavy investments into training as well as tax breaks set by government decree in 1998 stimulated the rapid expansion of the company and in 2002 output exceeded 200,000 cars for the first time (see Box 1 for an overview of the company). During 2003-2005, the factory underwent substantial technological upgrades to meet the requirements necessary for starting the production of Audi Q7 – hence the temporary decline of output. In 2006, the majority of the market still belonged to VW. KIA produced 5,014 passenger cars (KIA Cee'd), PSA 51,719 (Peugeot 207s) and Volkswagen 238,647 cars (VW Touareg, Audi Q7, VW Polo).

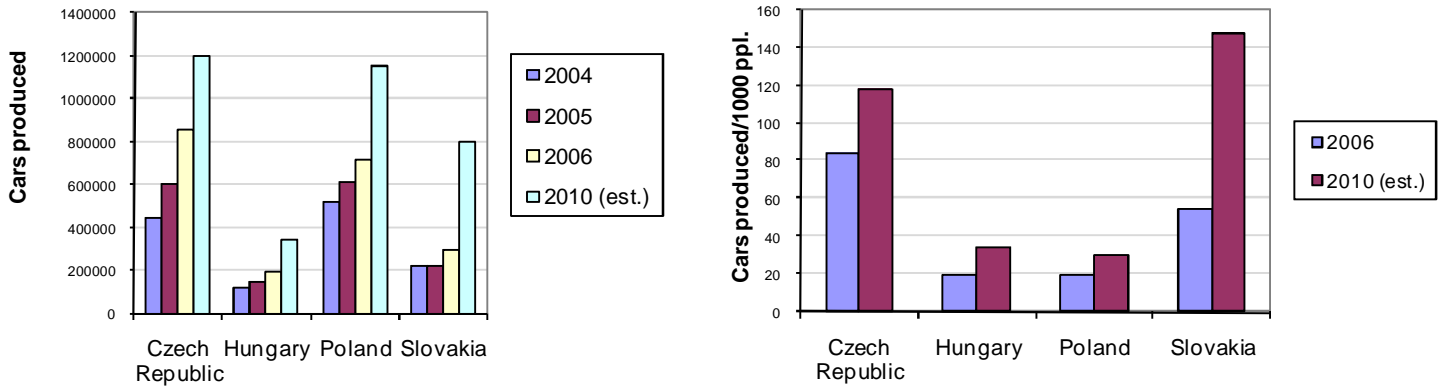
⁵³ Calculated on the basis of ACEA 2007: 19

Figure 9. Slovakia: Production of passenger cars, 1992-2006



Source: ZAP SR

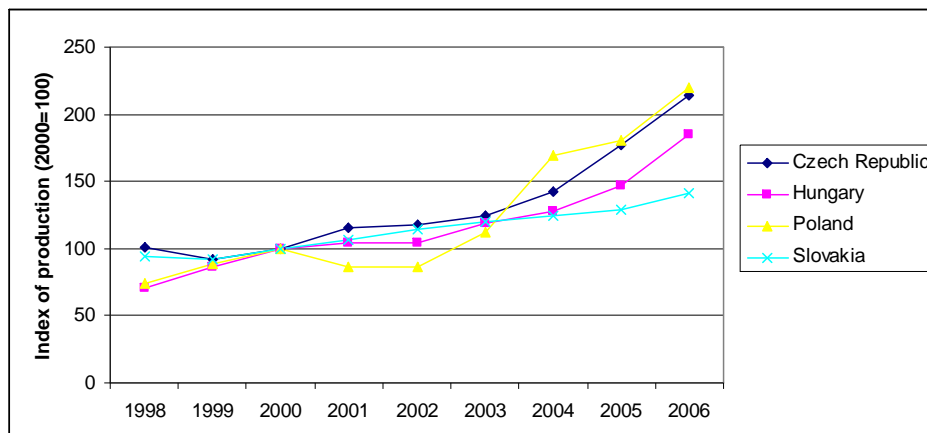
Figure 10. CEE: Current and forecasted production of cars, 2004-2010



Source: ACEA, ZAP, authors' estimates

4.7 Among the Visegrad countries, the Czech Republic lead the production in the region with almost 850,000 cars produced in 2006, followed by Poland with 632,300, Slovakia and Hungary (187,633). On a per capita basis, Slovakia will be the regional leader by 2010 when both PSA and KIA reach their full capacity (see Figure 10).

Figure 11. CEE: Automotive production, (NACE 34), 1998-2006



Source: Eurostat

4.8 Nevertheless, when analysing automotive industry, the whole production process should be taken into account. Nowadays, the production of particular car parts (including car engines) is typically subcontracted. This is also the case of the Slovak automotive industry. Therefore, when talking about the development of the automotive industry, it is worth considering also the dynamics of intermediate output. Indeed, the output of the whole automotive industry (NACE 34) was growing even higher than output of manufacturing of motor vehicles in Slovakia in 1998-2005 (see Figure 2A in the Appendix).

Box 1: Volkswagen Slovakia

VW was established in 1991 as a joint-venture with BAZ Bratislava. The original plan was to assemble 30,000 cars and produce 200,000 transmissions. The factory initially assembled VW Passat and only later moved to more complex all-wheel drive models (Golf Syncro). The skilled workforce and the positive experience with producing the Syncro models led to VW's decision to start production of the Touareg, the company's first ever sport-utility vehicle, in 2003. (The Bratislava plant also produces two other luxury SUVs from the VW group - Audi Q7 and Porsche Cayenne.) According to Jozef Uhrik, former CEO of VW, VW Touareg is 'a truly Slovak car', since 60 percent of the value is added by suppliers located in Slovakia.

VW has another factory in Martin, Slovakia, employing over 1,000 workers and specialized in the production of transmissions and transmission parts.

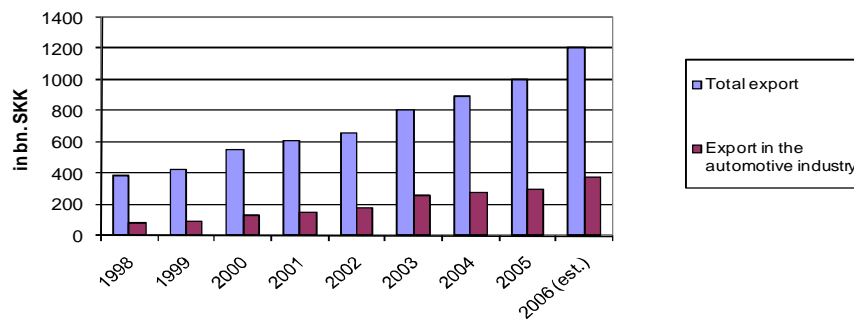
VW plans to invest EUR200 million in Slovakia in 2008-2009. Although a significant increase of the total number of produced cars in the factory in Bratislava is not planned after capacity is reached by 2010, Volkswagen Slovakia will increase the share of complex SUV models in its production in the following years.

Sources: Interview with Jozef Uhrik; VW press releases; Trend Jan 5, 2007 and Trend Top 200 2006

Exports

4.9 Most of the passenger cars produced in the three Slovak car factories are exported. Car exports have risen faster than overall exports since 1998, with the share of car exports rising from 20 percent in 1998 to more than one-third in 2005⁶. VW is the leading exporter. The largest market for Slovak exports of motor vehicles and parts thereof (SITC 78) is Germany (47 percent), followed by the United States (10 percent). The large US share is explained by high sales of SUVs VW Touareg and Audi Q7 on the American market (both manufactured exclusively in Bratislava). It is estimated that almost half of the production volume of Audi Q7 targets the American market.

Figure 12. Slovakia: Manufacturing and automobile exports, 1998-2006



Source: ZAP SR

4.10 Regarding the share of export of motor vehicles (SITC 781) in total exports, Slovakia is leading the Visegrad countries with approximately 12 percent in 2005, followed by the Czech Republic, Poland and Hungary (Figure 3A in the Appendix). The share of car exports in Slovakia dropped by 6 percentage points between 2003 and 2005, thanks to the dynamic development of the other parts of the economy and retooling of the VW factory in Bratislava. Moreover, this decrease is likely to be reversed going forward as output is boosted to capacity by 2010. Hungary is the only Visegrad country with a declining share of car exports within total exports since 1999.

Profitability

4.11 VW Slovakia is the largest company in the country by consolidated revenues and the fourth by profitability.⁵⁴ The company's turnover increased by almost 30 percent in 2006 (to EUR 5.2 billion) from 2005. VW's profit in 2005 was about EUR 136 million.⁵⁵ In comparison, the turnover of Škoda Auto from the Czech Republic amounted to EUR 6.7 billion in 2006 and its profit was EUR 383.2 billion (48 percent higher than in 2005.) TPCA's operation in Kolin has not yet recorded profit in its three years of existence.

Table 5. Sales, profits and employment of Czech and Slovak automotive firms, 2006

2006	Turnover (billion EUR)	Profit (million EUR after taxes)	Employees	Cars produced

⁵⁴ Data for 2005, Trend Top 200 2006

⁵⁵ Data for 2006 profit not available

VW Slovakia	5.2	N/A (135.7 in 2005)	9,200	238,647
Škoda Auto (Czech Rep.)	6.7	383.2	26,738	556,433
TPCA (Czech Rep.)	1.75	< 0	3,500	293,650

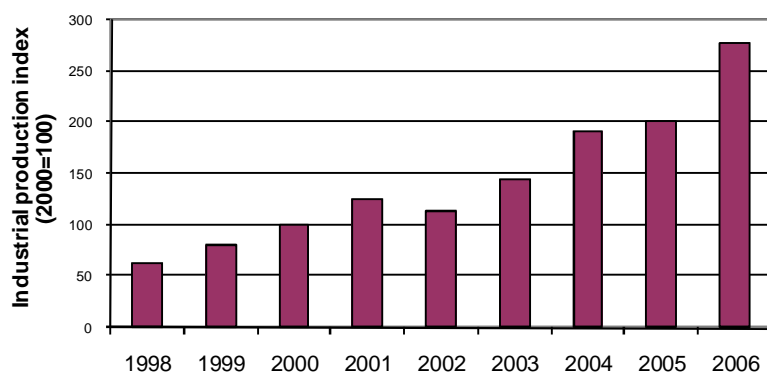
Source: Škoda Auto 2006 Annual Report + press releases

Linkages with local suppliers

4.12 Production of parts for automotive vehicles has been growing faster than production of cars since 1998 (Figure 13), reflecting, in part, growing exports to the neighbouring countries. VW remains the preferred destination for suppliers, although the share of other manufacturers is picking up strongly (see Figure 14). Available data suggests that the number of companies in the auto supply sector (NACE 343) increased from 18 in 1998 to 34 by 2001 and 49 by 2004 (Eurostat).

4.13 The industry is largely foreign-owned with traditional supply companies, including Johnson Controls, SAS Automotive, INA and Lear Corporation in the lead. The first three of these are among the largest five engineering companies in Slovakia.⁵⁶ Even though domestically-owned suppliers play an important role in the Slovak automotive industry, only Matador Automotive ranks among the biggest engineering companies in the country according to consolidated revenues.⁵⁷ (Table 4A in the Appendix lists top 25 engineering companies in Slovakia.) This should be seen in perspective, however, as Matador was a much smaller supplier in 1998. Indeed, the presence of foreign-owned suppliers is having a spillover effect, and should help spur further domestic competition.

Figure 13. Slovakia: Industrial production for the auto parts sector (NACE 343)

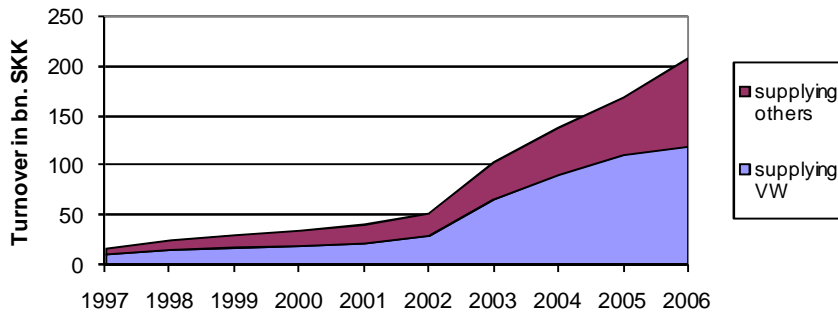


Source: Eurostat

Figure 14. Slovakia: Turnover in the auto parts sector, 1997-2006 (In billions of SKK)

⁵⁶ Trend Top 200 2006 rankings

⁵⁷ Trend Top 200 2006 rankings



Source: ZAP SR

4.14 The degree of propensity for linkages also depends on the specific type of production. The more complex a vehicle and the more technologically advanced and capital intensive its production, the more likely it has been that it will be manufactured in one factory only. The latter makes it more likely that links to local or regional suppliers will be developed. For example, VW Slovakia produces all VW cars based on the 7L and 4L platforms (VW Touareg, Porsche Cayenne and Audi Q7). According to VW, 70 percent of all components for the Slovak plant are manufactured in Slovakia. By contrast, the cheapest and the least complex of all models made in VW's Bratislava factory (the VW Polo) has an estimated local content of 20-30 percent. This reflects the fact that the Polo is also manufactured in Pamplona, Spain, with its own cluster of key suppliers.

4.15 The geographical proximity of KIA in Žilina and its sister factory Hyundai in Nošovice (Czech Republic), together with the production of models based on the same platform in both plants, will make it easier and more cost efficient to share suppliers and parts.. Under the arrangement, KIA will supply engines to the Nošovice plant and Hyundai will manufacture gearboxes for both factories (TREND 2006).⁵⁸ KIA in Žilina is the only plant Kia's parent has in Europe; Hyundai factory in Nošovice, meanwhile, will only be completed in 2009, hence the high propensity for linkages. Matador Automotive, the largest Slovak supplier of 'first-tier' components, has already signed an important contract with KIA.⁵⁹ In contrast to the arrangements by KIA, the PSA plant will import engines and other important parts from France and the neighbouring countries (including the Czech Republic).⁶⁰

4.16 Even though backward linkages are one of the most important sources of spillover for the host economy, measuring them is not easy. This paper finds that domestic market turnover for the sector (manufacture of transport equipment, NACE 34) is the most relevant proxy explaining growth of local suppliers' market. Figure 15 indicates a sharp increase in turnover during 2000 and 2006, reflecting the start of the production of VW Touareg in 2003 and the preparation of the PSA and the KIA investments.

⁵⁸ Trend, 11 September 2006

⁵⁹ Trend, 25 March 2006

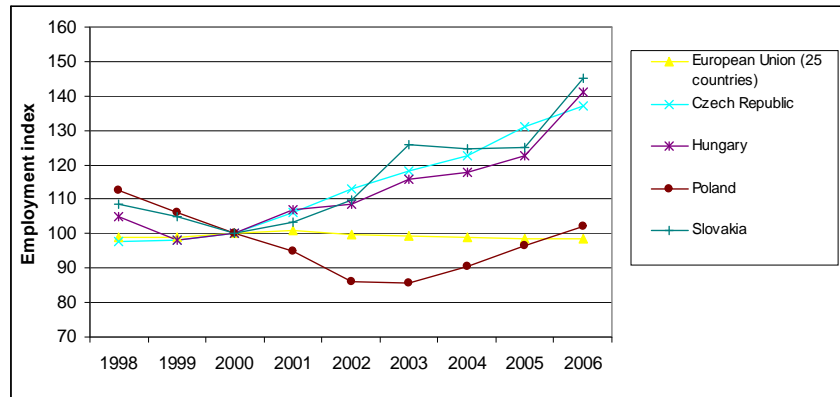
⁶⁰ Trend, 25 March 2006

Employment

4.17 According to the Slovak Automotive Industry Association (ZAR), the automotive industry accounts for about 10 percent of manufacturing employment in the country (Figure 5A in the Appendix for total employment in the sector). Data from the Statistical Office show a lower share of 6 percent, by contrast. Despite the discrepancy in these data, employment in the industry has been rising rapidly since at least since 2000.⁶¹ During 2000-2006, the automotive sector in Slovakia accounted for nearly 40 percent of all new jobs generated in manufacturing.

4.18 Reflecting developments in production and investment, employment in the automotive sector has grown most rapidly in Slovakia among the Visegrad countries (Figure 17). According to Euler Hermes, new EU member states have recorded an increase of 90,000 jobs in the automotive industry for the past six years, while 117,000 jobs in the sector were lost among the EU15 since 2000. It is estimated that the Slovak automotive sector will employ as many as 100,000 people by 2010.

Figure 15. Employment index (2000=100) in automotive industry CEE and EU25, 1998-2006



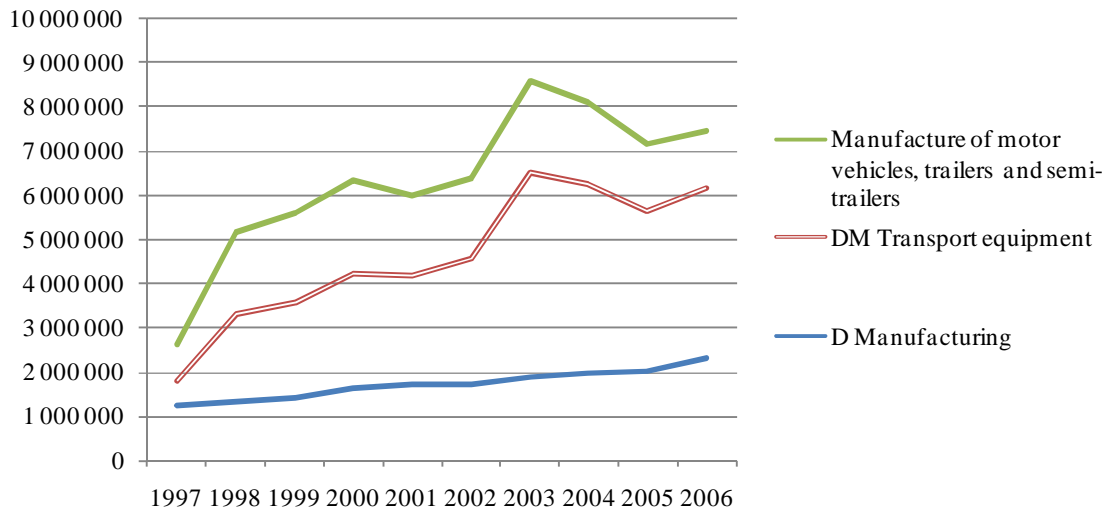
Source: Eurostat

Labor productivity

4.19 Productivity of labour in the automotive sector has been growing much faster than the manufacturing average (Figure 18). There were more pronounced peaks in productivity growth in 1998 and 2003, resulting from the start of automobile production in VW Slovakia (see Figure 9 in Section 4.3). A temporary decrease in productivity took place in 2005 when production in VW slowed down due to technology upgrading. Overall, the growth of productivity outpaced the growth of wages in the sector during 2000-2006. Moreover, with growth of labour productivity outpacing increases in average wages (Figure 6A in the Appendix), there is little risk that wage increases will contribute to higher inflation.

⁶¹ Data from Slovak Statistical Office show even a constant growth of employment in the Automotive industry at least since 1997.

Figure 16. Labour productivity in the automotive industry and in manufacturing in Slovakia, 1997-2006



Source: Slovak Statistical Office, authors' calculations

Note: labour productivity is expressed as yearly turnover per person employed (in constant 2000 SKK).

4.20 Comparing productivity in different manufacturing plants is difficult. Table 8 summarizes important data for VW Slovakia and Škoda Auto. VW Slovakia produces more cars per employee. Nevertheless, while the final output of VW produces are, in general, more complex and expensive cars, pre-assembled components produced outside the factory are a larger part of total output than in Škoda Auto. The latter, therefore, utilizes more employees. Therefore any comparison between the two companies should be purely informative.

Table 6. Comparison of financial and production figures between Czech Škoda Auto and Slovak Volkswagen in 2005

2005	Turnover (billion EUR)	Profit (million EUR after taxes)	Employees	Cars produced	Cars/employee	Turnover/employee (EUR thousands)
VW Slovakia	4.035	135.7	7,900	218,349	27.6	510.8
Škoda Auto	5.967	247.1	26,014	494,637	19	229.4

Source: Škoda Auto 2005 Annual Report and press releases.

Perspectives and challenges for the future of automotive industry in Slovakia

4.21 The Slovak automotive industry is expected to grow in the near future. According to ZAP's estimates, the automotive sector will employ nearly 100,000 people and produce 800,000 cars by 2010. Nonetheless, there are two main challenges for the future of the automotive industry in Slovakia.

4.22 Firstly, despite the skilled labour and still high unemployment (about 13 percent in 2006), the arrival of large investors to Slovakia has uncovered shortage of adequately qualified labour in the country (SME 2006), especially in close vicinity of the factories.⁶²

⁶³ The Slovak Ministry of Labour has reported long-term lack of qualified labour in a number of sectors and industries including machinery (welders, metal workers; Slovak Ministry of Labour 2006). In the car industry, the need for 40,000 additional workers will be dealt with by 'importing' labour from abroad and helping bring education to levels that would help serve the needs of the industry. For this reason, the car producers together with ZAP have commenced long-term cooperation with Slovak technical secondary schools and universities.

4.23 Secondly, larger investments are needed in research and development in the automotive industry.⁶⁴ According to the ZAP, the establishment and development of R&D centres at technical universities and in the Slovak Academy of Sciences is vital for the increase in Slovakia's competitiveness in the industry. Increased outlays on R&D should help boost growth in value added and help ensure strong and sustained output expansion even after the advantage of lower labour costs in Slovakia disappear.

5. SUMMARY AND CONCLUSIONS

5.1 Over the last decade, Slovakia has become more integrated into the global economy on the basis of ambitious and thorough economic reforms that helped attract large flows of foreign direct investment. The automotive industry has accounted for two out of every five jobs created in the country in recent years and has underpinned the surge in growth in output and exports. Recent investments in the automotive industry are yet to fully bear fruit; the three existing manufacturers will reach full capacity only by 2010, further strengthening the sector's significance for the country's economy. This section summarizes the evidence presented earlier.

5.2 The factors that underpinned the development of the automotive industry in Slovakia are numerous, but key among them are the decisive economic reforms begun in 1999 and strengthened in 2002-2005. The irreversibility of reforms has been all but guaranteed and Slovakia is likely to be the first among the larger central European countries that will join the eurozone in 2009. Initial conditions, including the quality of the labor force, have also been important.

5.3 Improved prospects for EU accession at the turn of the century, together with decisive progress in aligning domestic legislation with the *acquis* helped anchor investor expectations about economic policy and future developments. On the political front, reforms received impetus from the popular perception, likely correct, that the country would have been excluded from the 2004 accession wave without deep reforms. This was enough to unite the anti-Meciar political opposition and attract voters. It also

⁶² SME, 20 November 2006

⁶³ Labor mobility has been rather limited in Slovakia, even though there are large differences in wages and unemployment rates across the Slovak regions (Paci et al, 2007 for an overview).

⁶⁴ Interview with Jozef Uhrík.

allowed Prime Minister Dzurinda to remain in office for two consecutive mandates as the population supported continuity in economic policy that made it possible for EU accession to take place in 2004. EU membership, moreover, brought about options that would not have been available otherwise in terms of accessing new markets and fostering stability. From the investor perspective, the tax reform that set a flat rate for PIT and CIT, harmonized with a single VAT rate, brought transparency and predictability and was perceived very well.

5.4 The structure and level of education of the labour force were important advantages. Slovakia has very high share of population with secondary education, even by EU standards, and technical higher education was traditionally popular. This, coupled with the lowest costs of labour in the region and prospects of continued large wage differentials vis-à-vis the EU15, has also helped attract manufacturing FDI.

5.5 Slovakia's favourable geographic location in the center of Europe was also a factor, given that transport costs matter hugely for the automotive industry. Production linkages with other CEE countries and EU15 countries also mattered.

5.6 Finally, when looking at the recent investment deals, the issue of investment incentives is worth considering. Firstly, the fiscal incentives in the form of tax breaks offered to VW in 1998 helped trigger the expansion of the production and move it into the high-technology segment. This expansion of production helped attract car suppliers, resulting in a measurable agglomeration effect that ultimately helped attract other producers. All of this was possible although the government had not yet articulated its automotive policy in the 1990s. Secondly, to help attract the latest two big automotive investments (PSA of 2003 and Kia of 2004), the Slovak government offered generous incentives, even when compared with the last two big automotive projects located in the Czech Republic. Nonetheless, the attractive location offered in Slovakia (for PSA) mattered. The deal with Kia, meanwhile, seemed to be largely motivated by the large amount of state aid and other incentives. Promises of significant investment into local infrastructure helped the project advance without violating EU limits on state aid.

5.7 The impact of the automotive industry on the Slovak economy has been substantial, helping boost growth in output, exports and employment. The emergence of domestic car suppliers that have also begun supplying companies in the neighboring countries has been a welcome second-round effect, as has been the impact of stronger productivity growth than the average for the economy. Further, providing the education needed for the labor force of the 21 century, and creating the right incentives for more robust research and development activity are becoming key priorities for the government and will have a positive effect on the broader economy in the years to come. Another challenge for the authorities will be how to help boost labor mobility domestically and deal with regional disparities in economic development. While good policies in these areas should help delay the likely labor shortages, such shortages are likely to emerge over the medium term. Dealing with such shortages within the expanded EU is a key challenge.

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Jozef Uhrík, president of the Automotive Industry Association of the Slovak Republic (ZAP SR) and former CEO of Volkswagen Slovakia, 04 March 2007

Ondrej Socuvka, former Economic Advisor to Prime Minister Mikulas Dzurinda, 04 April 2007

A former high-ranking official at the Ministry of Economy, who did not wish to disclose his identity, 05 April 2007

APPENDIX

Table 1A. Share of Slovak trade with non-transition countries (in percent), 1992-2004

	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
Slovakia	n.a.	39.5	44.9	45.6	49.4	54.2	62.0	62.0	64.0	62.0	63.5	66.1	62.6

Source: EBRD Transition Report 2000 (1993 – 1998). EBRD Transition Report 2005 (1999 – 2004)

Table 2A. Share of trade in Slovak GDP, 1992-2004 (In percent)

	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04
Slovakia	117.0	93.2	91.6	94.7	100.9	104.6	110.9	105.3	114.8	140.4	127.3	135.7	138.6

Source: EBRD Transition Report 2000 (1993 – 1998). EBRD Transition Report 2005 (1999 – 2004)

Table 3A. Investment incentives in Slovakia and the Czech Republic in four largest greenfield automotive investments, 2002-2006

Start date	Country of project	Investor	Amount per job (estimated, in \$)
2002	Czech Republic	TPCA	37,000
2006	Czech Republic	Hyundai	48,000
2003	Slovakia	PSA Peugeot Citroën	50,000
2004	Slovakia	Kia Motors	86,000

Sources: Slovak Ministry of Finance; Czechinvest; authors' calculations.

Table 4A. The biggest companies of the Slovak engineering industry according to consolidated revenues in 2005

Rank	Automotive industry	Company	Net revenues 2005 (SKK thousands)	Change 2005/2004 (percent)
1.	yes	Volkswagen Slovakia, a.s., Bratislava	154 802 791	-11,0
2.		Whirlpool Slovakia, s.r.o., Bratislava	11 851 037	-10,3
3.	yes	Johnson Controls International, s.r.o., Bratislava1	9 903 778	n
4.	yes	SAS Automotive, s.r.o., Bratislava	7 998 928	-11,5
5.	yes	INA Skalica, s.r.o., Skalica	7 663 741	23,3
6.	yes	INA Kysuce, a.s., Kysucké Nové Mesto	5 922 898	38,9
7.		Embraco Slovakia, s.r.o., Spišská Nová Ves2	5 500 000	n
8.	yes	Lear Corporation Slovakia, s.r.o., Lozorno	4 179 352	-12,4
9.	yes	ZF Sachs Slovakia, a.s., Trnava	4 129 214	15,3
10.	yes	HBPO Slovakia, s.r.o., Lozorno	3 818 657	-6,7
11.		Slovenské energetické strojárne, a.s., Tlmače	3 654 607	-15,1
12.		Tatravagónka, a.s., Poprad	3 112 752	-13,2
13.	yes	Matador Automotive Vráble, a.s., Vráble	2 974 220	4,1
14.		Protherm Production, s.r.o., Skalica	2 841 107	11,3
15.	yes	Tower Automotive, a.s., Malacky	2 815 105	1,5
16.		Sauer-Danfoss, a.s., Považská Bystrica3	2 571 768	15,5
17.		ŽOS Trnava, a.s., Trnava	2 444 688	-13,0
18.		Slovnaft montáže a opravy, a.s., Bratislava	2 349 508	21,2
19.	yes	RF, s.r.o., Malacky	2 137 118	19,4
20.		Danfoss Compressors, s.r.o., Zlaté Moravce	1 962 908	38,8
21.		Omnia, a.s., Bratislava	1 937 344	12,0
22.		PSL, a.s., Považská Bystrica3, 4	1 868 534	28,8
23.		Slovenské lodenice Komárno, a.s., Bratislava	1 597 168	12,1
24.	yes	Küster-automobilová technika, s.r.o., Vlkanová	1 427 770	24,4
25.		ZF Boge Elastmetall Slovakia, a.s., Trnava	1 218 027	-3,3

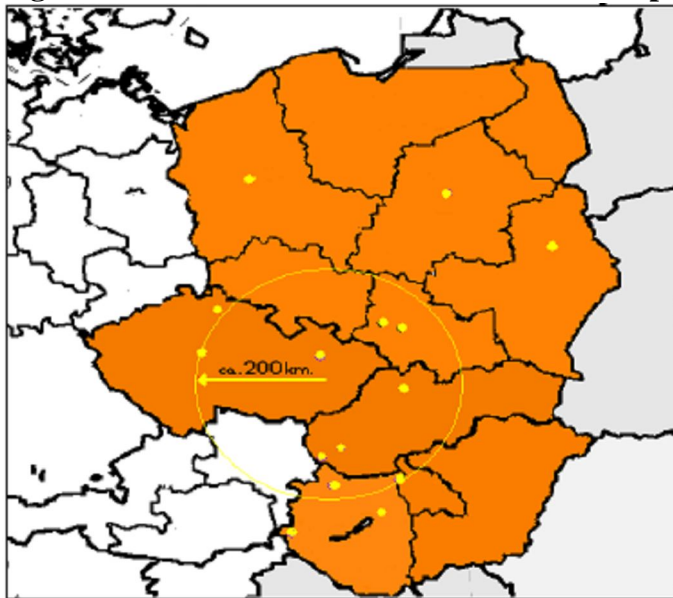
Source: Trend Top 200 2006

Table 5A. CEE: Tertiary education for age group 25-64, 1995-2004

<i>As a percentage of the population of the age group</i>										
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Czech Republic	10.6	10.4	10.6	10.4	10.8	11	11.1	11.9	12	12.3
Hungary	..	13.4	12.2	13.2	13.5	14	14	14.2	15.4	16.7
Poland	9.9	..	10.2	10.9	11.3	11.4	11.9	12.6	14.2	15.7
Slovak Republic	11.1	11.5	10.5	10.3	10.1	10.4	10.9	11	11.8	12.4
OECD average	19.3	20.1	20.8	20.7	21.2	21.9	22.6	23.4	24.1	25.2

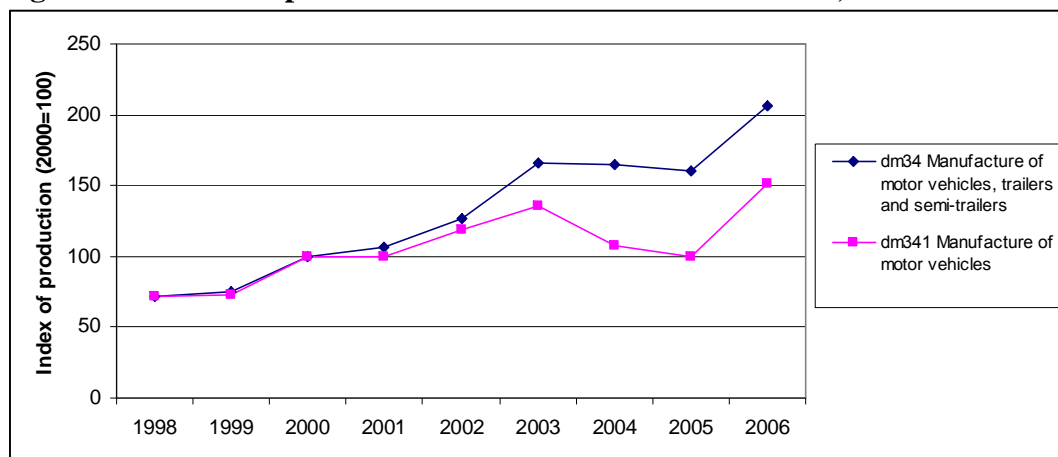
Source: OECD Factbook 2007

Figure 1A. Automotive Cluster in Central Europe



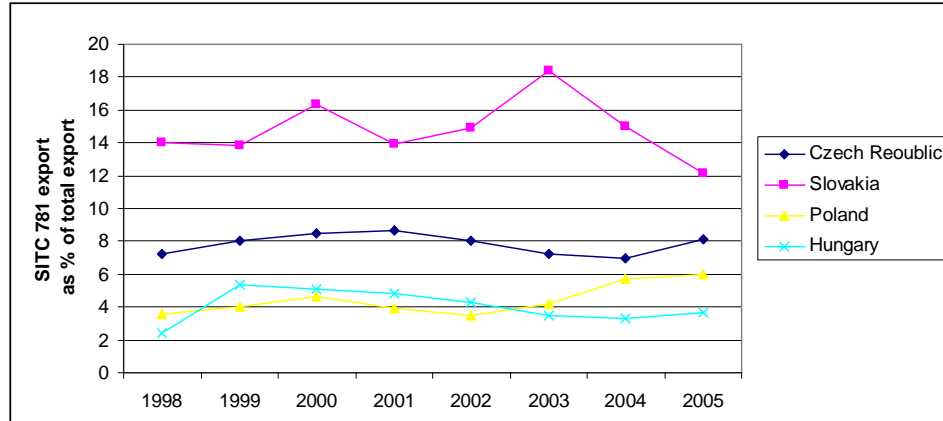
Source: IMF

Figure 2A. Index of production for NACE 34 and NACE 341, 1998-2006



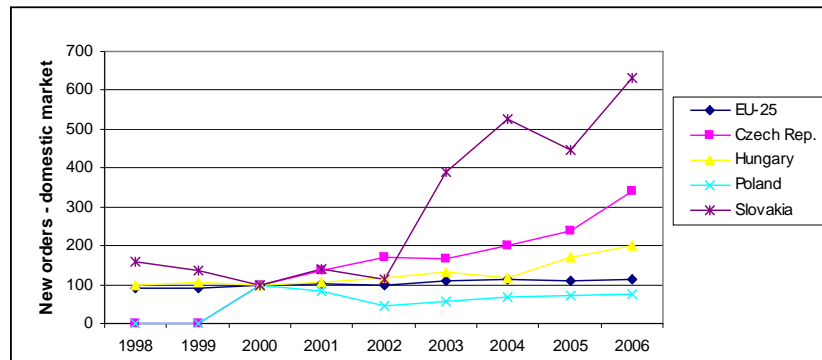
Source: Eurostat

Figure 3A. CEE: Export of motor vehicles (SITC 781) (In percent of total exports)



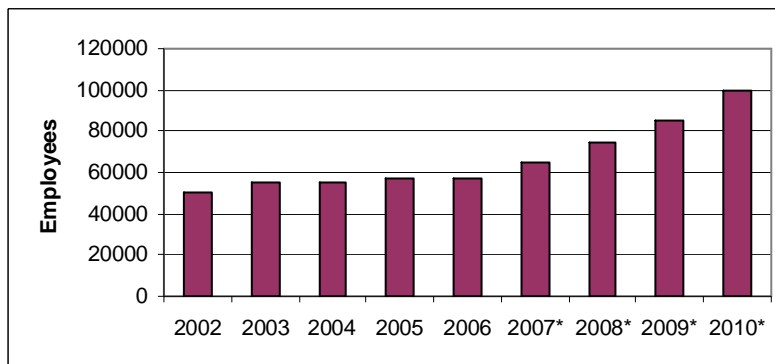
Source: COMTRADE, authors' calculations

Figure 4A. New orders NACE 34 - domestic market, 1998-2006



Source: Eurostat

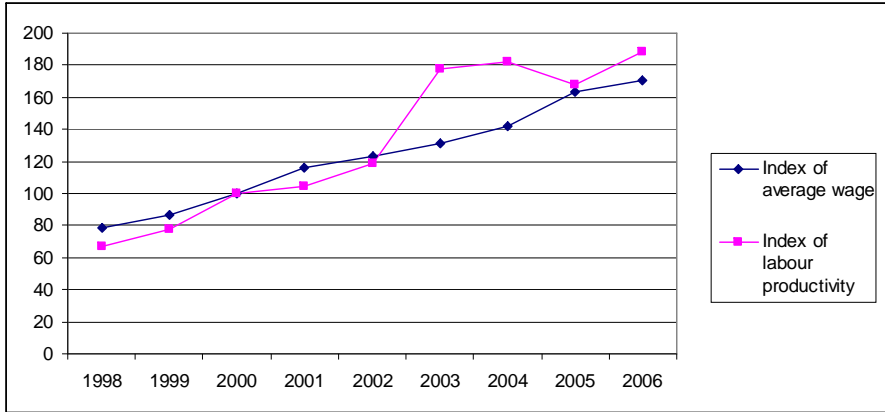
Figure 5A. Slovakia: Current and projected employment in the auto industry, 2002-2010



Source: ZAP SR

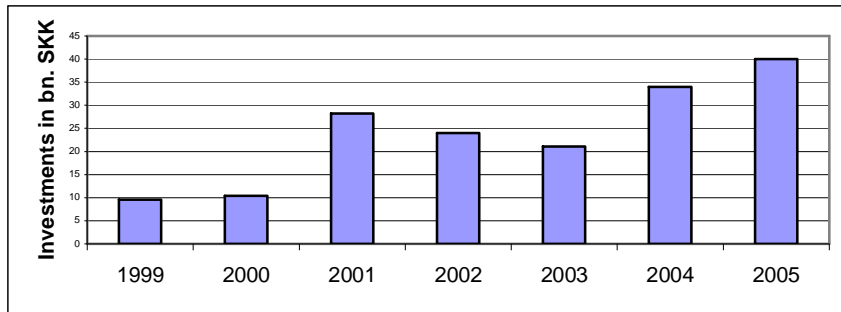
Note: * - projected by ZAP

Figure 6A. Indices of labour productivity and average wages in the automotive industry (NACE 34) in Slovakia, 1998-2006



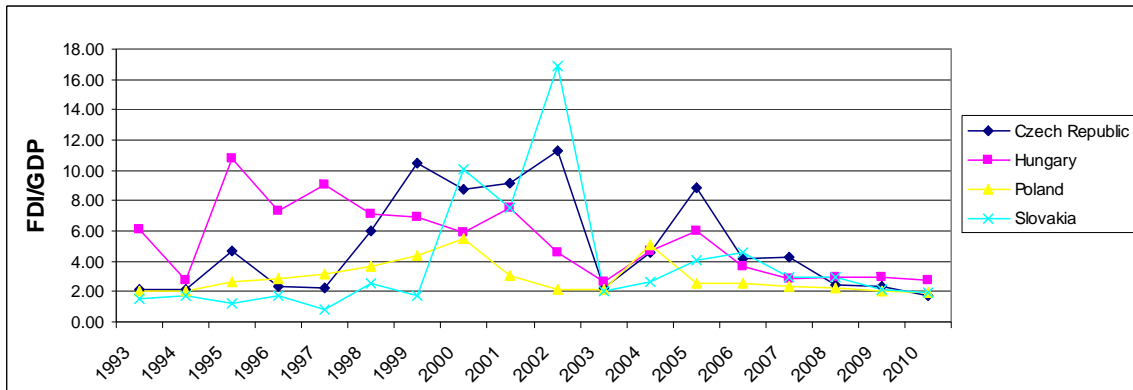
Source: Slovak Statistical Office, authors' calculations

Figure 7A. Investment in the total automotive industry in Slovakia, 1999-2005



Source: ZAP SR

Figure 8A. CEE: Foreign direct investment, 1993-2006 (In percent of GDP)



Source: EIU