4Q 2015 HIGHLIGHTS

Parties are getting ready for the March general election. Their most likely outcome is a two-party coalition including the clear election winner Smer and SNS or some center-right party.

British car maker Jaguar Land Rover has signed an investment treaty with the government. It pledged to invest €1.5bn and create 2,800 new jobs. Enel signed a contract to sell its 66% stake in power producer Slovenské elektrárne in two stages to Czech EPH.

The government is likely to build the Bratislava highway bypass as a PPP project, as Cintra's bid is "extraordinarily good" according to Prime Minister Robert Fico.

Economic growth slightly accelerated last year, and will stay relatively strong this year. Consumer prices fell for all of 2015, but should grow slightly this year. Economic growth generates new jobs, and unemployment is set to fall further this year.

POLITICS

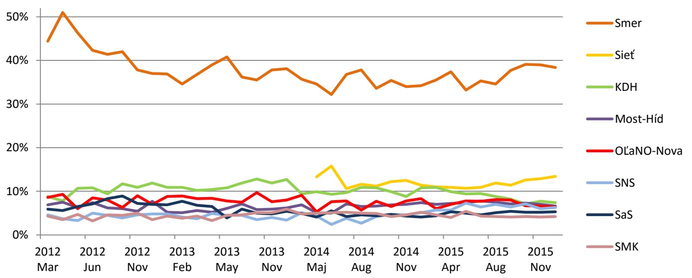
General election will be held on March 5

Political parties are getting ready for the March 5 general election. Twenty three political parties handed in their candidate sheets (26 parties ran in 2012). There is only one strong contender on the left side of the political spectrum, the Smer party. On the center-right, there are several parties with real chances to get to parliament (Sieť, KDH, Most-Híd and OĽaNO-Nova), one party struggling to pass the 5% threshold (SaS) and many parties with scant chance of success (Šanca, Skok, SDKÚ-DS, DS-SDKÚ, TIP and Sme rodina). Two nationalist parties (SNS and SMK) might get to parliament. There are a plethora of extremist parties – Kotleba – ĽSNS, Cesta, Priama demokracia, Spoločne za Slovensko and even the pro-Russia party Odvaha.

Smer is likely to form a two-party ruling coalition

The ruling party Smer will score another election victory. Voters are happy with its four-year one-party government. In a December poll by the Polis agency, Smer received the best grade for its actions in 2015, of 2.7 (on 1-5 scale, with 1 the best). Parties Most-Híd (2.9), SNS (3.1), Sieť (3.1) and KDH (3.4) followed. Smer's popularity in polls has stabilized at around 40%, while the popularity of the largest opposition party Sieť is climbing towards 13%. According to most polls, Smer will need a coalition partner to form a government. The SNS party is more than willing to join Smer, and the center-right parties are probably also open to that option. Smer's leader Robert Fico said on several occasions that he prefers a two-party coalition to another one-party government. He wants to share the responsibility of ruling the country. The two-party coalition including Smer is the most likely election outcome. Chances for another one-party Smer government are a bit smaller. The broad center-right coalition is by far the least likely option.

Chart 1
Polls



Source: Focus agency

The March 2016 general election results might differ from polls. As many as a third of supporters of the Sieť, OĽaNO and SaS parties admit they might vote for another party in March, according to the December poll by the Focus agency. The share of uncertain voters fell from 40 – 50% in the October poll by the same agency. On the other hand, the parties can gain votes from supporters of small parties with slim chances to enter parliament (SDKÚ, Šanca and Skok), as well as votes from undecided voters. The Smer, KDH and Most-Híd parties have more stable base, with just a tenth of their voters saying they might vote for some other party.

Smer's popularity surges on the back of migration crisis

The surge in Smer's popularity since the summer of 2015 owes much to its handling of the migration crisis. Smer adopted a harsh anti-migrant stance, and even filed charges against the EU Council for its decision to impose mandatory quotas for the redistribution of 160,000 refugees within the EU. Based on the quota system, Slovakia was to accept 802 refugees. "The quotas are nonsense and impractical, they are a fiasco. So far, just several hundred refugees have been relocated based on the quota system," explained Prime Minister Robert Fico. In his opinion the EU must find another way to cope with migrants. So far, Slovakia has taken just 150 refugees from Syria on a voluntary basis.

Centre-right parties in disarray

The center-right parties are still in disarray and have come up with no topics that could challenge the ruling Smer party. They keep talking about their cooperation. Most-Híd's Béla Bugár wanted the Most-Híd, KDH and Sieť parties to issue a joint declaration about their pre- or post-election cooperation, but even this was a tall order. Sieť's Radoslav Procházka in turn has talked about uniting the center-right parties into a single entity sometimes in 2018. He thinks an alternative to the dominant Smer party can't consist of one 15% party and three 7% parties, but must be a party as strong as Smer. Such a union is very unlikely, though.

Smer wants to continue its popular "social packages"

Smer presented the base of its election program, called the third social package, at its congress in early December. Ten measures costing €1bn (financed by improving tax collection, fighting tax evasion, and cutting public spending) will be implemented if Smer gets to the government after the March general election. Smer wants to increase the amount of income exempt from health levies (this will cost €90m annually). It wants to support municipalities in building 5,000 rental apartments via direct subsidies and cheap loans from the housing fund ŠFRB. It wants to build 2,000 flats for young teachers, at a total cost of €100m, who will not pay any rent but will pay just for energies. It wants to spend €50m upgrading dormitories. Smer plans to use €50m annually to hike Christmas pensions, €40m annually on caretakers for handicapped children and pensioners, and €100m on improving 2nd and 3rd class roads. Buses bringing commuters to trains will be free for students and seniors (€30m annually). Smer wants to spend €100m in 2016 – 20 on wages and equipment for 2,500 new policemen, as well as new kit for soldiers.

ECONOMY

Jaguar Land Rover arrives in Slovakia

The most important business event in Slovakia last year was the signing of the investment contract with British car maker Jaguar Land Rover on December 11. The car maker pledged to invest €1.5bn into its new plant in Nitra, launch production in September 2018, and employ 2,800 people by 2020 in making at least 150,000 cars annually (the next generation of the Land Rover Defender). In the second phase, it might invest a further €520m and create an additional 1,100 jobs. The government will provide the plant with investment stimuli totaling €130m in cash for technologies, but no tax breaks. The car plant PSA in Trnava received direct subsidies of €166m, and Kia Motors in Žilina €180m. The Jaguar Land Rover's CEO, Ralf Dieter Speth, said the government's welcoming approach, the location in the heart of Europe, and the quality labor force all played in Slovakia's favor. The Finance Ministry estimates the investment will increase the volume of Slovakia's GDP by 2.5% by 2020 and will create a total of 14,500 new jobs. The positive impact on GDP will culminate in 2019, when four car plants in Slovakia will make over 1.2m cars. The plant will be equally important for the car maker, which currently makes just 500,000 cars annually. It hopes growing demand in China, USA, and Western Europe will lift its sales.

In total, the government approved a €43m investment stimuli to 17 projects in 2015, plus the €130m stimulus for Jaguar Land Rover. The stimuli supported €185m in investments that will create 2,100 new jobs (plus a €1.5bn investment of JLR that will create 2,900 new jobs). To compare, the Czech government approved €908m in stimuli for 136 projects in 2014. In 2010 – 15, the stimuli totaled €530m in Slovakia, and as much as €2,015m in the Czech Republic.

The investment will further strengthen the automotive industry's position in the Slovak economy. Even Volkswagen's emissions scandal has not impacted production in the three Slovak car makers. The Bratislava plant of VW is still producing SUV models (Audi Q7 and VW Touareg) seven days a week and small city cars five days a week. The Trnava plant of PSA Peugeot Citroën expects to make 302,000 cars in 2015, up from 256,000 in 2014. The Žilina plant of Kia Motors anticipates its 2015 output at 330,000 (323,000 in 2014). The total car production in Slovakia is likely to have surpassed 1m for the first time in 2015.

Enel sells its stake in Slovenské elektrárne

The end of December also saw Enel of Italy signing a contract with Czech EPH (Daniel Křetínský and Patrik Tkáč) on acquiring the 66% stake Enel holds in Slovenské elektrárne. Enel deposited the stake into a new company, called HoldCo, and EPH will acquire a 50% stake in it for €150m in the first phase. When the first phase is closed, EPH will pay a further €225m. If EPH exercises an option it has been offered, it will purchase the remaining 50% in HoldCo for a further €375m once the Mochovce nuclear power plant is completed. The final price for the 66% stake in SE may differ from €750m, as it will depend on SE's financial performance, the costs of completing Mochovce, and the development of market power prices. Back in 2006, Enel paid €840m for the 66% stake.

The government might enter the fray too. In a memorandum it signed with Enel in December, the state was granted not only the option to buy a 17% stake in SE, but the entire 66% stake. The price for the stake is not discussed in the memorandum. EPH said it will respect the memorandum.

Cintra to build the Bratislava highway bypass

A consortium led by Cintra of Spain presented the lowest bid in the tender for the construction and 30-year maintenance of the Bratislava highway bypass. Its bid is an annual installment of €56.7m. Three other consortia bid too, including Vinci (€69.0m), Hochtief (€76.8m) and Strabag (€91.0m). Cintra has not been active in Slovakia so far; in various parts of the world, it runs 23 highways 3,000 km long. Its consortium also includes Porr of Austria and investment fund Macquarie Capital Group. Prime Minister Robert Fico deems Cintra's bid extraordinarily good. It seems likely the outgoing government will sign a contract with Cintra in January.

Improved business environment

Slovakia ranked a respectable 29th in World Bank Doing Business 2015, out of 189 countries. The ranking was the same as in 2014 if 2015's methodology is applied. Slovakia's ranking was the best in international trade (1st in the world) and registering property (5th), but lagged behind in ease of paying taxes (73rd) and dealing with construction permits (84th).

Table 1
Ranking of neighboring countries in Doing Business 2015
ranking and score 1 – 100, where 100 is the best

	2015	2010
Austria	21 (78.38)	28
Poland	25 (76.45)	72
Slovakia	29 (75.62)	42
CR	36 (73.95)	74
Hungary	42 (72.57)	47

Source: World Bank

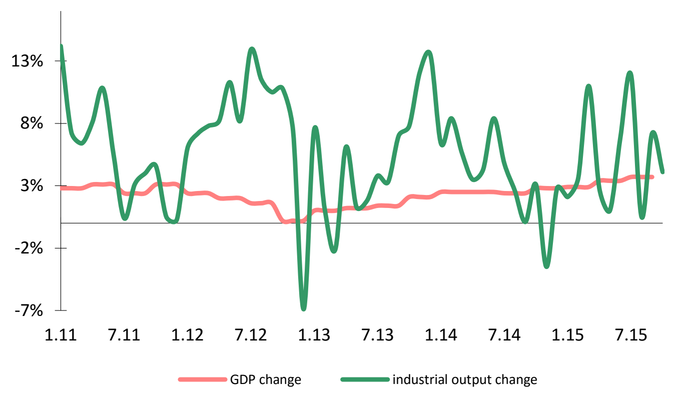
2016 state budget

Parliament approved the 2016 state budget on November 20. The government plans to cut the deficit to 1.9% of GDP in the election year, from the 2.5% expected for 2015. The budget again forwards the target of a balanced budget, this time to 2018. If tax intake is better than planned, the government is ready to spend a further €225m for significant investments and social packages. The independent fiscal responsibility council RRZ sees several risks in the budget that could drive the public finance deficit up to 2.7% of GDP. The major source of risks is higher than planned spending in healthcare. Interestingly, the budget approved by parliament includes €300m more in revenues than forecast by the Finance Ministry. Finance Minister Peter Kažimír promised not to spend the €300m until his forecast of higher tax intake materializes.

GDP growth quickens up

The economy picked up its pace to 3.7% in the third quarter. The fastest growth since the fourth quarter of 2010 was pulled by investments and domestic consumption. The key driver was the effort to spend the EU funds for the 2007 – 13 period. The current low interest rate environment spurs corporate investments too, as well as the investment of households into residential real estate. Next year, the contribution of EU funds to economic growth will be much smaller, but the planned start of the construction of the Jaguar Land Rover car plant in Nitra will partly offset this.

Chart 2
Changes in GDP and industrial output
%



Source: ŠÚ

The growth in household consumption was not reflected in retail sales, which were just 1.4% higher annually during the first three quarters. Such low growth is down to deflation, as labor market saw major improvements. Industry also pushed up the economic growth. Industrial output was 5.1% higher annually in the first three quarters, up from last year's 3.7%. The open Slovak economy benefitted from the acceleration of economic growth in the euro zone.

The Slovak economy grew at the third fastest pace in the EU between 2007 – 14, increasing the GDP per capita by 13.4%, according to Eurostat data. Only Poland (22%) and Lithuania (14.2%) managed quicker growth. Besides these countries, Germany and Austria handled the crisis well. On the other hand, the Greek GDP is now 25% lower and Italy's is 12% lower. In the EU as a whole, GDP per capita is roughly at the 2007 level. Employment fared much worse. The economic crisis killed 6.7m jobs in Europe. Even in Slovakia, employment grew just slightly. It is now lower in industry, but higher in services, IT, and the public sector.

Major improvement in the labor market—

Labor market saw major improvements in the third quarter of 2015. Real wages were 3.2% higher annually in the third quarter, at €861. The jobless rate was 1.6 points lower annually, at 11.3%. In fact, the Slovak unemployment rate fell to the euro zone's average for the very first time in October, according to Eurostat data. This is even more impressive given that the euro zone's jobless rate is the lowest since September 2009. The drop in unemployment in Slovakia was the second highest in the EU. The Czech jobless rate was the second lowest in the EU after Germany (4.5%).

Table 2
Unemployment in neighboring countries
%

	Oct '15	Oct '14
CR	4.7%	5.8%
Austria	5.6%	5.7%
Hungary	6.5%	7.3%
Poland	7.0%	8.4%
Slovakia	10.7%	12.7%

Source: Eurostat

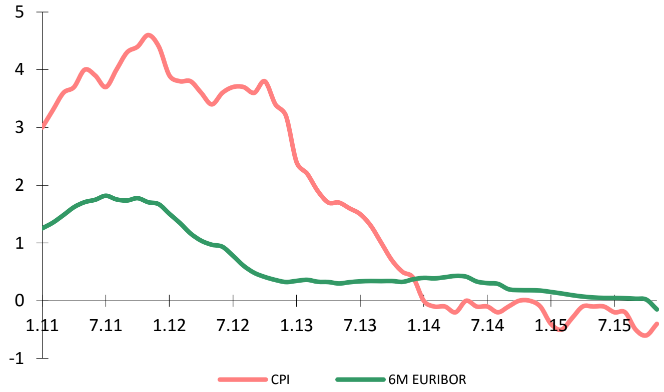
—leads to local labor shortages

Despite the double-digit unemployment rate, businesses increasingly complained of labor shortages. Unemployment will fall under 10% this year, which will "essentially exhaust the labor supply," according to Luboš Sirota, CEO of staffing agency McROY Group. The labor market will return to its condition in 2008, before the onset of the global economic slowdown. Directors of 66% of construction firms worry about the lack of qualified personnel, according to a quarterly analysis of CEEC Research. Similarly, half of German firms active in Slovakia are afraid of a lack of qualified personnel, according to a survey by the German-Slovak Chamber of Commerce. This will impact wages, as wage growth will pick up to 4%.

Low inflation

Inflation pressures are still absent in the Slovak economy. Consumer prices in November were 0.4% lower under an annual comparison. The last time prices increased was in December 2013. Their fall comes on the back of low global prices of crude oil. In November, much as in the whole of 2015, the item with the biggest fall in prices was transport, of -5.5% annually. This item was also impacted by the government's decision to provide free train fares to all students and seniors, starting in November 2014. The second biggest drop was in the prices of housing and energies (-1.7%). Here, the state comes into play, too. Prices of gas and electricity for households are regulated by the nominally independent regulator ÚRSO. It ruled on November 30 that power prices for households will fall by 1%, and gas prices by 3.6% as of January 1. Prices for small companies will fall by 1.1% (power) and 2.9% (gas). The third source of falling prices is domestic. Prices of telecom and postal services were 0.3% lower in November, also thanks to the arrival of the fourth mobile phone operator, 4ka (owned by local telecom operator Swan), in October.

Chart 3
Consumer prices and 6M EURIBOR
%



Source: ŠÚ

The Finance Ministry updated its forecast in September, reducing its estimate of GDP growth slightly. The key reasons for the step are the fragile economic recovery in Western Europe and tensions in Ukraine.

Table 3
Forecasts by the Ministry of Finance
%

	2015	2016	2017	2018
real change in GDP	3.2	3.7	3.6	3.6
real change in wages	2.2	2.4	2.6	2.6
change in employment (SU)	1.2	0.8	0.7	0.7
unemployment rate (SU)	12.1	11.3	10.5	9.7
inflation	0.2	1.3	1.9	2.1
current account (% of GDP)	-0.2	0.8	1.7	2.3

Source: MF SR

