SLOVAK REPUBLIC

Highlights

- **GDP growth has been sustained by buoyant domestic demand.** The final disbursements under the European Union (EU) Structural Funds and a recovering domestic labour market have underpinned strong domestic demand and falling unemployment.
- **The Slovak Republic has become a significant regional hub for energy transmission.** Two important energy projects with Hungary were completed in 2015, and two further gas pipelines are expected to be operational by 2020.
- **The regulatory environment for start-ups was significantly improved.** A new legal entity form has been established and relations between entrepreneurs and investors will be streamlined. New regulations will also provide a range of tax exemptions for innovators, including from outside the EU.

Key priorities for 2016

- **The government should advance and expand mechanisms based on market-oriented financial instruments to more effectively utilise EU structural funds.** The Slovak Republic stands to benefit from the second highest allocation within the EU of structural funds (in per capita terms), but previous disbursements have shown long-standing inefficiencies in procurement and project generation.
- **Regional disparities should be addressed.** Even though the aggregate income per capita increased to 71 per cent of the eurozone average in 2014, the Slovak Republic's regional disparities remain among the highest in Europe. Well-targeted social spending programmes and greater emphasis on infrastructure improvements and other steps to catalyse investments and job creation in weak regions could reduce these inequalities.
- **Policies to address labour market exclusion should continue.** The labour market for young workers remains difficult, with unemployment rates remaining among the highest, and employment rates among the lowest in the EU for persons aged 15-24. The government's measures to reduce youth unemployment have advanced, including a recently approved act on in-work training and a health contribution scheme to support low-income workers.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	2.8	1.5	1.4	2.5	3.1
Inflation (average)	4.1	3.7	1.5	-0.1	-0.2
Government balance/GDP	-4.1	-4.2	-2.6	-2.8	-2.7
Current account balance/GDP	-5.0	0.9	2.0	0.8	0.4
Net FDI/GDP [neg. sign = inflows]	-2.8	-3.2	0.3	0.2	-1.0
External debt/GDP	74.7	78.0	84.7	83.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	47.6	47.7	49.4	51.5	n.a.

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Macroeconomic performance

After a significant slow-down in 2012 and 2013, GDP growth picked up to 2.5 per cent last year and 3.1 per cent during the first half of 2015. Domestic demand saw a continuing recovery in 2014, particularly driven by public investments, as the final tranches of the expiring EU Structural Funds were being disbursed. Household consumption recovered from its decline in 2011-13 with an annual growth of 2.3 per cent in 2014, reflecting improvements in the labour market and strong real wage growth. Following a contraction in 2012-13, gross fixed capital formation grew by 3.5 per cent last year. This was in particular driven by expenditure on equipment and non-residential construction, whereas residential investment declined. The planned investment in automotive plants as well as in telecommunications, is likely to further underpin investment growth financed by the private sector.

Export volume growth slowed to 4.6 per cent in 2014. Given buoyant domestic demand and increasing imports the external sector no longer provided support to overall growth. Exports to Russia registered a drop of 18 per cent last year, although they represent only a small portion (less than 4 per cent of GDP) of total exports. In 2015 the depreciation of the euro has boosted exports, and prospects for exports have further improved with the announcement of capacity expansion in the car industry.

Labour market conditions continue to improve. The unemployment rate fell to 11.7 per cent in July 2015, from a peak of 14.9 per cent in the immediate post-crisis period. Households' purchasing power also improved as real wages showed strong growth of 4.2 per cent in 2014. The employment rate reached 66.8 per cent in the first quarter of 2015, still well short of the EU target of 75 per cent. However, the Slovak Republic still suffers from substantial long-term unemployment and regional exclusion – underlined by an unemployment rate of 16.6 per cent in the eastern region of the country.

In 2014 the European Commission (EC) lifted the Excessive Deficit Procedure against the Slovak Republic. The country had been subject to this procedure since 2009. According to the EC's forecasts the deficit will remain below the threshold of 3 per cent of GDP both in 2015 and 2016, even though the government has adopted a number of social programmes. Public finances traditionally suffer from revenue ratios well below regional averages and VAT collection has been particularly poor. A comprehensive action plan is being implemented to raise collection performance and the corporate tax base has been broadened.

GDP growth is expected to gain momentum. Domestic demand is expected to remain the main driver of growth over the medium term. In particular, private sector investments and further declining unemployment should underpin these developments. Against this background, there is likely to be a pick-up in growth to 3.1 and 3.2 per cent in 2015 and 2016, respectively.

Major structural reform developments

The Slovak Republic has become a significant regional hub for energy transmission. A second oil pipeline with Hungary was completed in February 2015 and will allow the tapping of supplies from the Adria pipeline, which is connected with MOL's refinery in Hungary. In addition, a gas pipeline between these two countries was completed in 2015, from which Hungary will be the greatest beneficiary as it ensures access to the Western European gas network. Two additional gas projects are under construction. One pipeline with Poland will be finalised in 2020 and another, Eastring, is expected to connect Ukraine with the Western Balkans and Turkey by 2018.

Business research and development (R&D) expenditure remains among the lowest in the EU. The country's industrial sector exports a substantial share of high and medium technology-intensive manufactured goods. However, as yet industry does not mobilise meaningful R&D investments. Compared with the EU-28 average of 1.3 per cent of GDP, the Slovak Republic's R&D expenditures by businesses reached only about 0.4 per cent of GDP in 2013. R&D activities remain to a large extent financed within foreign-owned enterprises. Labour productivity has grown by 5.8 per cent since 2010, slightly faster than the average in the EU-28. Since 2007 to 2014 the country's world export market share has increased by more than 10 per cent.

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In June 2015 the government approved a package of measures to support start-ups. Under the new and simplified procedures, entrepreneurs will be able to register a joint stock company. In addition, start-ups will be exempted from the obligation to pay certain taxes for the first three years of operations. Visas for skilled workers from outside the EU will be granted and a national centre for entrepreneurs will disseminate innovation. The rate of firm start-ups in the Slovak Republic has continuously declined since 2010 and stood at just under 10 per cent in 2013, compared with 16 per cent in 2009.

A new law helps to streamline procedures related to investment incentives. Under this law, which came into effect in mid-2015, decisions on investment incentives will be taken more expeditiously and more transparently. This could give crucial support to inward foreign direct investment, which has declined in recent years. One of the first beneficiaries of the new amendments was Jaguar Land Rover, owned by Tata Motors, an Indian automobile manufacturer, which in August 2015 signed a letter of intent to construct a factory in Nitra by 2018. This would be the biggest greenfield investment in the Slovak Republic in the last seven years.

The Slovak Republic was allocated €13.7 billion from EU Structural and Investment Funds for 2014-2020. This was the second highest allocation in the EU in per capita terms (after Slovenia). The seven operational programmes that were prepared by the government were adopted by the EC in December 2014. A key priority under the programmes will be to increase competitiveness while encouraging efficient energy solutions. The greatest share of the funds is expected to support road infrastructure, IT, telecommunications and the environment. During the previous programming period 2007-2013, the Slovak Republic had managed to absorb only about 80 per cent of the committed funds by October 2015. This is one of the lowest in the EU and underlines inefficient procedures within certain managing authorities; in particular with regard to public procurement. Substantial funds risk being foregone if not spent by the end of 2015, under the EU's de-commitment procedure.

Innovative financial instruments are being developed to support the efficient spending of EU Structural Funds. The Slovak Investment Holding has been established and will be endowed with €450 million or about 3 per cent of the total Structural Funds allocation. The government expects that this initial allocation can be leveraged with private funds about two or three times this initial allocation. The investment holding will then fund projects that are in line with the state's objectives through loans, guarantees or equity participations. A challenge will be to identify a sufficient portfolio of projects that are commercially viable and of interest to private co-financing. Through the investment holding and the Slovak Guarantee and Development Bank the government will also contribute €400 million to the European Fund for Strategic Investments (EFSI, also known as the "Juncker investment plan"). The priorities for national projects will be the knowledge economy, energy and transport sectors.

The government has used expanded fiscal headroom to adopt a number of social programmes. The first social programme took effect in early 2015 and includes a minimum wage rise, a decrease in payroll deductions for low-income earners and a gas price reduction for households during 2015-16. The second social package will be implemented in January 2016 and will comprise a further increase in the minimum wage, VAT reductions on basic foods, hospital renovations and special programmes for regions with unemployment over 20 per cent. The total cost of the programmes is expected to reach 1.4 per cent of GDP.