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European Commission
Directorate-General for Economic and Financial Affairs

In-Depth Review 2024

Slovakia

EUROPEAN ECONOMY

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This in-depth review presents the main findings of the Commission's staff assessment of macroeconomic vulnerabilities for Slovakia for the purposes of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances. It provides technical input to the Commission for the Communication "European Semester – 2024 Spring Package" that will set out the Commission's assessment as to the existence of imbalances or excessive imbalances in Slovakia. That Communication will be published in June 2024. The current version has been presented and discussed with the Member States in the Economic Policy Committee of the Council.

This publication reproduces staff working document SWD(2024) 84 final, that was discussed with Member States in the Economic Policy Committee of the Council on 20 March 2024.

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1. INTRODUCTION

This in-depth review (IDR) analyses the extent of Slovakia's vulnerabilities related to cost competitiveness, external accounts, house prices and household debt. Last year, an in-depth review was undertaken for Slovakia, and the Commission concluded that Slovakia was not experiencing imbalances, as its vulnerabilities seemed overall contained in the near future and were expected to ease as economic conditions normalised. This year's IDR, which follows the 2024 Alert Mechanism Report (AMR)published in November 2023, again examines these, and any newly emerging vulnerabilities, and their implications ([1]).

The vulnerabilities in Slovakia are analysed in a macroeconomic context of persistently high inflation differentials ([2]). GDP growth moderated in 2022 and early 2023 in light of continuing high inflationary pressure, and stagnating global demand, despite easing of supply chain disruptions. Slovakia experienced a slowdown in GDP growth to 1.1% in 2023, compared to 1.8% in 2022. According to the Commission Winter 2024 Interim Forecast, real GDP growth is projected to be 2.3% in 2024 and 2.6% in 2025. Growth will be mainly supported by private consumption and by further investments in the automotive sector that are expected to lead to an acceleration in exports. Headline inflation started to moderate in 2023, but remained high, at 6.6%, in December 2023. The pass-through from energy and food prices to other goods and services continues, with core inflation reaching 6.8% in December 2023. In this context, further wage increases are forecast, with nominal compensation of employees expected to grow by 8.0% in 2023. In 2024, inflation is projected to continue declining, but remain high. Going forward, unexpected shocks to economic performance of Slovakia's main trade partners could adversely affect the current account and fiscal balances. If inflation becomes entrenched at an elevated level, debt financing costs could also remain higher.

High integration with Germany and Czechia makes Slovakia prone to spillovers resulting from economic developments in these economies ([3]). The Slovak economy is highly dependent on imports of German and Czech goods and services, while Germany and Czechia are major destinations for Slovakian exports ([4]). When it comes to external demand, the largest shares of total value added in the Slovak economy are embedded in exports to Germany, US and China, while Slovakian domestic demand is mostly dependent on value added generated in Germany and Czechia. As Slovakia's direct or indirect exposures to non-EU partners are moderate, geopolitical and trade tensions appear to pose some risk to its economy.

([1]) European Commission (2023), *Alert Mechanism Report 2024*, COM(2023) 902 final; and European Commission (2023), Alert Mechanism Report 2024, SWD(2023) 901 final.

([2]) Forecast figures for GDP growth and inflation come from the Commission Winter 2024 Interim Forecast (European Economy, Institutional Paper 268). All other forecast data used in the IDR come from the Commission Autumn 2023 Forecast (European Economy, Institutional Paper 258), unless stated otherwise, and all calculations are carried out using these data to ensure the coherence of their various components. The cut-off date for the data for the preparation of this in-depth review was 20 February 2024. Actual out-turn data that have become available after the Autumn and Winter Interim forecasts, and before the cut-off date for the IDR, are used and supersede figures from those forecasts.

([3]) In the context of the multiple disrupting shocks that affected the world economy and the EU in the past few years, Commission services have run an exercise to estimate the spillovers and the degree of exposures of Member State economies to various partners and industries, in terms of nominal trade, value-added trade, inflation and financial assets. See European Commission Institutional Paper 2024 (forthcoming) - *Economic spillovers and exposures in the EU*.

([4]) Czechia and Germany account for 18.7% and 17.9% of Slovakia's imports, and for 12.4% and 22.4% of Slovakia's exports, respectively.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Slovakia continues to face macroeconomic challenges related to its weakening cost competitiveness, negative external balance, dynamic house prices, and elevated household debt. In recent years, inflation in Slovakia has persistently exceeded the euro area average, with a notable increase in that gap from mid-2021, which only started gradually to close after the second half of 2023. The persistent nature of this heightened inflation gap poses a risk to Slovakia's competitive position, which started to weaken already before the pandemic. In 2022, the external balance of the Slovak economy experienced a sharp decline, primarily attributable to the marked rise in energy prices. This has led to a pronounced shift in the current account, which exhibited a substantial deficit following a prolonged phase of moderate deficits. However, improvements have been under way since mid-2022. Nonetheless, the large government deficit worsened in 2023 and is set to continue weighing on the economy's net external position in the coming years. Alongside these developments, the Slovak real estate market witnessed an exceptional growth in house prices in the 2 years until the end of 2022 - a trend paralleled by robust credit growth to households - before starting to fall.

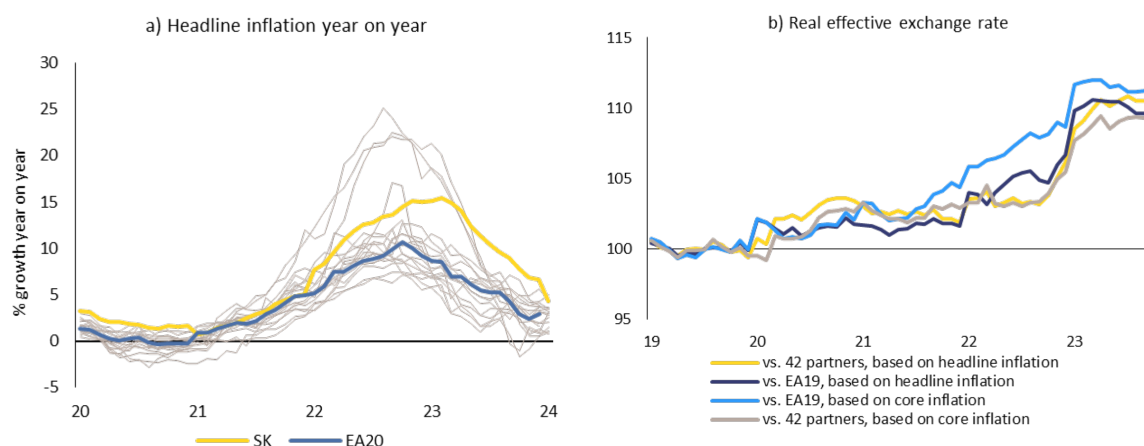
Assessment of the gravity, evolution and prospects of macroeconomic vulnerabilities

Cost competitiveness

Between mid-2021 and mid-2023, the inflation rate in Slovakia was high and markedly exceeded that in most other euro area countries. From 2018, inflation as measured by the harmonised index of consumer prices (HICP) consistently and markedly exceeded that of the EU and the euro area. This trend intensified from mid-2021, with inflation reaching 12.1% in 2022 (rising from 2.8% in 2021), primarily driven by the sharp rise in food and energy prices, which was later amplified by the Russian invasion of Ukraine. This surge led to a strong divergence from the EU and the euro area 2022 averages of 9.2% and of 8.4%, respectively.

Since the second quarter of 2023, inflation has been declining but it remains comparatively high, posing a risk for competitiveness. HICP inflation dropped to 6.6% in December 2023, still significantly above the 2.9% registered in the euro area (Graph 2.1). The December core inflation in Slovakia also remained at a considerable level of 6.8%, compared to a more moderate rate of 3.4% in the euro area. Due to extensive government measures to limit the impact of energy price increases for households and businesses, the impact of energy prices on HICP inflation was less significant compared to neighbouring countries. Therefore, declining energy prices also had a comparably weaker downward impact on Slovakia's inflation, which remains high due to rising food prices. As a result, inflation is projected to remain high in 2024, exceeding the forecasts for other euro area countries. These inflation differentials with other euro area countries, Slovakia's major trading partners, pose a risk of further erosion in Slovakia's price competitiveness should they persist.

Graph 2.1: **Headline inflation and real effective exchange rate developments**



Source: Eurostat, AMECO, ECB and European Commission services calculations.

The real appreciation driven by significant inflation differentials may, over time, negatively impact Slovak exports. In 2021 and 2022, affected by supply chain disruptions, Slovak exporters registered a decline in market shares. In 2023, as supply bottlenecks eased, the export market share started to recover, albeit slowly. Still, the real appreciation, fuelled by significant inflation differentials, continues to negatively impact Slovak exports. While inflation in the country decelerated faster than in the rest of the euro area in 2023, it remained higher, resulting in a further real appreciation. However, according to the Commission's analysis, domestic price inflation in Slovakia had a relatively minor impact on the overall increase in export prices ([5]). This is mainly related to the fact that the products of the Slovak manufacturing sector have a substantial import content. In such a situation, export-price movements are predominantly influenced by changes in import prices, with a limited negative effect on price competitiveness. Nevertheless, particularly if the inflation differentials remain significant for longer and are reinforced by strong wage growth, the current inflation trends might still result in a more sustained decline in the economy's cost competitiveness, and ultimately affect exports.

Starting from 2015, Slovakia experienced a consistent increase in unit labour costs (ULC) in excess of euro area and EU averages. Nominal wages grew steadily from 2015, exceeding 5% annually from 2017. The nominal ULC growth in Slovakia averaged 4.3% annually between 2015 and 2023, notably surpassing the euro area average of 2.6%. While inflation differentials between Slovakia and the euro area were rather significant from 2017 onwards, real wage growth still surpassed growth in productivity until 2021. The years 2022 and 2023 saw a substantial inflation surge, leading to a decline in real wages, including for minimum wage earners, a trend more pronounced in Slovakia than in the EU and the euro area.

Projections indicate a limited slowdown in ULC growth in the short term. The Slovak labour market remains very tight, and it is forecast to remain so due to ongoing robust labour demand and a declining population. This is likely to exert pressure on wages, particularly given Slovakia's labour-intensive production system. In 2024 and 2025, nominal wage growth is forecast at 7.9% and 5.9% respectively, which is above expected inflation rates. This will contribute further to ULC growth, as

([5]) *Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-depth Reviews*, European Economy: Institutional Paper 198. European Commission (2023).

productivity continues to lag. From 2024 onwards, real wages are expected to start increasing, as wage growth surpasses inflation. However, if inflation remains high, this may pose a risk to ULC growth in 2024 and 2025, potentially adversely affecting Slovakia's competitiveness position.

The speed at which Slovakia's productivity is converging with other EU Member States has decelerated. Compared to its EU counterparts, Slovakia's relatively stronger labour productivity growth has slowed down since 2019. This moderation in productivity growth can be attributed to several factors. First, while the contribution of capital deepening strengthened over time, there were less extensive foreign direct investment inflows in new production capacities. Secondly, the economy exhibited a slowdown in technological advancement, limiting the corresponding contribution of total factor productivity. Finally, the country is experiencing negative demographic dynamics and shortages of skilled labour, which also create an additional drag on innovation ([6]).

The real effective exchange rate (REER) appreciated strongly until Q2 2023 and stabilised afterwards, showing signs of a potential overvaluation. During the period from 2016 to 2022, Slovakia experienced a strong increase in both HICP and ULC-based REERs. In 2023, the REER growth flattened out, but the level remains high, according to both HICP and ULC metrics. The cumulative impact of past appreciations points to an overvalued REER by around 5%, according to Commission estimates ([7]). In 2021 and 2022, the primary factor contributing to the headline REER appreciation was the core inflation differential relative to the euro area, as the differential was even larger for core inflation than for headline inflation, for example excluding energy and food inflation. Starting from 2023, however, the energy and food prices differential also started to contribute to appreciation of the REER, together with the change of REER with non-euro area partners. The Commission's Autumn 2023 Forecast expects that strong ULC growth in 2024 and 2025 will continue, preventing the ULC-based REERs of Slovakia from reverting to a more balanced position. Furthermore, the overall policies stance appears to stimulate domestic demand. If the persistent inflation differentials do not decrease further, continued high levels of REER and ULC may lead to losses in competitiveness.

In the absence of changes in the production structure and broad productivity improvements, the challenges to Slovakia's cost competitiveness are likely to remain. Exports of machinery and equipment were responsible for around 60% of total exports in 2022. Productivity gains have been concentrated in industry, specifically the automotive sector and its suppliers, representing the backbone of the Slovak economy. These gains, however, do not spill over to other sectors and activities, especially to SMEs, which account for more than 70% of employment. This limits the pace of overall productivity growth. Despite pressures on its price competitiveness, it is not expected that the Slovak economy will undergo any major shifts in its production structure in the short term. As discussed below, the deep integration of Slovakia in the international automotive industry's supply chains, with a strong dependence on investment decisions of large multinational companies, limits the economy's capability to shift production or quickly expand into other, preferably high-tech, industrial sectors. Such a shift would require continuation of strategic reskilling and upskilling efforts ([8]).

([6]) According to the European Year of Skills Flash Eurobarometer 529, SMEs in Slovakia are overall the most likely in the EU to state that it is 'very' or 'moderately' difficult to retain skilled workers (90% of SMEs). SMEs in Slovakia are also among the most likely to find it difficult to find skilled workers (77% of SMEs).

([7]) For a detailed description of the methodology, see Coutinho et al. (2021): *Methodologies for the Assessment of Real Effective Exchange Rates*.

([8]) In energy-intensive industries, workers' participation in education and training increased from 4% in 2015 to 16.2% in 2022 and is now above the EU average (10.4%).

Slovakia's dependence on low to medium value-added economic activities presents a point of concern for its medium- to long-term economic development. While Slovakia is well integrated into global value chains, its role is predominantly concentrated in activities related to labour-intensive assembly using imported components. According to the IMF, in 2018, Slovakia was ranked second by the size of the automotive industry's gross value added in the total manufacturing gross value added ([9]). According to the OECD 2021 input/output data, the share of domestic value added in Slovakia's gross exports of vehicles was 33%, compared to 85% in the EU and 91% in the OECD ([10]). This leads to a high dependency on imports and makes a rather limited contribution to domestic value added in its exports. As the Slovak economy's production and export activities are heavily focused on the automotive sector, the structural changes driven by the ongoing green and digital transitions are expected to have a profound impact on the economy's structural dynamics.

Despite recently falling inflation, the continuing inflation differentials and their effects on price competitiveness can affect Slovakia's external position. The country's initial position was characterised by relatively low labour costs compared to many other EU counterparts, strengthened by a dynamic integration into global value chains. It has provided the basis for its initial resilience to adverse impacts of declining price competitiveness, which was aggravated by the energy prices shock. Nonetheless, for Slovakia's future development and international competitiveness, much will depend on the country's ability to mitigate the consequences of high inflation. Slovakia will need to ensure the revival of productivity growth and address the challenges to its economic structure presented by the green and digital transitions.

External balances

Slovakia's current account remains in deficit, despite a substantial improvement since late 2022. Until the pandemic, Slovakia's current account deficit was hovering around 2-3%. However, since then, the current account deficit widened considerably and reached 7.3% of GDP (on a four-quarter moving-sum basis) in the last quarter of 2022 (Graph 2.2). The deterioration was among the steepest observed in the EU. By the end of the third quarter of 2023, the current account balance recovered to -3.0% of GDP. Monthly data point at further improvements in the last quarter, with the whole of 2023 estimated at around -1.6%. This level is still significantly lower than what would be expected based on economic fundamentals, around 0% of GDP, and is close to the levels necessary to attain the prudential level of the net international investment position (NIIP), slightly above -2%, or to stabilise the NIIP over the medium term, -2.5% ([11]).

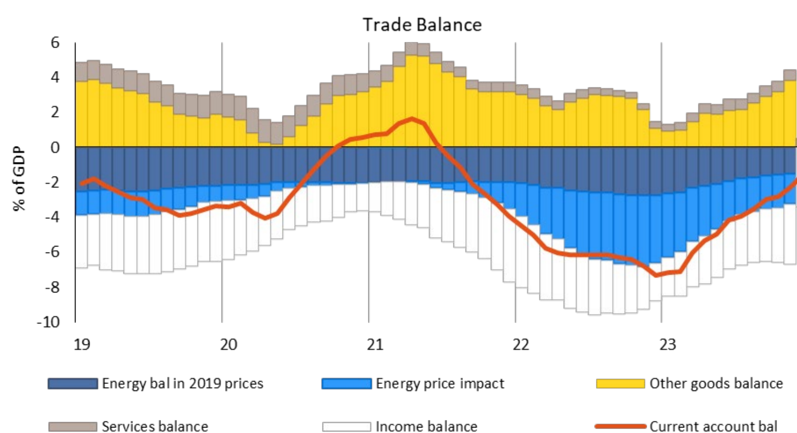
The swings in the current account balance have been primarily driven by shifts in the goods trade balance, in particular energy goods. In 2022, the goods trade balance was deeply negative at -5.7% of GDP. It was largely influenced by the energy balance, which, by the end of 2022, deteriorated to -6.6% of GDP, driven by the surge in energy prices. However, the energy trade balance improved to -3.5% of GDP by the end of the third quarter of 2023, following the drop in energy prices (Graph 2.2) and a gradual decline in the volume of energy imports over the last few years. In addition, the balance in non-energy goods also improved markedly, by 1.8% of GDP, while the balance of incomes deteriorated by 0.8% of GDP.

([9]) IMF Country Report, June 2022.

([10]) Report on Productivity and Competitiveness 2022, Institute of Economic Analysis (IHA).

([11]) Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-depth Reviews, European Economy: Institutional Paper 198. European Commission (2023).

Graph 2.2: **Current account**



Source: Eurostat and European Commission services calculations.

The key factors behind the fluctuations in overall export and import flows were terms of trade effects and real demand, which contributed markedly in 2023. In 2022, the influence of deflators on trade flows was sizeable and remained strong in the first half of 2023. The rise in import prices has been stronger than in export prices, contributing to the deterioration of the trade balance. In constant prices, however, the trade balance did not deteriorate as strongly. The impact from increases in domestic demand and GDP on the trade balance in 2022 and 2023 can primarily be attributed to changes in the corresponding deflators. In real terms, however, the drop in the growth of real domestic demand, consumption and investment in the course of 2023 played an important role in improving the current account balance. The economic recovery thus lags behind the euro area, which showed a stronger performance in 2020-2023. In annual terms, domestic demand posted negative growth rates in the first three quarters of 2023 and remained around pre-pandemic levels.

The net lending position of the government worsened in 2023 and is set to continue weighing on the economy's net external position in the coming years. The government deficit declined from a substantial 5.4% of GDP in 2020 to 2.0% of GDP in 2022 (Graph 2.4a). However, in 2023, it jumped to 6.1% of GDP. This increase was driven by measures to dampen the impact of higher energy prices, contributing 1.9 pps to the 2023 public deficit. As some of these measures have been prolonged into 2024, the budget deficit in 2024 is expected to reach 6.3% of GDP, providing an additional positive impulse to domestic demand. In 2023, the higher public deficit and the worsening financial position of households were partially compensated for by the better financial position (mainly due to higher profits) of corporations, which led to an improvement in the total economy's net external position. This pattern is expected to continue in 2024 and 2025, although the financial position of households, which is set to improve, is expected to remain negative. While government debt is expected to stay below 60% of GDP in 2024, this projection is subject to high uncertainty regarding possible swings in inflation and/or interest rates. Risks to fiscal sustainability are low in the short term but high in the medium and long term ([12]).

For 2024 and 2025, the current account balance is expected to stabilise at around -3.0% of GDP. With the moderation of energy prices and the resolution of temporary supply chain disruptions, Slovak exports, particularly in goods, are expected to regain momentum. The

([12]) These results are based on the debt sustainability analysis published in the 2023 Country Report, which follows the multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 spring forecast. See 2023 Country Report, Commission Staff Working Document SWD(2023) 625 final.

Commission's Autumn 2023 Forecast projects Slovak exports to grow strongly by 4.9% in 2024 and 3.9% in 2025, compared to an anticipated growth in imports by 5.3% in 2024 and 3.5% in 2025. The current account is forecast to stabilise from 2023 onwards, with the deficit expected to reach and stay around levels close to 3.0% in 2024 and 2025. The goods trade balance is expected to negatively affect the current account balance in 2024 and 2025. The positive services trade balance is expected to be the only factor limiting the current account deficit. From 2023 onwards, the net saving position of households is expected to remain negative, while corporations are set to shift to a strongly positive net lending stance. Despite an overall weakness, a high government deficit contributes to aggregate demand and stimulates demand for imported goods and services, weighing on the current account balance. In addition to decreasing net exports, a high budget deficit can spur inflation and weigh on cost competitiveness.

Slovakia's net international investment position (NIIP) has improved only slightly, and its negative net position remains sizeable. In the past 10 years, the Slovak NIIP fluctuated between -60% and -70% of GDP and it improved to -51.0% of GDP by the third quarter of 2023. Nonetheless, the NIIP continues to exceed both the fundamental and prudential thresholds ([13]). In gross terms, foreign direct investment forms a significant portion of liabilities, encompassing equity and intercompany loans, with a minimal dependence on foreign credit in the private sector. This significantly reduces the risk of sudden capital outflows. Sector-wise, the central bank's position has deteriorated since 2019, while the positions of the general government and the private sector have shown some improvement (Graph 2.4c).

In the medium term, Slovakia's NIIP is projected to gradually decline in the absence of a large improvement in its net lending position. Projections for the next decade (Graph 2.4b) suggest that, under a baseline scenario, Slovakia's NIIP deteriorates to almost -75% of GDP by 2033 ([14]). An upside scenario shows that a sizeable improvement in the net lending position and GDP growth is necessary to keep the NIIP broadly unchanged, assuming that interest rates stay in line with the baseline assumptions. Should the net lending/borrowing position and/or GDP growth worsen compared to the baseline assumptions, as in Scenario 2 and Scenario 3, the NIIP will fall below -100% of GDP by 2033.

Housing market

House prices in Slovakia have almost doubled over the last decade, driven by strong economic fundamentals and low interest rates. Between 2012 and 2022, house prices in Slovakia grew by 90%, and in 2022 alone by 13.7%. Such an unabated and long-lasting rise in prices is the result of a combination of several factors, above all sustained economic growth and a low interest rate environment. With the exception of the second quarter of 2020, nominal wages have

([13]) For a detailed description of the methodology, see Coutinho et al. (2018): *Methodologies for the Assessment of Current Account Benchmarks*, European Economy Discussion Paper 86.

([14]) In the baseline scenario, assumptions for GDP growth and interest rates come from the Commission's Autumn 2023 medium-term forecast. For the net lending/borrowing position, simplified assumptions are made. Namely, beyond 2025, the trade, non-investment primary income, secondary income and capital account balances remain at their levels projected for 2025 in the Autumn Forecast. However, the capital account and secondary income are adjusted for flow of both Recovery and Resilience Facility and multiannual financial framework funds. Scenario 1 assumes GDP growth to be higher by 1 pp. and the trade balance to be higher by 2 pps in each year starting in 2024 compared to the baseline scenario. Scenario 2 assumes GDP growth lower by 1 pp., the trade balance lower by 2 pps and the interest spread between liabilities and assets higher by 0.5 pps. Scenario 3 assumes a lower capital account balance by 0.5 pps compared to the baseline on top of Scenario 2 assumptions.

recorded strong positive growth rates, a characteristic for converging economies ([15]). Consequently, a significant increase in disposable income and favourable labour conditions contributed to a strong housing demand. At the same time, the environment of low mortgage rates and improving economic conditions contributed to the acceleration of mortgage growth, which further spurred the demand for real estate and led to a remarkable increase in household indebtedness.

Higher interest rates have triggered a fall in house prices since the end of 2022. Higher interest rates have hampered the capacity of households to take on mortgage debt to purchase a dwelling, significantly weakening the demand for real estate. While the average value of mortgage originations has decreased only slightly since the summer of 2022, the number of new mortgages has fallen by almost 50% (see the section on household debt below). House prices experienced a downward trend for four consecutive quarters from mid-2022, with annual growth rates turning negative as of the second quarter of 2023 (Graph 2.4d). The quarterly year-on-year decrease in nominal house prices was, on average, 3.8% in September 2023 ([16]). According to the National Bank of Slovakia, the decline in prices has spanned across all regions in Slovakia and in all segments of the housing market from single-family houses to flats of all sizes and number of rooms. This represents the biggest fall in over a decade since the great financial crisis, which had resulted in a decline in property prices of more than 20%.

The recent fall in house prices has reduced the overvaluation of the housing market, but the house price-to-income and price-to-rent ratios still stand higher than before the pandemic. In 2021, the European Systemic Risk Board identified signs of house price overvaluation, elevated house price growth, and increasing household indebtedness ([17]). According to the Commission's valuation methodology, house prices were overvalued by 11% in 2022 ([18]). Because of the rise in house prices up to mid-2022, the price-to-income ratio in 2022 stood 20% higher than a decade before and 11% higher than 2019 before the pandemic. Similarly, despite an increase in nominal rents from the end of 2021, the price-to-rent ratio in 2022 was almost 80% higher than a decade before, and over 20% higher than before the pandemic. The decline in house prices from mid-2022 resulted in a dampening of the housing overvaluation.

The deterioration of housing affordability stopped in 2023 and is expected to gradually improve. The increase in house prices over the years significantly worsened housing affordability in Slovakia, with the strongest deterioration occurring in the years 2020-2022. Both the price-to-income ratio and the household borrowing capacity deteriorated, as the increase in income was unable to compensate for the increase in the costs of mortgages. More recently, in mid-2023, housing affordability improved on the back of swift growth in nominal wages and a less pronounced rise in interest rates. Further improvements in housing affordability are under way, as nominal wages outpaced inflation and house price growth in the third quarter of 2023. According to the Commission

([15]) However, in real terms, from the first quarter of 2021 wage growth decelerated, eventually turning negative as of the first quarter of 2022.

([16]) The decrease in prices for newly built buildings amounted to 4.6% in the third quarter year-on-year. According to the National Bank of Slovakia, the decrease is even more remarkable (10%).

([17]) Warning of the European Systemic Risk Board of 2 December 2021 on medium-term vulnerabilities in the residential real estate sector of Slovakia (ESRB/2021/16).

([18]) The Commission valuation model is an econometric model based on a cointegration analysis to assess whether house prices are overvalued or undervalued. It factors in various drivers of house price developments, including income variables, as well as cost variables and demographics. The model attempts to determine how house prices relate to the fundamental drivers in the economy.

Autumn 2023 Forecast, this trend is expected to continue and, together with the anticipated dampening in housing prices, should contribute to improving the affordability of housing.

An insufficient housing supply contributed to the sharp increase in house prices in recent years, and housing supply remained weak also in 2023. Over the previous 5 years before the pandemic, the average growth of dwellings built amounted to 6.2%, against an average mortgage growth of almost 12% over the same period. The number of dwellings per thousand inhabitants in Slovakia is among the lowest across OECD countries. Sluggish housing supply coupled with dynamic demand contributed to a rapid and long-lasting increase in house prices over the last few years. The housing supply has further slowed down recently. Compared to 2022, residential investment as a share of GDP and the number of building permits decreased in 2023 by 14% and 19%, respectively. Residential investment amounts to 3.7% of GDP and total investment in housing as a percentage of GDP has remained below the EU average. In the near future, the housing supply stock is expected to rebound, due to the considerable number of dwellings currently under construction after delays brought about by the pandemic. However, going forward, the housing supply is expected to decline again. According to the Slovak Statistical Office, the number of permitted dwellings (4 232) in the third quarter of 2023 recorded the lowest value since the first quarter of 2022, weighing on new construction in the future.

Inefficiencies in the public administration represent a significant factor behind the insufficient housing supply. In Slovakia, it takes on average 300 days to issue a building permit. In absolute terms, the number of issued permits per inhabitant has been lower than in other EU countries. Land-use policy in Slovakia is highly decentralised, giving municipalities the authority to grant building permits. However, smaller municipalities, in particular, face challenges due to limited financial and human resources. The decentralised system has also resulted in strong reliance on municipalities' own resources for construction activities. The fragmentation and decentralisation of the land-use planning and construction administration can also delay construction projects due to the resistance of local communities.

The share of households owning their houses is exceptionally high in Slovakia, and the property taxation system is inefficient. Slovakia is among the EU countries with the highest homeownership as over 90% of households own their homes. Additionally, according to 2021 data from the Cadastre Authority of the Slovak Republic, over 96% of homeowners own up to two dwellings and over 81% own one single dwelling. The high share results in low residential mobility that, in combination with inadequate transport infrastructure, hampers labour market mobility. However, the high homeownership in the country is hardly reflected in public revenues from property taxation, as revenues collected from property taxes are low compared to other EU countries (only 0.5% of GDP against an EU average of 2.2%) ([19]). Moreover, Slovakia is one of the few countries using an area-based instead of market-based taxation system, together with regional peers like Poland and Czechia, whereby property taxes are calculated on the area of the property rather than its market value. As a consequence, while house prices have soared over the last decade, tax revenues, as a share of GDP, have remained steady.

The home rental market in Slovakia is underdeveloped and among the smallest in the EU. As a result of the high rate of homeownership, less than 7% of the population lived in rented flats in 2020. The tax system encourages homeownership over renting, and rental regulation does not strike an appropriate balance between the protection of tenants and landlords. The share of people who do

([19]) *Immovable Property Taxation for Sustainable & Inclusive Growth* - Alexander Leodolter, Savina Princen and Aleksander Rutkowski (January 2022, ECFIN).

not declare their rental income is assumed to be high ([20]). Since the fourth quarter of 2021, the growth rate of nominal rent prices in Slovakia has accelerated, yet not as much as for house prices. According to the National Bank of Slovakia, the volume of rental offers is not increasing, despite the increase in demand for renting. The current legislative framework in Slovakia provides stronger incentives to offer real estate with shorter-term rental contracts. The Short-Term Rental Act (2014) made the rules for short-term rent contracts more flexible by introducing a 15-30-day notice period for terminating the lease, at the cost of disproportionately favouring landlords over tenants ([21]). The Act led to contracts signed for an indefinite period of time becoming rare, while this used to be the norm in the past. The popularity of short-term rental platforms, which surged before the pandemic, has further encouraged the prevalence of short-term contracts. Young people aged 18-34 are strongly affected by the underdeveloped rental market, with around 71.2% of them still living with their parents in 2022, against an EU average of 49.4% ([22]).

The supply of social rental housing in Slovakia is limited and housing allowances are low. According to the 2021 population census, the share of social renting houses only represented 2.5% of the total housing stock. The provision and administration of social rental housing in Slovakia is ensured by local authorities, which receive financial support from the State Housing Development Fund for constructing or acquiring social housing. Nonetheless, municipalities encounter challenges, such as a lack of available land for social rental housing development and bureaucratic obstacles in applying for support. The reform of the Public Procurement Act, which entered into force in 2022 under Slovakia's recovery and resilience plan, should help speed up procurement procedures of rental housing by local authorities. Additionally, by the end of 2023, Slovakia hosted more than 100 000 Ukrainian displaced people, increasing the demand for affordable housing. Housing allowances in Slovakia are limited and provided solely to low-income homeowners and renters who qualify for 'material need' assistance. The eligibility criteria to obtain such allowances are particularly rigid.

While housing supply remains insufficient, the number of vacant dwellings remains significant. The Metropolitan Institute of Bratislava estimates that there are around 7.5% of unoccupied apartments in Bratislava, contrasting with the 2021 census, according to which almost a quarter of apartments in the capital were unoccupied ([23]). Such a high share of vacant dwellings can be explained by a combination of improper rental legislation and the current area-based taxation system, which does not provide strong incentives to put a vacant dwelling on the market. Vacant houses or apartments indirectly contribute to an insufficient housing supply and an underdeveloped rental market, as they decrease the pool of property available for renting or buying.

([20]) However, estimates of the shadow rental market are unavailable.
([21]) Act No 98/2014 on short-term apartment rental.
([22]) EU-SILC survey (Eurostat) - Share of young adults aged 18-34 living with their parents by age and sex.
([23]) How many unoccupied apartments are there in Bratislava? 9 November 2023 – Metropolitan Institute of Bratislava.

Household debt

Household debt-to-GDP in Slovakia has been rising significantly over the last decade. Household debt, which accounts for approximately 50% of private debt, has been rising every year from 25% of GDP in 2010 to 47.1% in 2022. In 2023, it declined to 44% of GDP, below the prudential threshold (48%) but above the fundamentals-based benchmark (29%) (see Table 2.2). The household debt level in Slovakia is now higher than those of regional peers, such as Poland, Hungary and Czechia, but still remains below the EU average as the starting point for the increases was comparatively low.

The growth in household debt is driven by the rapid growth of mortgages. Over the years, households have benefited from several factors, including historically low interest rates on mortgages, a sound disposable income, and favourable developments in the labour market. This has boosted a solid demand for mortgages. Thanks to the adoption of the euro, Slovakia had lower interest rates than other neighbouring countries, incentivising individuals to take on mortgages, which contributed to the overheating of the housing market. Competition further intensified after the entry into force of the Act on Housing Credits in 2016, which imposed a cap on the fees that banks can charge clients for shifting their mortgage loans to another bank.

Since the third quarter of 2022, mortgage origination has started slowing due to rising interest rates. The ECB's decision, in July 2022, to increase its main policy rate by 0.5 pps translated into higher interest rates on mortgages and consumer credits in Slovakia ([24]). From the record low of 0.9% in the fourth quarter of 2021, rates for new mortgages increased to 1.8% in the second quarter of 2022 and reached a peak of almost 4.5% a year later in July 2023 (Graph 2.4e). As a consequence, mortgage origination in the first quarter of 2023 was more than 30% lower compared to the 2020-2022 average ([25]). While the average amount of mortgages provided has remained roughly unchanged, an increasingly smaller number of mortgages are being granted.

After increasing considerably, the strong growth of mortgage interest rates is gradually decelerating, and mortgage demand is stabilising. While mortgage rates rose by 0.7 pps on average each quarter between March 2022 and March 2023, they increased by only 0.3 pps in the second quarter of 2023 ([26]). In August and September 2023, they remained almost unchanged. As a result, mortgage demand has also stabilised. Although the mortgage origination is lower compared to the previous 3 years, it has stopped falling. Furthermore, the share of borrowers with a debt-service-to-income (DSTI) ratio at the regulatory limit was no longer rising in the second quarter of 2023.

Mortgages are typically taken out by higher-income households and households with more family members. The share of home-owning households with a mortgage is high in Slovakia (24.9%) compared to regional peers (Poland, Hungary, Czechia), yet in line with the EU average (24.7%) ([27]). Higher-income households are more likely to take out mortgages. Specifically, among the top 20% of households with the highest income, around 40% of households have a mortgage. At the same time, households with more family members are more indebted. Younger borrowers have taken the brunt of the increased mortgage rates as they have the highest debt-to-income ratio.

([24]) However, the interest rate on consumer credit started rising after the mortgage rate.

([25]) National Bank of Slovakia – Financial Stability Report (May 2023).

([26]) Increasing mortgage repayments is manageable for most households – Analytical Commentary of the National Bank of Slovakia (August 2023).

([27]) Eurostat (2022) - Distribution of population by tenure status, type of household and income group.

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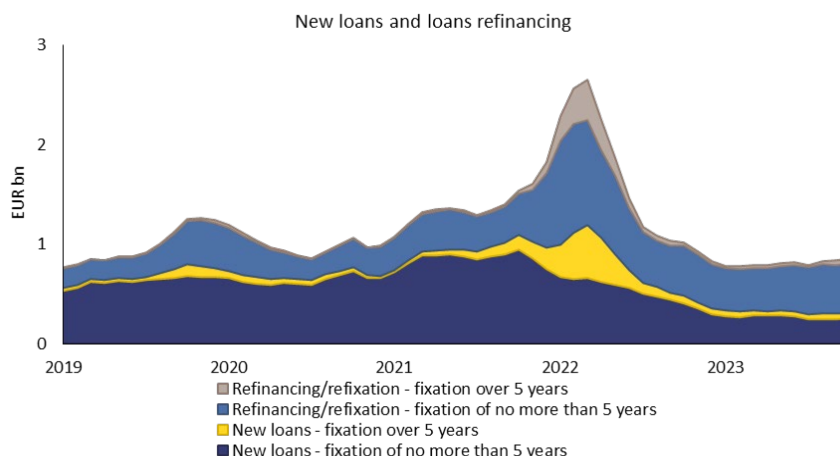
Although there was a decline in the number of mortgages granted across all age groups, the slowdown was slightly more noticeable among younger households ([28]).

The National Bank of Slovakia (NBS) has introduced measures to limit potential risks of real estate developments on the banking sector. In 2018, the NBS introduced a set of borrower-based measures. A limit on debt-to-income ratio (DTI) for both housing and consumer loans was phased in, whereby only 5% of total loans can exceed the limit of 8 times the borrower's yearly net disposable income. As of 2022, following the European Systemic Risk Board assessment in 2021, the NBS further tightened DTI limits for borrowers above 40 years old whose loan maturity exceeds retirement age. Similarly, the NBS tightened loan-to-value (LTV) limits for housing loans, whereby no loan may exceed an LTV of 90% and only 20% of total loans can have an LTV above 80%. From 2020, the NBS also adjusted the limit on the debt-service-to-income (DSTI) ratio, determining that only 5% of new loans can be granted with DSTI up to 70%, and 5% of new consumer loans with maturity not exceeding 5 years can be granted with DSTI up to 70%. An *ex post* assessment of the borrower-based measures conducted by the NBS shows that the DSTI measures mainly affected the riskiest borrowers with lower educational attainments and income, whereas exemptions from DTI limits are mainly provided to borrowers with higher education and a higher volume of loans ([29]). Another macroprudential measure sets the maximum maturity of consumer loans at 8 years. This measure limits excessive household indebtedness by restricting the possibility to top up their mortgage with a consumer loan, which was a common practice in the past.

The increases in mortgage rates and repayments appear manageable for mortgage holders. The borrower-based measures introduced in 2018 helped households continue to meet their obligations and repay their loans, although expenditure growth, mostly driven by higher mortgage rates, had outpaced income growth in 2022, and a similar trend is estimated for 2023. Households' financial situation is mitigated by favourable labour market conditions and the prevalence of fixed-rate mortgages (Graph 2.3) ([30]). However, given the fixation period of around 3 to 5 years, interest rates will rise at the next refixation. About 20% of total loans is going to be subject to refixation in 2024 and 2025. According to the NBS, households' ability to repay their loans should not be at risk unless the labour market deteriorates significantly. While the rise in the cost of living has resulted in a deceleration of economic growth, the labour market has remained stable, with the unemployment rate on a downward trajectory and expectations that real wages will rebound in 2023. The additional payments, following refixation, are not expected to exceed 20% of income. On average, the increase in monthly repayments is not expected to exceed EUR 100 and only 1% of mortgage holders are expected to face larger increases ([31]). Moreover, only 0.4% of mortgage holders subject to an increase in the repayment would face a financial distress. On top of that, although mortgages have become riskier due to the increase in interest rates and in repayments, there has been no increase in defaults and the non-performing loans ratio for mortgages is at a record low (Graph 2.4f) ([32]). In view of this, the NBS notes that the current situation does not warrant additional measures to mitigate the risk of default.

([28]) National Bank of Slovakia – Financial Stability Report (November 2023).
([29]) Cesnak, Klacso and Vasil (2021) - *Analysis of the Impact of Borrower-Based Measures*.
([30]) Unlike for households' mortgages, which benefit from a fixed-rate environment, two thirds of commercial loans are subject to variable rates.
([31]) National Bank of Slovakia (2023) - Analytical Commentary.
([32]) National Bank of Slovakia – Financial Stability Report (November 2023).

Graph 2.3: **New loans and loans refinancing**



Source: National Bank of Slovakia.

The Slovak banking sector remains resilient, profitable and well capitalised. Mainly because of higher interest rates on corporate loans, banks have experienced a vigorous increase in profitability. In September 2023, profits of Slovak banks, mostly driven by a 31% increase in net interest income, amounted to EUR 875 billion, recording an increase of EUR 50 billion compared to 2022 ([33]). Additionally, banks have sufficient liquidity and capital. Weaker demand for mortgages has eased liquidity pressure on banks. The liquidity coverage ratio of the banking sector remains in the range of 180-185% of total net cash flows, therefore adhering to Basel III's requirement of at least 100%. The non-performing loans ratio in the second quarter of 2023 equalled 1.83%, in line with the EU average. At the end of June 2023, the total capital ratio stood at 19.7%, which is above pre-pandemic levels, placing Slovakia on a par with the EU average ([34]). More recently, in August 2023, the NBS increased the countercyclical capital buffer rate by 50 basis points, to 1.5% of risk-weighted assets. While the NBS expects the financial cycle to remain on a cooling trend, at present there is no intention to reduce the countercyclical capital buffer rate in light of potential threats to banks' portfolios.

([33]) Financial Stability Report (November 2023) - National Bank of Slovakia.
([34]) European Banking Authority – Interactive Dashboard (2023).

Assessment of MIP-relevant policies

Aligning wage increases with growth in productivity is a key step towards improving cost competitiveness. In this respect there is a need for policy measures that increase skills and worker productivity through training and technology. Furthermore, stimulating labour mobility, both between sectors and geographically, should help mitigate skills shortages and alleviate excessive pressure on wages.

Facilitating innovation and strengthening education are key to increasing non-price competitiveness and promoting productivity growth, curbing competitiveness risks. To improve the Slovak economy's ability to perform in sectors beyond medium-tech assembly, it is important to have a well-defined national research and innovation strategy, which focuses on streamlining complex regulations for business and on improving the skills base by attracting and retaining high skilled individuals. The fact that small firms with low productivity constitute a significant portion of Slovak businesses highlights the necessity of policies aimed at boosting the innovation capabilities of smaller firms and promote the growth of the most productive ones. Although the productivity of small and medium-sized enterprises (SMEs) increased, it still lags behind that of their counterparts in other EU and OECD countries. SMEs still face challenges related to regulatory burden and availability of financing, hampering their ability to invest and innovate. These companies often face delays in implementation of their projects due to lengthy planning and approval processes, highlighting the need for action on reducing administrative complexities. It is therefore important to address a number of structural issues, such as the limited capacity of public administration, as well as challenges faced by SMEs related to delayed payments and access to finance. Thus the critical policy areas for improving non-price productivity are in the area of business environment, effective educational and training programmes and robust research and development initiatives.

Slovakia's high level of dependence on energy imports constitutes a major challenge that requires continuous policy action. There is a need for extensive measures to reduce the energy intensity of the country's economy and promote renewable energy production. In this respect, reforms and investment in Slovakia's recovery and resilience plan (RRP) and REPowerEU are positioned to contribute to this energy transition. It is important to continue policy actions to lessen administrative hurdles for renewables, improve the regulatory framework, increase grid capacity and improve the energy efficiency of buildings. This should reduce energy import dependence and help protect the economy against potential shocks to its current account balance. The above policies are expected to bear fruit in the medium to long term.

In the short term, bringing down the large government deficit is an important step towards decreasing the pressure on the external balance and inflation. Slovakia had a very high public deficit, above 6% of GDP, in 2023 and the deficit is forecast to remain high in the near future. Some deficit-increasing measures, such as the approved untargeted support for borrowers with high mortgage payments, can also have a pro-inflationary effect. On the other side, phasing out the government's untargeted interventions in the energy market can reduce government borrowing while supporting price incentives for businesses and people to moderate their energy consumption.

The implementation of the amendment to the Construction Act is significantly delayed, weighing on housing supply. The Construction Act, together with the Act on Land-Use Planning, both adopted in 2022, are expected to shorten the length of construction procedures and reduce the administrative burden, which are among the main factors limiting housing supply. The major change

brought about by the amendments, adopted in 2022, entails making the process of obtaining a building permit simpler and speedier (down to 40 days, from a current average of 300 working days). This is partly the result of introducing electronic processes to obtain permits and digitalisation of data related to construction and land-use planning. Another significant change in the legislation is the transfer of powers related to construction proceedings from municipalities to a central state body, the Slovak Office for Spatial Planning and Construction. The Construction Act, initially scheduled for implementation in April 2024, is now delayed until 2025.

The amendments to the Law on State Support for Rental Housing are aimed at improving rental housing availability. In the last decades, Slovakia has lacked adequate state support for rental housing, resulting in a high share of homeowners. The amendments to the Law on State Support for Rental Housing entered into force in July 2022 and aim to address insufficient housing conditions. Among other measures, the amendments will create a new agency that would be responsible for issuing housing projects and overseeing project implementation. Additionally, the amendments call for the lowering of VAT on procuring state-supported rental flats, from 20 to 5%. The amendments plan to increase the stock of social rental housing by creating 9 000 new apartments, either by building or buying existing ones. However, the Act was not properly scrutinised before adoption, and so far none of the 9 000 apartments has been either built or bought.

Social housing in Slovakia could be more significantly supported through existing institutional frameworks, starting with the State Housing Development Fund. The provision and administration of social rental housing is the responsibility of municipalities. However, local authorities face a number of obstacles in expanding social housing stock. To facilitate the construction or acquisition of social housing, local authorities obtain financial support through subsidies and long-term loans with favourable terms from a state fund known as the State Housing Development Fund ([35]). The Fund, established in 1996, uses public funds and its own funds to support the construction and renovation of residential buildings via favourable loans to municipalities. However, with the increasing share of EU structural funding in the Fund, the contribution of the state budget to the Fund has progressively declined, indicating some crowding out by the increased EU funding. The financial instruments within the cohesion funds are also to be used for improving the supply of affordable rental housing.

Going from an area-based to a value-based property taxation could reduce the gap between supply and demand for properties. Slovakia, together with a very few countries (e.g. Poland and Czechia) has area-based taxation, under which property is taxed based on its area rather than by its estimated market value. In such a taxation scenario, the location, quality, type, number of rooms and age of the dwelling are not factored in, which hampers equity and efficiency. The revenues flowing from recurrent property taxes in Slovakia are low. While Slovakia does not currently possess systems or sufficient data to align property value to market values, a value-based taxation system would improve fairness, increase tax revenues and help dampen real estate demand. In the 2023 country-specific recommendations from the Commission, the importance of overhauling the taxation system in Slovakia was highlighted. In that context, Slovakia was advised to make its tax mix more efficient and more supportive of inclusive and sustainable growth, by leveraging the potential for environmental and property taxation.

The housing stock in Slovakia remains energy inefficient, though renovation programmes are planned. The average energy consumption in residential buildings is still above the OECD

([35]) Draft OECD Economic Survey: Slovakia 2024.

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average, leading to households allocating a high share of their budget to electricity and gas bills ([24]). Energy consumption for domestic heating is also the largest contributor to high air pollution and residential heating is responsible for over 10% of CO_2 emissions. The share of renewable energy in gross final energy consumption for heating and cooling in 2021 amounted to 19.5%, below the EU average of 22.9% ([25]). Slovakia's recovery and resilience plan includes investment to improve the energy efficiency of older family houses, while achieving at least 30% of energy savings. In addition, with the introduction of the REPowerEU chapter, Slovakia will be carrying out energy efficiency interventions in approximately 85 buildings, and supporting the renovation of households at risk of energy poverty.

Public support for borrowers with high mortgage payments is costly and can increase property prices. From 2024, mortgage holders will be able to request a monthly contribution and tax allowance to cover the cost of the increased mortgage repayments. The measure will support debtholders who earn up to 1.6 times the average wage, currently equivalent to EUR 2 086. The contribution would amount to 75% of the difference between the increased and original monthly instalment, with a yearly cap at EUR 1 800 per mortgage holder. Such a measure raises concerns as it potentially distorts the working of monetary policy transmission, in particular the higher interest rates aiming to curb credit growth and inflation. The expected budget impact in 2024 is around EUR 88 million (0.07% of GDP), which contributes to a very high forecast deficit of 6.3% of GDP in 2024. In addition, the National Bank of Slovakia assessed this support as unnecessary for solving the problem of increased interest payments for Slovak households, as most of them would be able to cope with the increased mortgage payments even without this support ([36]). Moreover, the support for mortgage holders has the potential to further increase demand for mortgages and exacerbate the environment of high house prices.

Macroprudential measures to address housing market vulnerabilities are assessed by the ESRB as appropriate and sufficient. In 2021, the European Systemic Risk Board (ESRB) had issued a warning to Slovakia indicating the presence of vulnerabilities in the housing market. Specifically, it signalled vulnerabilities related to housing overvaluation, elevated house price growth and increasing household indebtedness. The macroprudential measures taken by Slovakia were regarded as appropriate but only partially sufficient. In February 2024, the ESRB assesses that Slovakia's medium-term property risks remain at medium level. The current policy measures were reassessed as being appropriate and sufficient. It was suggested to adjust borrower-based measures (DTI or DSTI limits) to address vulnerabilities linked to high DTI and DSTI levels. Over the years, the share of mortgages with a high DSTI ratio has risen the most among young borrowers. The share of young borrowers with a DSTI level close to the regulatory limit increased from 19% in 2021 to over 38% in the second quarter of 2023 ([37]).

The new government has approved a bank levy to redistribute increased profits by financial institutions. The profitability of the banking sector increased sharply in 2023 owing to interest income. Already in September 2023, profits recorded an increase of EUR 50 million compared to the entire previous year. Despite this historic increase in the profit levels of the Slovak banking sector, from the beginning of 2022 it was still lagging behind most EU countries. The levy on banks' profits is set at 30% for 2024 and is expected to fall 5 pps per year, to 15% in 2027. Therefore, Slovak banks will pay an effective tax rate of 45% in 2024, which is expected to increase tax revenues by EUR 340 million (0.26% of GDP) in 2024. According to the government, the tax rate will not jeopardise the banks' stability or resilience and will allow the government to address the country's

([36]) Financial Stability Report (November 2023), National Bank of Slovakia. Link: https://nbs.sk/aktuality/narast-splatok-hypotek-pocitia-vsetky-dotknute-domacnosti-no-zvladnu-to/.

([37]) Financial Stability Report (November 2023), National Bank of Slovakia.

budget deficit in 2024. However, the bank levy would not improve the long-term sustainability of Slovakia's public finances as it is set to gradually decline back to 15% by 2027, before being eliminated in 2028. Moreover, it would risk increasing the costs of bank clients (either in the form of higher interest or higher fees), to whom the banks would probably transfer this burden. In addition, the bank levy could hamper banks' ability to generate a sufficient capital buffer and to cover demand for loans. The European Central Bank (ECB) has warned that a bank levy could undermine the capital position of lenders, impact the provision of new lending and distort monetary policy ([38]). In addition, Slovakia did not consult the ECB on the introduction of the bank levy.

Further policy actions could support cost competitiveness, external sustainability, housing market and the high household debt going forward. Cost competitiveness can be supported by preserving nationally financed investment and ensuring the effective absorption of Recovery and Resilience Facility grants, cohesion policy funds and other EU funds, in particular to stimulate the green and digital transitions. This could improve productivity, decrease energy demand and increase external sustainability. Further support could come from improving the business environment by lightening the administrative burden faced by the SMEs and improving their access to finance. However, progress in reducing vulnerabilities has been undermined by some recent measures stimulating demand. Further increases in public expenditure could negatively affect external balances and inflation. The recently introduced support for borrowers with high mortgage payments could be reconsidered, due to its potential to stimulate demand for mortgages, which could fuel an increase in house prices. Instead, accelerating the implementation of the amendments to the Construction Act and Act on Land-Use Planning could sustain the housing supply. Additionally, social housing could be supported through existing institutional frameworks such as the State Housing Development Fund. Finally, a more efficient tax mix could, in turn, incentivise renting.

Table 2.1: **MIP-relevant policy progress in Slovakia:**

Vulnerability	Policies enacted since January 2023	Policies in progress since January 2023
Cost competitiveness	Special levies on profits from electricity sales and revenue cap on energy producers with profits.	Price caps on energy and heating supply for companies and households.
External Sustainability	Measures to enact additional provisions for pensions. Increase in tax bonus for families to protect households' purchasing power.	Increased allowances to households to protect their purchasing power.
Housing market		Construction Act and Act on Land-Use Planning Law on State Support for Rental Housing.
Household debt	In August 2023, the National Bank of Slovakia increased the countercyclical capital buffer rate by 50 basis points, to 1.5% of risk-weighted assets.	Support for borrowers with high mortgage payments Bank levy redistributing profits of financial institutions.

CONCLUSION

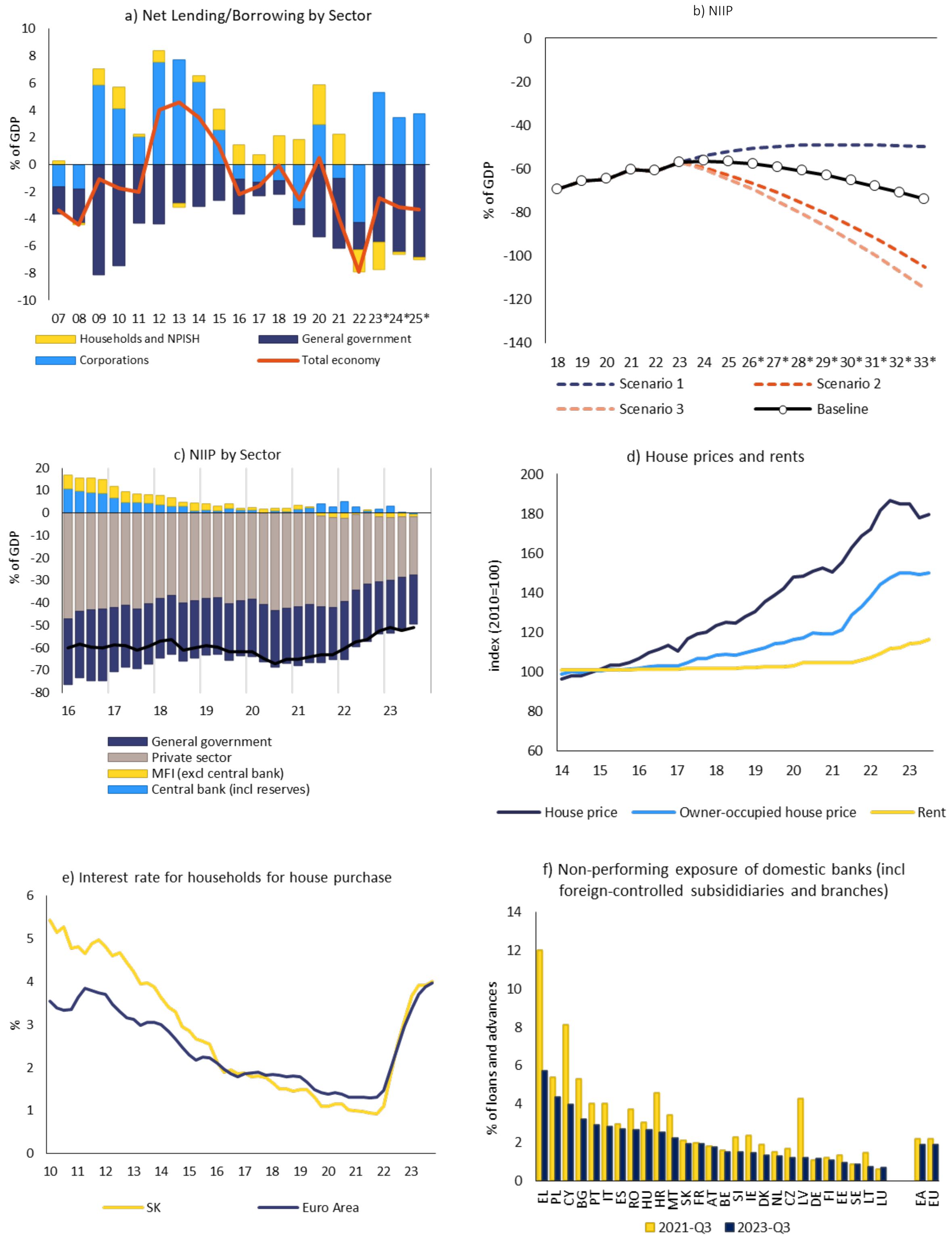
Despite some recent improvements, the challenges for Slovakia's cost competitiveness, external balance, housing market and household debt persist. As energy prices decrease, Slovakia is expected to see a partial decrease in pressure on its price competitiveness. Nevertheless, inflation is projected to remain among the highest in the euro area and the EU in 2024 and 2025,

([38]) https://www.ecb.europa.eu/pub/pdf/legal/ecb.con_2023_26.en.pdf?64b480053a7fa7efcc6298681063888c.

potentially adding to concerns about competitiveness and delaying the improvement of the trade balance. It remains uncertain whether inflation and unit labour cost growth will return to their long-term trajectory or cost competitiveness issues will persist. While the current account deficit is expected to decrease, it will still be considerable in the foreseeable future. Household demand for mortgages has dampened in recent months due to the hike in interest rates. Consequently, property prices fell across all regions in Slovakia, also resulting in a narrowing of the valuation gap; over the near future, house prices can be expected to rise again, as constrained supply will remain. The financial sector remains sound and demand for mortgages is expected to gradually recover in line with the ongoing monetary cycle. However, this could again spur an increase in house prices.

To manage the identified vulnerabilities and risks effectively, continuous efforts seem warranted to put mitigating policies in place. Increasing dynamism in the labour market, in particular, by investing in workers' skills and encouraging labour mobility, would mitigate some excessive pressure on wages. Improving non-price competitiveness and promoting productivity growth are essential to offsetting cost competitiveness losses, and it is important to control expenditure that feeds the excess demand, i.e. to decrease the current account deficit. This goal can be supported through adequate fiscal consolidation that would dampen domestic demand as well as prevent rises in the government debt ratio. Furthermore, limiting the untargeted interventions in the energy market would support the price incentives to decrease energy consumption and imports. Shift from an area-based to a value-based property taxation would increase fairness, support public finances and further decrease demand for properties. An improvement in the property market could also be ensured by greater support for renting through a more effective tax mix. Social housing could be supported through existing institutional frameworks such as the State Housing Development Fund. To improve the external position and reduce the government deficit, it could be necessary to avoid inefficient and expensive measures such as mortgage allowances, which distort monetary policy signals and therefore pose a risk of additional inflation, increased demand for loans and buoyant property price growth.

Graph 2.4: **Selected graphs, Slovakia**



Source: Eurostat, Ameco, ECB and European Commission calculations.

Table 2.2: **Selected economic and financial indicators (Part 1), Slovakia**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast 2024	 2025
Real GDP	7.3	2.1	3.2	-3.3	4.8	1.8	1.1	2.6	2.7
p.m.: Real GDP (Winter 2024 interim Forecast)							*1.1*	*2.3*	*2.6*
Contribution to GDP growth:									
Domestic demand	5.2	0.6	3.2	-3.1	3.0	3.1	-0.4	2.8	2.1
Inventories	0.3	-0.6	0.4	-1.9	2.6	-0.2	-3.3	0.3	0.2
Net exports	1.8	2.0	-0.4	1.6	-0.9	-1.2	4.8	-0.5	0.4
Output gap (2)	1.0	-0.1	0.1	-2.8	0.3	0.5	-0.4	-0.5	-0.4
Unemployment rate	15.3	12.6	9.1	6.7	6.8	6.1	5.7	5.4	5.2
Harmonised index of consumer prices (HICP)	4.9	2.7	1.0	2.0	2.8	12.1	11.0	3.6	2.7
p.m.: HICP (Winter 2024 interim Forecast)								*3.5*	*2.6*
HICP excluding energy and unprocessed food (y-o-y)	3.9	2.5	1.3	2.4	3.4	10.4	11.4	2.5	2.2
GDP deflator	3.5	1.0	1.1	2.4	2.4	7.5	10.5	4.2	2.9
External position									
Current account balance (% of GDP), balance of payments	-7.2	-3.6	-1.9	0.6	-4.0	-7.3	-1.6	-3.0	-2.6
Trade balance (% of GDP), balance of payments	-2.8	-0.2	1.6	2.1	0.2	-5.2	.	.	.
Primary income balance (% of GDP)	-3.9	-2.3	-2.0	-0.8	-3.2	-1.4	.	.	.
Secondary income balance (% of GDP)	-0.5	-1.2	-1.5	-0.7	-1.0	-0.7	.	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-0.7	-0.4	0.0	0.0	0.0	0.0	0.1	0.0	0.2
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-1.8	-1.4	-1.9	-1.8	-1.6	-1.3	-0.8	-0.5	0.0
Capital account balance (% of GDP)	0.2	1.3	1.3	0.8	1.1	1.1	.	.	.
Net international investment position (% of GDP)	-47.2	-61.4	-66.1	-64.7	-60.5	-61.0	.	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	0.3	-9.9	-14.6	-14.8	-14.4	-18.2	.	.	.
Net FDI flows (% of GDP)	-5.7	-2.0	-1.1	2.6	-1.3	-2.1	.	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	2.2	2.0	3.6	5.4	1.4	6.0	9.1	5.3	3.3
Nominal compensation per employee	8.3	3.8	4.3	3.9	6.9	6.0	9.7	7.9	5.9
Labour productivity (real, hours worked)	5.5	1.8	2.1	6.0	4.7	-2.4	0.1	2.0	2.1
Real effective exchange rate (ULC)	5.7	2.2	1.4	1.3	1.1	1.8	1.2	0.7	0.5
Real effective exchange rate (HICP)	8.1	2.6	0.5	2.1	0.0	2.0	.	.	.
Export performance vs. advanced countries (% change over 5 years)	.	8.5	3.5	7.5	2.3	-3.1	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	47.3	66.5	86.5	94.8	92.6	92.7	85.3	.	.
Household debt, consolidated (% of GDP)	11.9	24.6	38.6	46.5	47.0	47.1	44.0	.	.
Household debt, fundamental benchmark (% of GDP) (6)	12.9	19.9	26.2	29.6	30.0	29.1	29.3	.	.
Household debt, prudential threshold (% of GDP) (6)	54.2	44.6	55.8	50.5	48.1	47.8	47.6	.	.
Non-financial corporate debt, consolidated (% of GDP)	35.4	42.0	47.9	48.3	45.6	45.5	41.3	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	43.0	42.5	45.2	47.3	47.4	45.5	45.1	.	.
Corporate debt, prudential threshold (% of GDP) (6)	69.8	57.6	74.4	68.2	67.1	67.8	70.7	.	.
Private credit flow, consolidated (% of GDP)	6.9	6.0	5.8	2.6	4.5	9.3	5.9e	.	.
Household credit flow, consolidated (% of credit stock)	41.1	15.3	9.8	5.6	7.8	8.8	.	.	.
Non-financial corporate credit flow, consolidated (% of credit stock)	13.7	17.4	7.8	0.0	3.0	17.8	.	.	.
Net savings rate of households (% of net disposable income)	0.7	1.7	3.0	5.5	4.2	-2.5	.	.	.

(e) estimate based on ECB quarterly data

(1) Potential output is the highest level of production an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.

(2) Deviation of actual output from potential output as % of potential GDP.

(3) Current accounts in line with fundamentals ('current account norms') are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), 'Methodologies for the assessment of current account benchmarks', European Economy, Discussion Paper 86/2018, for details.

(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of Commission's T+10 projections.

(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.

(6) Fundamental benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds identify a threshold above which banking crises become more likely. The fundamentals-based and the prudential benchmarks are calculated following Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), 'Is Private Debt Excessive?', Open Economies Review, 1- 42.

Source: Eurostat and ECB as of 2024-02-20, where available; European Commission for forecast figures (Autumn Forecast 2023).

Table 2.2: **Selected economic and financial indicators (Part 2), Slovakia**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast 2024	forecast 2025
Housing market									
House price index, nominal	.	-1.1	6.0	9.6	6.4	13.7	.	.	
House price index, deflated	.	-3.6	4.9	7.2	3.0	1.3	.	.	
Overvaluation gap (%) (7)	-2.9	1.2	-5.0	10.2	11.1	15.6	15.8	.	
Price-to-income overvaluation gap (%) (8)	3.6	3.1	-5.9	4.3	5.2	8.7	-0.6	.	
Residential investment (% of GDP)	3.1	2.9	3.0	3.8	4.0	4.3	.	.	
Government debt									
General government balance (% of GDP)	-2.8	-5.4	-1.9	-5.4	-5.2	-2.0	-6.1	-6.3	-6.2
General government gross debt (% of GDP)	36.3	40.1	51.1	58.9	61.1	57.8	56.4	58.5	61.2
Banking sector									
Return on equity (%)	6.7	4.8	5.5	4.3	5.8	7.0	.	.	
Common Equity Tier 1 ratio	28.3	19.0	17.9	19.8	20.3	21.6	.	.	
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	1.5	3.4	3.3	2.1	1.7	1.5	.	.	
Gross non-performing loans (% of gross loans) (9)	.	.	4.0	2.5	2.0	1.7	1.9	.	
Cost of borrowing for corporations (%)	.	4.0	2.2	1.9	1.8	3.9	5.9	.	
Cost of borrowing for households for house purchase (%)	.	5.2	1.9	1.0	0.9	3.1	4.0	.	

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), 'Assessing House Price Developments in the EU', European Economy - Discussion Papers 2015 - 048, Directorate-General for Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long-term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long-term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

Source: Eurostat and ECB as of 2024-02-20, where available; European Commission for forecast figures (Autumn Forecast 2023).

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