SLOVAK REPUBLIC

Highlights

- **Recent GDP growth has been driven by several components.** Household consumption, investment and exports all supported GDP growth in 2017 and further in the first half of 2018. Investment benefited from strong credit growth and extended production capacity in the car industry.
- **Major education reforms are being developed.** A 10-year national programme for the development of the education sector has been launched with the main aim of easing over the long term the mounting skills mismatch problem in the labour market.
- **The ease of doing business is improving.** A package of 25 measures to improve the ease of doing business was approved by the government. It is mainly intended to improve conditions for family businesses and to reduce red tape for employers.

Key priorities for 2019

- **The booming credit market should be carefully monitored.** The annual double-digit growth of credit to the private sector, in particular mortgage lending, over the past 10 years may pose financial stability risks.
- **Labour market shortages should be addressed through short-term, as well as long-term, measures.** Recent labour market and education reforms are steps in the right direction but will take time to yield full benefits, so more rapid measures such as relaxed migration policies may be required to counterbalance the current record-high skilled labour needs.
- **Trust in the judiciary should be enhanced.** The Slovak Republic remains one of the lowest-ranked European Union (EU) member states in terms of perceived independence of the judiciary. Among other measures, the appointment process of judges, including the security screening, should be strengthened.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.8	3.9	3.3	3.4	3.9
Inflation (average)	-0.1	-0.3	-0.5	1.4	2.7
Government balance/GDP	-2.7	-2.7	-2.2	-1.0	-0.8
Current account balance/GDP	1.1	-1.7	-2.2	-2.0	-1.8
Net FDI/GDP [neg. sign = inflows]	-0.5	-0.1	-0.8	-2.0	-1.5
External debt/GDP	90.0	85.2	90.9	110.8	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	50.9	53.9	57.3	60.1	n.a.

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Macroeconomic performance

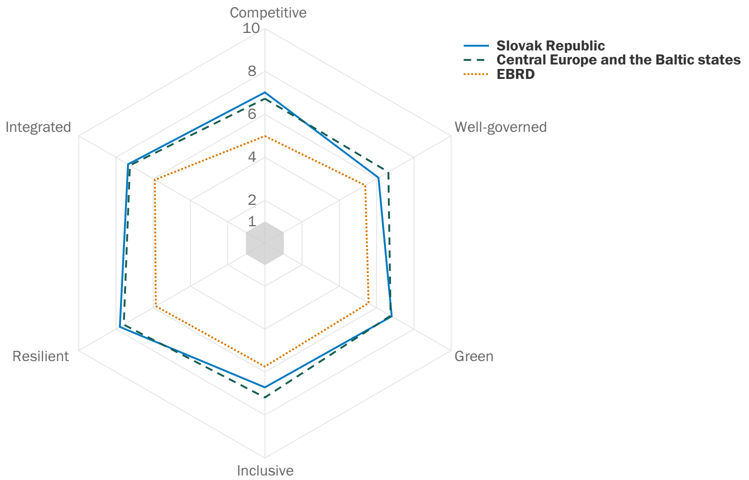
Household consumption and investment are keeping GDP growth strong. The economic expansion of recent years accelerated to 3.2 per cent in 2017 and to 3.9 per cent in the first half of 2018. GDP growth has been fairly balanced, underpinned by a further strengthening of household consumption and buoyant investment. Net exports have positively contributed to GDP growth, benefiting from strong external demand and extended production capacity in the car industry.

Credit to the private sector has experienced double-digit growth. Even though mortgage credit growth slowed somewhat as a result of the recently introduced macro-prudential measures, overall credit to the private sector rose by 11.6 per cent in 2017 and further by 10.0 per cent year-on-year in the first half of 2018. Its overall stock exceeded 60 per cent of GDP in mid-2018, with household credit comprising two-thirds of it. On the demand side, this development is supported by robust economic growth, accommodative monetary policy by the European Central Bank and the preference of households and businesses to lock in lower borrowing costs for longer maturities. On the supply side, the low interest margins have put downward pressure on the profitability of the banking sector, thus encouraging increased volume amid further eased credit conditions. According to a recent IMF study, private sector indebtedness has become higher than levels implied by economic fundamentals. Therefore, further tightening of macro-prudential measures should not be ruled out.

Record-high skilled labour shortages are a bottleneck for the booming economy. While the unemployment rate dropped to below 7 per cent in mid-2018, the share of long-term unemployed stood at 63 per cent of the total unemployed, which is one of the highest rates in the EU. The high levels of structural unemployment and skills mismatch exacerbate the already-persisting labour shortages, which have ballooned over time, largely triggered by significant gaps in the quality of education. The recently launched education reform (see below) is designed to ease the pressures in the labour market, but positive results are likely to be in the long term only.

Domestic demand will likely remain the key growth engine. This year, GDP growth is forecast to reach 3.9 per cent, rising marginally to 4.0 per cent in 2019. Investment is expected to remain solid, underpinned by the anticipation of faster EU funds utilisation and a further expansion of production capacities in the car industry. Labour shortages will contribute to rising nominal wages and, as a result, household consumption will remain strong, only slightly held back by growing inflation. On the downside, the rising trade protectionism constitutes a direct risk for the export-oriented Slovak economy. Long-term growth will strongly depend on ultimate solutions to structural challenges, in particular in the labour market.

Assessment of transition qualities (1-10)



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Major structural reform developments

A major education reform will address labour shortages. In June 2018, the government approved a 10-year national programme for the development of the education sector. The programme consists of five action plans, containing 106 measures split into three areas: regional education, university education and lifelong learning. A large part of the reform is devoted to inclusive education, such as the integration of marginalised Roma communities and pupils from socially disadvantaged environments. The reform is also aimed at increasing the attractiveness of the teaching profession, including through expanding the number of professional staff at schools as well as providing higher teachers' wages. The reform is expected to cost €9 billion over the next 10 years. The quality of the education system does not effectively address the country's regional disparities. In 2017, 17.7 per cent of the youth population (aged between 15 and 24) living in the eastern part of the Slovak Republic were neither in employment nor in education, compared with 7.9 per cent in the capital, Bratislava.

Further measures to soften the tight labour market have been introduced. As skilled-labour shortages have been a key problem impeding stronger industrial production, the government approved in February 2018 the establishment of a new advisory body: a government council for employment development. The council will have three key tasks: first, to monitor the current situation in the labour market and to provide recommendations to the respective ministers; second, to work on measures to boost the supply of qualified labour and address the sources for its shortage; and third, to coordinate the policies of the individual ministries. Also, in October 2018, the government approved a new strategy to simplify the conditions for employing skilled workers from non-EU countries. This streamlining only applies to designated professions where labour offices record a lack of qualified workers and for regions with unemployment rates below 5 per cent.

The business environment is expected to improve. A package of 25 measures to improve the ease of doing business in the Slovak Republic was approved by the government in May 2018. It is mainly intended to improve conditions for family businesses and to reduce red tape for employers. The proposed measures include a reduction of interactions between businesses and public administration, which involves the "once only" principle, now enshrined as an EU standard. As a result, an obligation to submit certain documents that are accessible from public registers should be eliminated. Also, the package envisages a simplification of social security procedures, as well as accelerated procedures for granting temporary residence to foreigners. In the World Bank's *Doing Business 2019* report, the Slovak Republic took 42nd position out of 190 countries.

Public procurement law is being amended. In August 2018, an amendment to the law on public procurement was approved by the government. The bill is intended to accelerate tenders, increase transparency and preserve participants' rights. If successfully implemented, it will make public spending more efficient, including through better utilisation of EU funds. By the end of September 2017, the Slovak Republic had absorbed only about 14 per cent of EU funds in the current budget through 11 operational programmes (OPs). The highest share has been drawn under OP Integrated Infrastructure.

Conditions for granting regional investment assistance have been revised. The new law, which was adopted by the government in February 2018, is intended to address regional disparities as well as to attract investors in higher value added activities. The approved changes envisage, among others, a removal of the requirement for job creation in industrial projects. In case of direct investment aid for industrial projects in developed regions with low unemployment, the priority is to support investment into high-tech industries and innovative technologies. The favoured type of aid will be a tax relief. Also, investments by small and medium-sized enterprises will be preferred. Research and development business enterprise expenditures in the Slovak Republic represented only 0.4 per cent of GDP in 2016, substantially below the EU average of 1.3 per cent.

North-South gas market integration has progressed. In May 2018, gas transmission operators, the Polish Gaz-System and the Slovak Eustream, signed an agreement to construct a 165-km long gas interconnection. Earlier this year, Eustream and Transgaz, a Romanian gas transport operator, signed a Memorandum of Understanding in February 2018 to construct a gas interconnection with the Slovak Republic. Both pipelines will be crucial parts of the North-South gas interconnections, which will provide a direct link between the liquid western Europe markets, including from Norway, and the Balkans and Turkey. This way, regional security of supply as well as natural gas markets integration will be enhanced. The project was granted EU support under the Connecting Europe Facility in December 2017. The construction is expected to be completed by the end of 2021.