SLOVAK REPUBLIC

Highlights

- **The economy has been growing robustly.** In 2016 GDP grew by 3.3 per cent, largely propelled by strong household consumption and net exports. At the same time, investment, particularly in the public sector, saw a sharp decline.
- **New covered bond legislation is being introduced.** The new law is expected to jump-start the Slovak covered bond market, provide banks with cheaper term funding, attract international investors to the market, and in turn result in better conditions for mortgages.
- **Public finances have been improved through greater efficiencies.** The Finance Ministry's programme to seek efficiencies in public spending has identified potential savings of almost 2.5 per cent of GDP since its launch in 2016.

Key priorities for 2018

- **Workforce skills need to be enhanced.** The Slovak Republic faces high structural unemployment, particularly among the low-skilled. A sustained effort is needed to improve labour mobility and ensure that tertiary education and vocational training better match the needs of the labour market.
- **Municipal waste management remains one of the main environmental challenges.** Still, the landfilling rate of municipal waste, at 68 per cent in 2015, remains significantly above the EU average levels of 25 per cent. The recycling rate stands only at 15 per cent, whereas the EU average is 45 per cent. A new law on waste management came into force in January 2016, although reaching the 50 per cent recycling target by 2020 remains questionable.
- **Weak EU funds absorption needs to be addressed.** This will require a stronger focus on addressing regulatory requirements in the current EU budget, focusing on a greater share of repayable instruments in projects, as well as more attention on combating fraud and other misuse of funds.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.5	2.8	3.9	3.3	3.3
Inflation (average)	1.5	-0.1	-0.3	-0.5	1.3
Government balance/GDP	-2.7	-2.7	-2.7	-2.2	-1.5
Current account balance/GDP	1.9	1.1	-1.7	-1.5	0.2
Net FDI/GDP [neg. sign = inflows]	-0.3	-0.6	-0.1	0.6	-1.1
External debt/GDP	82.1	90.2	85.4	91.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	49.0	51.0	54.0	57.4	n.a.

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Macroeconomic performance

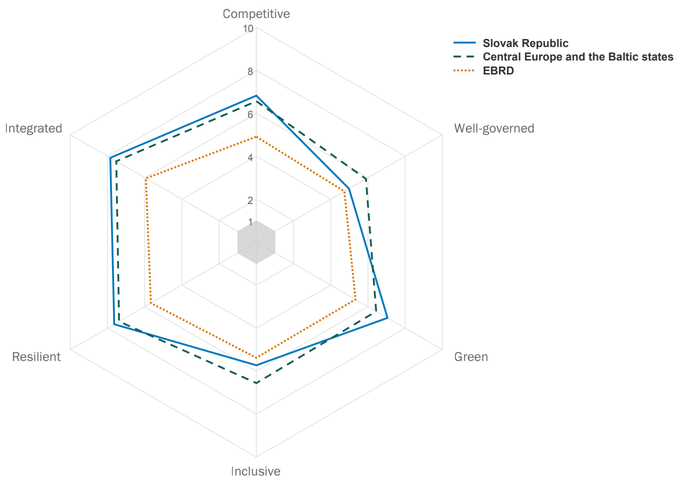
GDP growth has been robust. Economic growth slowed somewhat from 3.9 per cent in 2015 to 3.3 per cent in 2016, but still remained the strongest in central Europe and the Baltic states in 2016. Solid employment growth, rising disposable incomes and double-digit growth in credit to households supported strong private consumption. In contrast, investment expenditures declined by 8.3 per cent in 2016 and continued to fall over the first six months of 2017, by 3.4 per cent, as the drawing of EU funds has been sluggish. During the first half of 2017, economic growth reached 3.2 per cent year-on-year.

The labour market is tightening. Shortages of qualified labour have been a problem for some time in the automotive industry and are now slowing the development of the IT industry, which is located in the eastern part of the country and where the unemployment rate remains high, at 13.2 per cent in 2016. Overall, the national unemployment rate fell to 7.6 per cent in June 2017, but the increasingly cited labour shortages are putting more and more pressure on wages, which increased year-on-year by 4.2 per cent in nominal terms in the first half of 2017. A rapidly declining working-age population is also a threat to the Slovak Republic's development model.

Improved VAT collection has delivered strong results. According to the Slovak financial administration, the VAT collection ratio improved to 75 per cent in 2016 from only 50 per cent in 2012, thanks to the introduced tax avoidance measures, such as the new VAT filing system – the so-called VAT ledger statements. The fiscal budget has gained more than 3.0 per cent of GDP of additional revenues since 2012. In 2016 the budget deficit declined to 2.2 per cent of GDP, which was also a result of the slump in public investment. Further fiscal measures already being introduced include a reduction in the corporate income tax rate (from 23 to 22 per cent), the introduction of a dividend tax, a levy on non-life insurance and changes in social and health security contributions (increase and abolishment of maximum assessment bases).

Solid household consumption and a gradual recovery in investment are set to underpin strong GDP growth. In 2017 GDP growth is forecast to reach 3.3 per cent before it accelerates to 3.5 per cent in 2018. Risks to the outlook constitute a weaker-than-anticipated recovery in the eurozone as well as slow absorption of EU funds.

Assessment of transition qualities (1-10)



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Major structural reform developments

Further measures to improve the governance of public projects have been introduced. In July 2017 the government approved a new methodology to evaluate the return on capital intensive projects and their compliance with the state's strategy. According to the methodology's proponents, it is expected to be a direct tool against corruption of public funds, including those from the EU. In addition, in January 2017 the government signed a Memorandum of Understanding with the OECD to carry out an audit of anti-corruption legislation. The audit is designed to determine whether the legislation is effective and whether it could pose a threat to economic growth.

The public efficiency spending programme has been extended to new sectors. Following its introduction in March 2016, the "value for money" programme was extended in 2017 to three new areas: education, social and labour market policies, and the environment. The government believes that there is potential for savings of almost 0.5 per cent of GDP in these areas. The idea of the value-for-money programme is to put more pressure on public administration to carefully calculate and rationalise expenditure decisions and execute the best available alternative through projects that add the most value. Last year's review, carried out in transport, healthcare and IT services, identified potential savings of some 2 per cent of GDP by 2020.

The government is working on measures to address qualified labour shortages. A reform package, presented as part of the 2018 state budget, was adopted by the government in October 2017. Measures are aimed at increasing the income of workers and enhancing labour mobility, particularly in the regions of most interest to investors. Cross-border integration of labour is also advancing. As a first step, the Hungarian and Slovak authorities signed a Memorandum of Understanding in April 2017 on cooperation between the two countries' social security companies, ministries and other labour market agencies. Skilled-labour shortages are reaching unprecedented levels, with almost 25 per cent of industry respondents of the European Commission's business survey citing qualified labour shortages as a limiting factor on production. This is significantly above the EU-28 average of 13 per cent in mid-2017.

The capital market is being strengthened through a new covered bond law. In August 2017 the government passed a resolution adopting a draft law on covered bonds. The new law, put together with technical support from the EBRD, extensively amends the existing framework and aligns it with current international standards, including the European Banking Authority's recommendations and the European Commission's position on covered bonds. It is expected to jump-start the Slovak covered bond market, provide banks with a cheaper way of term funding, attract international investors to the market, and in turn result in better conditions for mortgages. The law will come into force from January 2018.

Energy security is being enhanced. The Hungarian and Slovak national power grid operators signed in March 2017 an agreement to construct a new cross-border power interconnection between the two countries. The project is to be completed by the end of 2020. Also, in November 2016 the Polish and Slovak gas carrier companies signed an application to construct a new gas pipeline by 2020. The investment will be co-financed by the European Commission's Connecting Europe Facility fund and will be part of the North-South-East corridor, which will link gas infrastructure and liquefied natural gas terminals in central Europe. The final investment decision on the gas interconnection is expected by mid-December 2017.

The Slovak Republic may become a gateway into Europe for Chinese investors. The Slovak Republic's involvement in the Belt and Road Initiative (BRI) is steadily increasing, although not necessarily in the construction of physical infrastructure. In April 2017 the Slovak government passed a resolution to develop economic ties with China until 2020 and in May government representatives of the two countries agreed to include the Slovak Republic in the BRI.

Several measures were introduced to improve insolvency regulations. An amendment to the act on bankruptcy and restructuring, introduced in March 2017, cancels the option of forgiving more than half of debts. At the same time, it imposes a five-year maturity on the remaining portion of the debt under corporate restructuring, unless creditors voluntarily agree otherwise. In the World Bank *Doing Business 2018* report, resolving insolvency is ranked 42nd out of 190 countries. Length and costs of insolvency proceedings still remain more than double the OECD average.