September 2010
IMF Country Report No. 10/290

**Slovak Republic: 2010 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with Slovak Republic, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 19, 2010, with the officials of Slovak Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 16, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 3, 2010 discussion of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

# Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with the Slovak Republic

Approved by Anne-Marie Gulde-Wolf and Thomas Dorsey

August 16, 2010


**Executive Summary**

**Background**: After tumbling in the first quarter of 2009, economic activity has steadily recovered. Industrial output and exports are rising fast, and banks remain generally well capitalized and liquid, albeit with lower profitability. However, the government deficit has widened to an unsustainable level, and long-term unemployment surged above already high pre-crisis levels. A centre-left coalition lost its majority in June 2010 elections, and a new, centre-right coalition, was formed shortly before the mission.

**Context of past surveillance**: Staff supported fiscal stimulus in 2009, but recommended fiscal consolidation from 2010. The authorities agreed, in principle, on the need for adjustment in 2010, but did not implement corresponding policies.

**Challenges**: Following euro adoption, maintaining macroeconomic stability and external competitiveness within the monetary union is the overarching challenge. Recent events in the euro area caution that this is not an easy task, and will require fiscal prudence and structural reforms to achieve continued productivity gains. In the wake of the crisis, cutting the general government deficit to below 3 percent of GDP by 2013 through a front-loaded, multi-year consolidation will be a priority. Tacking long-term unemployment through labor market reforms will be another key post-crisis challenge.

**Staff views**: The economic environment should continue to improve in line with the global recovery, with real GDP projected to grow at about 4 percent a year in 2010–11. However, macroeconomic stability will hinge on anchoring fiscal policy within a credible medium-term framework that gradually reduces the deficit to below the Maastricht norm in 2013. Improving the allocation of government expenditures and undertaking structural reforms to strengthen the labor market, education, and governance will help bring down long-term unemployment and enhance growth.

**Authorities' views**: The new government is committed to fiscal consolidation and structural reforms. In particular, it intends to cut the deficit by around 2½ percentage points of GDP in 2011, and plans to improve the education system, public procurement and the judiciary.

**Mission team**: Mr. De Broeck (Head), Ms. Mitra, and Messrs. Mehrez and Tulin (all EUR) visited Bratislava during July 08–19, 2010, and held discussions with the Minister of Finance, the Governor of the National Bank of Slovakia, and other key central bank and government officials, and financial sector, labor, and business representatives. Mr. Kiekens (Executive Director) and Mr. Jakoby (Senior Advisor to the Executive Director) also attended meetings.

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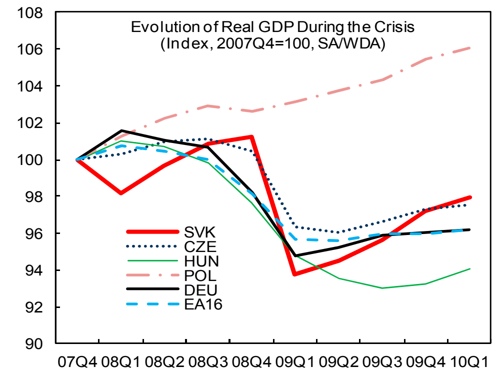
# I. Background

1. **The economy is emerging from a deep recession**. Real GDP declined by 4.7 percent in 2009, following a collapse in the first quarter and recovery throughout the rest of the year, which continued into 2010. Though starting later, the initial drop in real GDP was larger than in most of Slovakia's neighbors. But the recovery also has been more pronounced—year-on-year growth in the first and second quarters of 2010 was near 5 percent, the highest in the EU. At 1 percent in July 2010 (year-on-year), inflation is significantly below the euro area average.




Source: Haver Analytics.

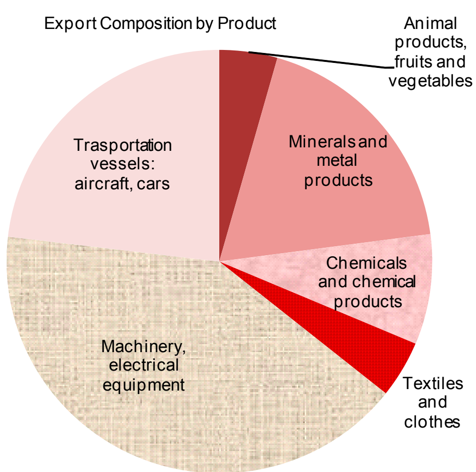
2. **Given its high degree of trade openness, Slovakia has been particularly exposed to the crisis**. As demand from its trading partners plummetted, exports fell and FDI faltered. The decline was mainly in the manufacturing sector, particularly in consumer electronics, cars and intermediate goods. However, manufacturing rebounded quickly with the global turnaround in major export-oriented industries. In addition, a large and growing share of Slovakia's exports go to emerging and developing economies that have weathered the crisis well.

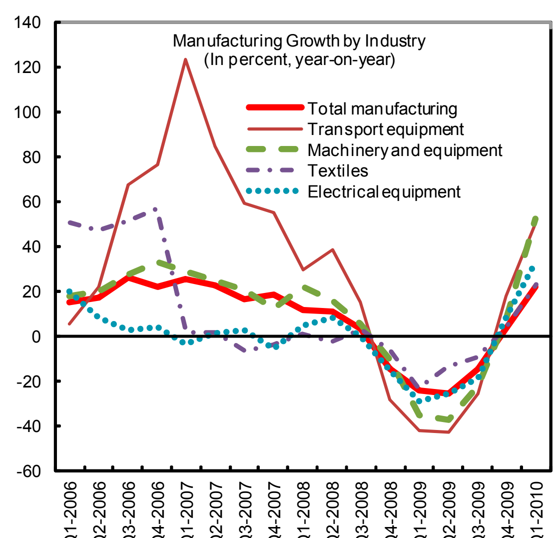
Exports of Slovakia by Region or Country of Destination

(In percent of total country's exports)

| | 2000 | 2009 |
|---|---|---|
| Euro Area | 60.3 | 49.0 |
| of which to Germany | 30.1 | 19.7 |
| Emerging and Developing Economies | 32.2 | 40.4 |
| Cent. & East. Europe | 27.8 | 33.2 |
| Czech Republic | 15.2 | 13.2 |
| Poland | 5.6 | 7.9 |

Sources: IMF, DOTS; and IMF staff calculations.

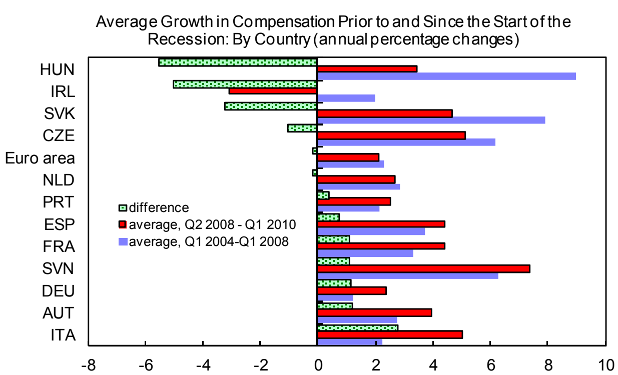


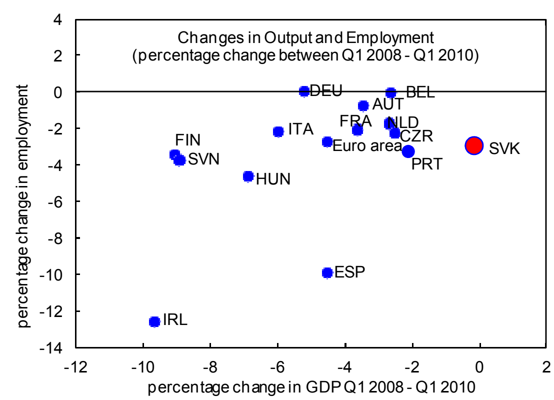




Sources: Haver Analytics; and IMF staff calculations.

3. **Strong fundamentals and suitable policies have confined the impact of the external shock**. A relatively sound fiscal position with a low public debt prior to the downturn, low debt ratios of households and companies, and a prudent and internally-oriented financial sector contained domestic second-round effects following the substantial external shock. Furthermore, automatic stabilizers and some discretionary fiscal stimulus provided appropriate demand support. Euro area membership helped maintain confidence and facilitated low interest rates. Private consumption declined only moderately, in spite of wage cuts and a sharp increase in the unemployment rate.

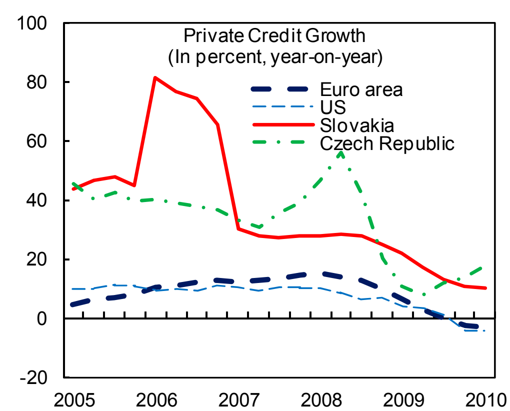
4. **The downturn has, however, exacerbated the unemployment problem**. The Slovak labor market reacted to the external shock and output contraction by wage growth moderation and a deep cut in employment. Employment in the first quarter of 2010 was still around 7 percent below its peak pre-crisis level (in the third quarter of 2008), while output had almost recovered. The unemployment rate rose to about 15 percent in the first quarter of 2010 from less than 9 percent before the crisis (labor force survey data). Unemployment increased particularly among low skill and young workers and in economically-lagging regions, pushing up the already high long-term unemployment rate by 3 percentage points and bringing various structural labor market distortions to the fore.




Sources: ECB; Haver Analytics; and IMF staff calculations.

5. **Credit has continued to grow, but at a much slower rate than before the crisis**. The slowdown reflects tougher lending standards, but also lower demand; there are no indications of a generalized credit crunch. Moreover, Slovakia has benefited from the interest rate cuts by the ECB. Until the start of 2010, real exchange rate appreciation mostly offset the effects of a lower interest rate. In the first half of 2010, a weaker euro was accompanied by real exchange rate depreciation, contributing to supporting monetary conditions.

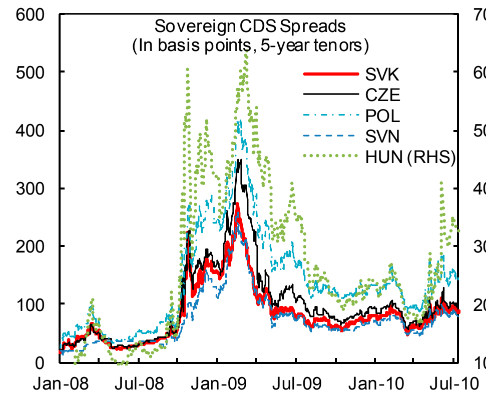



Sources: Haver Analytics, and IMF staff calculations.

## Box 1. The Impact of the Euro Adoption

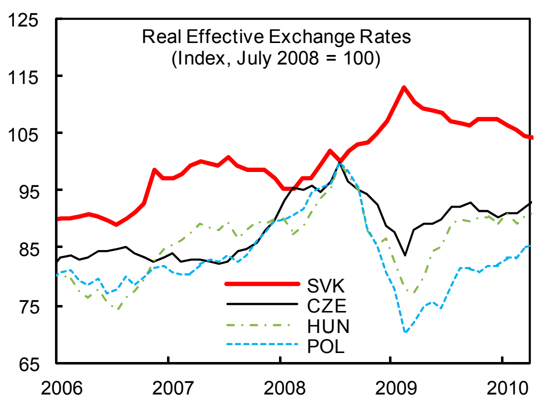
**Euro adoption has benefited Slovakia by enhancing the policy regime and increasing stability**. To fulfil euro convergence critera, Slovakia improved its macroeconomic management, strengthened fiscal discipline, and undertook various structural reforms, including tax and labor market reforms. Euro adoption itself has increased market confidence and diminished exchange rate risks.

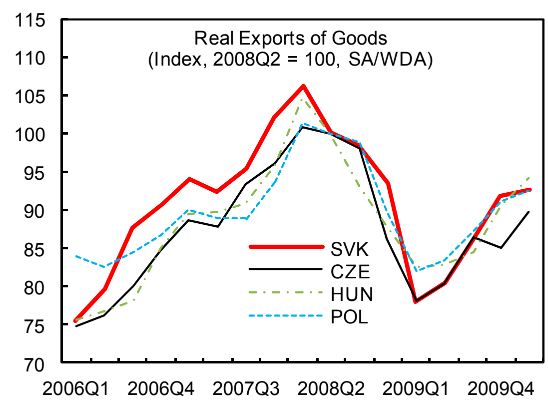
**Thus, market confidence was maintained during the crisis.** Slovakia's sovereign debt CDS spreads remained low relative to similar economies, even during the spike in rates in early 2009 and during the recent sovereign debt crisis. Slovakia has successfully placed euro-denominated domestic and eurobonds at yields significantly below those of both neighboring non-euro area countries and peripheral euro area members. Going forward, euro adoption will facilitate deeper integration of Slovakia's domestic bond market. Although euro adoption has led to losses of foreign exchange trading revenues in the banking sector,[1] it had no major impact on its soundness, and reduced exchange rate risks.




Source: Datastream.

**Euro adoption has been accompanied by real exchange rate appreciation, although the impact on exports appears limited**. During the second half of 2008, Slovakia's REER appreciated by about 15 percent, in part reflecting a sharp depreciation in its main CEE trading partners. Nevertheless, export performance has been relatively similar. Exports of goods declined by about 20 percent in all four Visegrad countries before gradually recovering, and net exports' contribution to growth has been similar (except Hungary). Moreover, the risk that price adjustments at the time of euro adoption would push up inflation and the REER did not materialize, and the REER depreciated again in the first half of 2010 in tandem with broader euro movements.




Sources: Haver Analytics; and IMF staff calculations.

**Looking ahead, while euro adoption has provided benefits, the travails of euro zone peripherals are reminders of the importance of sound macroeconomic policies**. Giving up monetary policy and exchange rate tools reduces flexibility and places greater emphasis on sound fiscal and structural policies. Extra care should be given to enhancing economic flexibility and reducing vulnerabilities. As exemplified during the recent sovereign risk tensions in peripheral euro area countries with weak fiscal positions, membership of a monetary union by itself cannot prevent a loss of market confidence and can complicate the response to it.

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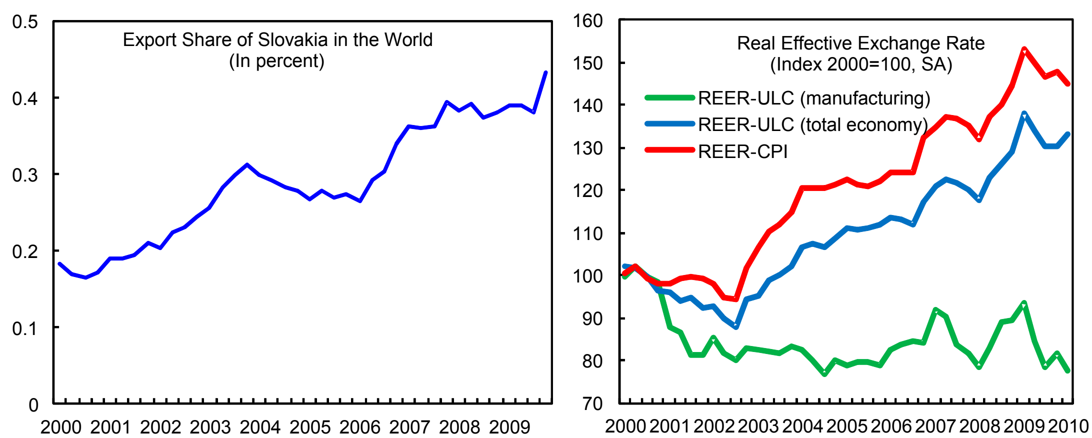
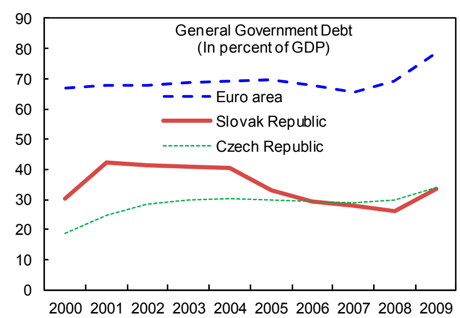
[1] Profits from foreign exchange trading dropped 77 percent to 72 million euros in 2009.

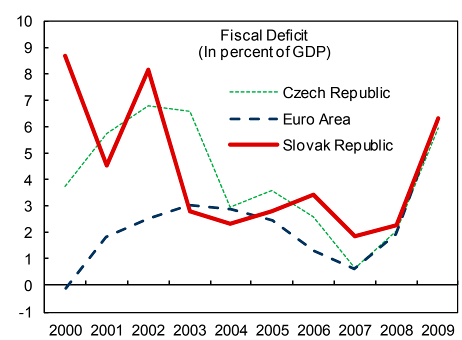
6. **Competitiveness has been maintained and the current account deficit has narrowed sharply**. The deficit fell from 6.5 percent of GDP in 2008 to 3.2 percent of GDP in 2009. As in other Visegrad countries, a steep drop in imports surpassed that in exports, reflecting the economic downturn and vanishing FDI-related imports. The plunge in FDI and profits also resulted in a drop in net investment income outflows, from 5.4 to 3.8 percent of GDP. However, the 2009 export contraction did not reflect a loss of competitiveness. The real effective exchange rate in unit labor cost terms has remained broadly stable, reflecting strong productivity growth in the tradable sector. CGER calculations suggest that the real exchange rate is broadly in equilibrium, exports rebounded in the first half of 2010, and Slovakia further increased its market share in global exports.




Sources: IMF, DOTS; OECD; and Haver Analytics.

7. **The deterioration in the fiscal position is a major concern**. While spending continued to expand at its fast pre-crisis pace during the crisis, tax revenue fell even more than output. A discretionary stimulus on the order of ½ percentage point of GDP added to the 2009 deficit, which swelled to 7¼ percent of GDP. As potential output has also declined, most of the revenue loss relative to the pre-crisis trend is permanent, and the 2009 structural deficit is estimated at about 6 percent of GDP. Developments in the first half of the year, a further weakening in corporate tax revenue collection in spite of the recovery in particular, indicate that without correction the 2010 deficit will reach almost 8 percent of GDP. Nevertheless, market confidence has remained intact even during the recent turmoil in peripheral euro area countries, reflecting the still relatively low public debt and expectations that the new government will tackle the fiscal deterioration through a credible consolidation.



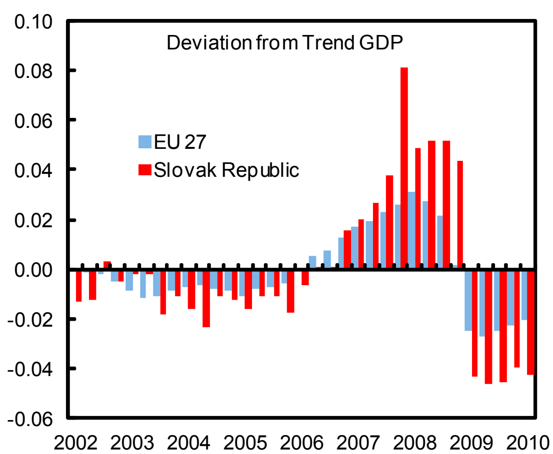




Sources: IMF, WEO; and IMF staff calculations.

## II. Outlook

8. **An improved global outlook will help the continued recovery**. Real GDP growth is projected at about 4 percent in 2010 and about 4¼ percent in the following years. The relatively large improvement in 2010 compared with 2009 in part is due to a base effect (about 2 percentage points), but also reflects continued recovery. A rebound in external demand is the main driving source, along with some firming of investment and consumption. Unemployment is projected to decline gradually, as jobs lost in the manufacturing sector are gradually reestablished. However, long-term unemployment will likely remain high. In line with the recovery in global and domestic demand and reflecting Balassa-Samuelson effects, inflation is projected to rise moderately in 2010–11, approaching 3 percent over the medium-term.

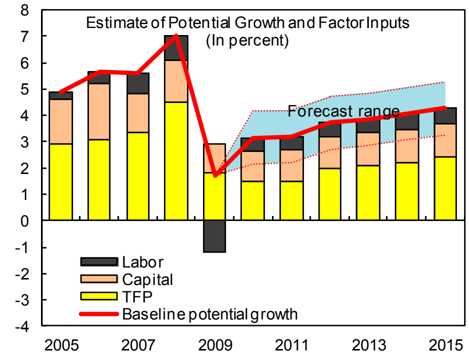
9. **The 2010 projection is supported by favorable high frequency indicators, but external and domestic risks remain substantial**. Industrial production has been growing steadily since spring 2009, surveys of consumer and industrial confidence indicators show continued improvement, and industrial employment has begun to recover since March 2010. But the projected rebound will depend on the strength of the recovery in the EU, to which Slovakia is closely linked, and in Germany in particular. In this regard, sovereign debt risk and possibly accelerated fiscal consolidation in the euro area create an exceptionally uncertain external environment. Domestically, sluggish bank lending, a further decline in real estate prices, and loss of fiscal credibility could also have a negative impact.



Source: IMF staff estimates.

10. **While the authorities generally shared staff's short-term outlook, they emphasized the risks**. They expressed concerns about a possibly weaker-than-projected global recovery and about the pace of improvement in the labor market and the prospect of a jobless recovery in particular. Staff concurred that downside risks are large, but was more upbeat on the employment outlook overall, based on the rebound in industrial production, wage moderation, and the relatively high flexibility of the labor market. However, staff acknowledged that the projected resumption of steady growth would do little to bring down structural unemployment.

11. **The authorities and staff agreed that the recession represents a permanent loss of potential output and lower potential growth**. While the uncertainty around any estimate of potential output during a crisis is wide, preliminary estimates suggest that the economy's

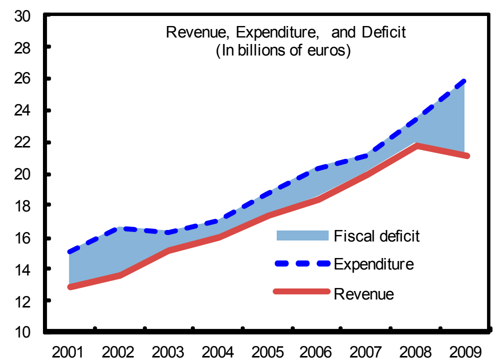


Source: IMF staff estimates.

potential output declined by about 8 percent during 2009–10. The potential growth rate is estimated to have declined from 5–6 percent before the crisis to around 1¼ percent in 2009 and around 3 percent in 2010–12, due to an increase in structural unemployment, reduced FDI inflows, and lower TFP growth. Potential growth should recover and rebound to around 4 percent in the medium term.

## III. Fiscal Policy

12. **Relatively sound fiscal policies in the pre-crisis period helped contain the deficit and bring down the public debt**. Rapid pre-crisis growth allowed Slovakia to reduce revenue collection as a share of GDP, while maintaining room for strong expenditure growth in real terms and for deficit reduction. General government revenue and general government expenditure as a share of GDP dropped by around 6 percent and around 10 percent, respectively, during 2001–08, and hence the general government deficit was brought down from 6½ percent of GDP in 2001 to 2¼ percent of GDP in 2008.



Sources: IMF, WEO; and IMF staff calculations.

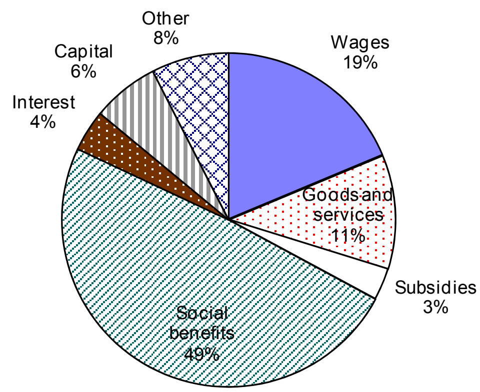
13. **However, the crisis has pushed the deficit to an unsustainable level**. The crisis-induced deterioration in the fiscal position is mostly structural, and requires a policy response. The structural deficit is projected further to widen from less than 6 percent in 2009 to around 7 percent this year. Staff recommended tight expenditure control for the remainder of 2010 to limit the widening of the deficit. The authorities concurred, but noted that with the year more than half over only a limited reduction in the deficit could be achieved, and that the focus should be on the 2011 budget. With the benefit of hindsight of the crisis and the associated sharp deterioration in the underlying fiscal position, additional pre-crisis deficit reduction could have provided more cushion during the downturn.

14. **The authorities expressed a strong commitment to fiscal consolidation starting in 2011 and aimed at bringing down the deficit to below 3 percent of GDP by 2013**. The authorities envisage a front-loaded adjustment of about 2½ percent of GDP in 2011, which will bring the deficit down to almost 4 percent of GDP. The new government further wants to reduce the deficit to below the Maastricht norm and bring the negative debt dynamics to an end in 2013, its last full year in office. Staff agreed with the planned adjustment, and concurred that this size of adjustment should not impede further economic recovery and

would reassure investors. However, according to staff's projections, the 2011 deficit would be closer to 5 percent of GDP.

15. **The magnitude of the planned 2011 adjustment will be challenging and require a combination of expenditure and revenue measures**. Staff suggested that expenditure curbs could focus on the largest expenditure categories consisting of wages and social benefits (including pensions)—almost 70 percent of public expenditures. Steps could include temporarily freezing, in nominal terms, public sector wages, pensions, and some social benefits, and restraining local government outlays. So far, spending on these items had continued to grow at high pre-crisis rates, crowding out other government spending and absorbing an ever-larger share of GDP. With regard to revenue, staff advised the authorities to consider hiking rates—the VAT rate, which at 19 percent is low relative to neighboring countries, in particular. Other steps could include eliminating exemptions in corporate and income taxes, VAT and social contributions; and lifting the income ceiling on social security contributions. Some of these suggestions, such as eliminating exemptions, are incorporated in the new government's program submitted to Parliament in early August 2010; others, including changes in the VAT rate, are left for consideration in the preparation of the 2011 budget.

Expenditures by Category, 2010




Sources: NBS, and IMF staff estimates.

16. **Staff recommended focusing the 2012–13 adjustment effort on the expenditure side**. To increase stability and reduce uncertainty in the tax environment facing businesses, staff recommended avoiding tax policy changes beyond 2011. With regard to expenditures, staff suggested that an expenditure growth norm could anchor the consolidation effort beyond 2011. An annual real expenditure growth ceiling of 2 percent or less would gradually eliminate the structural expenditure-revenue gap that emerged with the crisis, and could help achieve the 2013 deficit target. Such an expenditure growth ceiling would usefully be incorporated in the multi-year budget to be presented to Parliament in the fall. Staff also suggested institutional and structural fiscal reforms, notably efforts to strengthen the medium-term budget framework and program budgeting, to facilitate the identification of strategic expenditure policy priorities and their alignment with the recommended aggregate expenditure growth norm. The authorities were open to these suggestions, but argued that they were considering a broader reform of Slovakia's fiscal governance framework in early 2011 and did not want to limit their options for the time being.

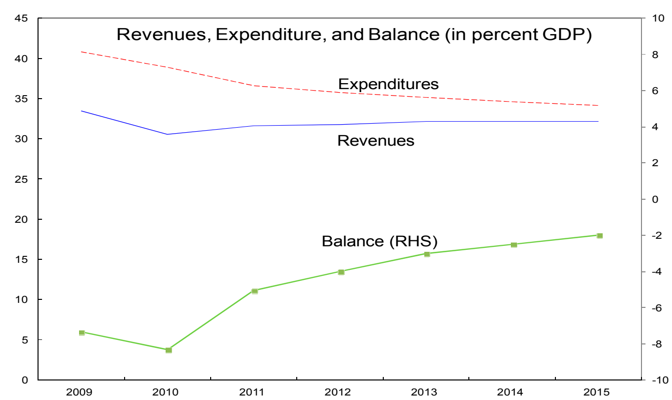
17. **The authorities and staff agreed that other fiscal institutional and structural reforms remained a priority**. Staff indicated that reforms to address unsustainable expenditure dynamics in health care, associated with ineffective cost control and population

aging, in line with recommendations from the IMF,[1] the OECD and the World Bank would be a key. In addition, creating a stable legal and regulatory environment to match the objective of the second pillar pension fund would be important. The authorities pointed to other reforms that are high on their agenda, notably improving public investment planning and implementation, including a re-evaluation of PPPs; strengthening the capacity to absorb EU funds; and unifying the collection of taxes and social security contributions.

## Box 2. Expenditure Rule

**An expenditure rule is particularly suitable to the authorities' plan of reducing the general government deficit through expenditure consolidation**. An expenditure rule can provide a credible and transparent downward deficit path and offer countercyclical fiscal policy. In addition, it is simple to design, implement, and monitor. The rate of expenditure growth can be set according to planned fiscal consolidation paths taking into account rigidities in the budgetary items. The rule is often set in real terms and implemented using a CPI-based deflator to translate into nominal terms. This reduces the effect of an unanticipated inflation shock.

**A ceiling that from 2012 caps annual real expenditure growth at 2 percent would bring the deficit to below three percent of GDP by 2013, based on the projected real GDP growth**.[1] Such an expenditure cap would enhance confidence, while offering simplicity and transparency. Moreover, in combination with a medium-term budget framework, it would facilitate the allocation of medium-term expenditures according to the authorities' objectives, and would leave room for countercyclical fiscal policy. Faster output growth would result in a faster fiscal consolidation, while a negative output shock could translate into a higher temporary deficit, without raising concerns over long-term sustainability.



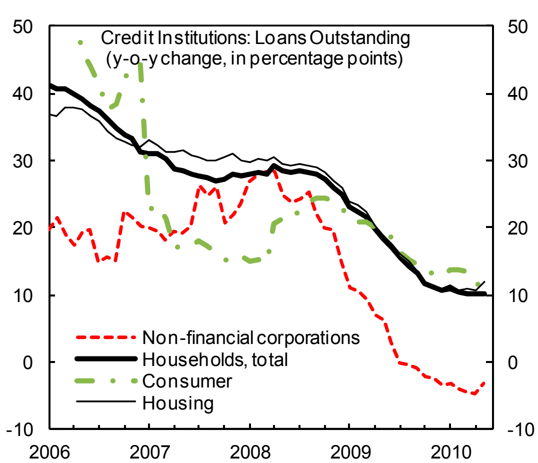

[1] Assumes a fiscal deficit of 5 percent of GDP or less is achieved in 2011.

[1] As discussed in IMF Working Paper No. 07/226 available at http://www.imf.org/external/pubs/cat/longres.cfm?sk=21329.0

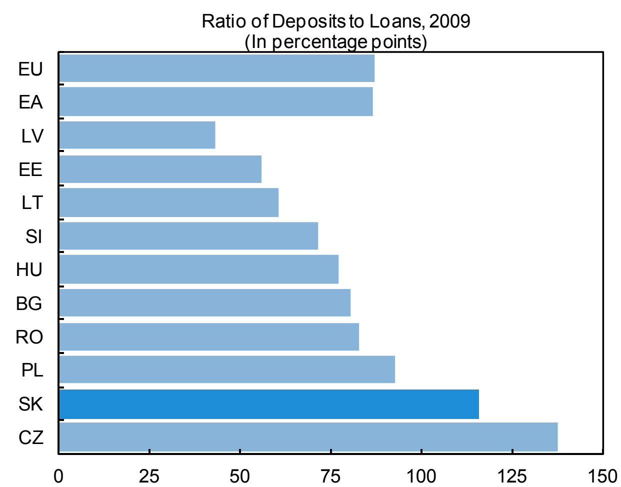
18. **Although growing, public debt is still relatively low**. Public debt as a percent of GDP reached 36 percent by end 2009. The foreign currency component is negligible following euro adoption, and the maturity profile is spread uniformly over the next 10 years. Financing needs have continued to be met easily, at a premium of around 100 basis points above German bunds, and CDS spread have remained low. The domestic financial sector is the main investor in Slovak government bonds, but the authorities plan to diversify the investor basis.

## IV. Financial Sector

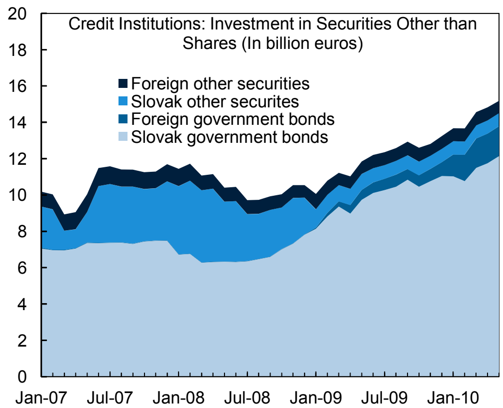
19. **The financial sector is weathering the global financial crisis generally well**. As part of the profits generated in 2009 was added to capital, the sector's capital adequacy ratio has continued to improve, reaching 12.7 percent in March 2010. Liquidity is high, the deposits-to-loans ratio remains above one in the aggregate, and the domestic banking sector is a net creditor vis-à-vis foreign banks. The rise in nonperforming loans (NPL) has begun to slow in early 2010, and, with the exception of some smaller banks, profitability has recovered. Foreign currency exposure has dropped substantially following euro adoption, and exposures to toxic assets and sovereign risk in peripheral euro area members are very limited. Although new lending activity in the corporate and commercial real estate segments remains weak, retail lending, housing loans in particular, is picking up gradually. With corporate and commercial real estate lending stagnating, the composition of bank assets has shifted toward additional investment in government bonds.

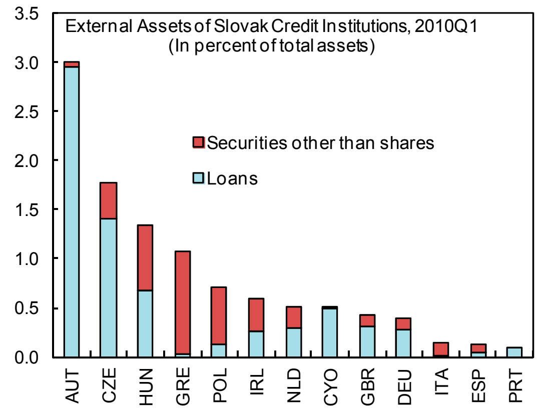



Source: National Bank of Slovakia.




Sources: ECB; and IMF staff calculations.




Source: National Bank of Slovakia.

20. **Stress tests carried out by the National Bank indicate that the banking system in the aggregate is sound and would withstand severe shocks to output and employment**. However, concerns over loans to the corporate and real estate sectors suggest that the ratio of NPL could continue to grow, albeit at a much slower rate. In both the residential and the commercial real estate segments, prices are not expected, in the short term, to recover from the steep price drops last year. The main risk is a further decrease in the quality of commercial real estate loans, which are concentrated among the largest loans in many banking portfolios. Direct exposure to sovereign debt issued outside Slovakia is limited, and domestic banks are expected to be able to cope with indirect risk through exposed parent banks were it to materialize. The National Bank did not directly participate in the EU-wide stress testing exercise, but subsidiaries that account for almost 80 percent of consolidated banking sector assets were assessed as part of their parent bank groups, which all met the capital adequacy threshold. The Bank publishes the aggregate, but not the individual, results of its own stress tests.

21. **The Slovak supervisor expressed concerns about regulatory and supervisory initiatives at the EU level**. The National Bank in its capacity of supervisor saw a risk that (to-be-established) EU-level supervisory authorities could reduce its own authority and flexibility to react to domestic emergencies. In particular, the Bank argued that power to take specific measures in emergencies should not be delegated to a supra-national institution, since it would not face the fiscal consequences of its decisions. Staff pointed out that the EU initiatives responded to serious weaknesses in supervision and crisis management of large banking groups revealed by the crisis, and that on balance they would also benefit Slovakia.

22. **Some commercial banks saw the new EU Directive on deposit insurance and proposed Basel III regulations as ill-suited for the domestic banking sector**. In line with the EU Directive, Slovakia will limit deposit insurance coverage to EUR 100,000, but maintain a full guarantee below this ceiling. The country's largest deposit taking banks argued that, taking into account the limited financial wealth of the average Slovak investor, this new arrangement in practice would continue to provide full unlimited protection, a

source of disadvantage to conservative banks in attracting deposits. According to some of the largest commercial banks, the "one-size-fits-all" approach of some recent EU and Basel III regulatory proposals—notably the treatment of retail deposits and mortgages under the proposed net stable funding ratio—would not be well tailored to the specific characteristics and needs of the Slovak banking sector, which focuses on the transformation of savings deposits into long-term loans. These proposals could be costly to comply with and limit their ability to manage liquidity and provide credit. They also argued that the regulatory uncertainty complicated their operations. Staff indicated that supra-national regulatory initiatives should not be assessed solely from the perspective of a particular country or institution, and that deviations from their uniform applicability in integrated euro area financial markets could encourage distortionary regulatory arbitrage.

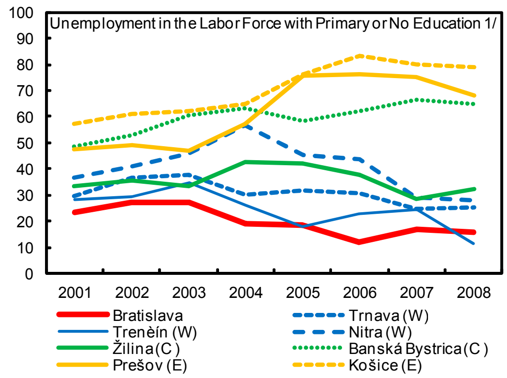
## V. Labor Market and Structural Reforms

23. **Unemployment and its regional dispersion are a major concern**. At around 15 percent, the national unemployment rate is the second highest in the euro area. Unemployment is particularly high and persistent among low skill workers, exceeding 50 percent in some regions with low economic development. Although the minimum wage (EUR 307) is modest in absolute terms, in some regions it is relatively high and can exceed 50 percent of the average wage, representing a significant cost for potential employers. On the other hand, the minimum wage is not much higher than alternative income support benefits, affecting incentives to enter the labor market.

24. **Long term unemployment is likely to remain high and will require sustained and multi-pronged efforts**. Staff recommended that these efforts should include strengthening the orientation of education and vocational programs towards labor market needs, and improving active labor market policies—notably through additional training for young unemployed, better targeted subsidized job creation programs, and more focus on high unemployment regions. Addressing the regional dimension of structural unemployment furthermore will require infrastructure investment in high-unemployment regions, regional wage flexibility, and steps to ease housing and administrative barriers to inter-regional mobility. To ease labor cost and work incentive constraints on the employment of low skill workers, the authorities are considering, and staff supports, a scheme that for these workers combines reduced social security contributions for employers with some in-job benefits for employees. When well designed, the fiscal costs of such a scheme would be limited.

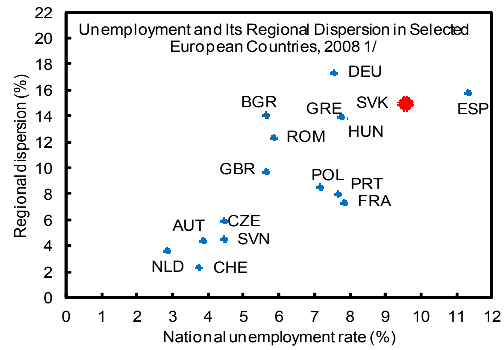
## Box 3. Minimum Wage and Regional Unemployment

**Slovak regions with lower economic development also experience higher unemployment**. Disposable income in the high-unemployment eastern regions is about 25 percent lower than in the western regions. Moreover, unemployment among low skill workers had continued to increase in these regions during 2002–08, despite robust growth. Low income and high unemployment in some regions can be attributed to a lack of infrastructure and capital,[1] low human capital, labor markets distortions, and limited labor mobility.[2]




Sources: National authorities; and IMF staff calculations.
1/ "C" stands for central regions, "E" - eastern regions, and "W" - western regions of Slovakia.

**The minimum wage stands out as high in some regions**. It is uniformly set and exceeds 50 percent of the average wage in some districts. For example, in Bratislava the minimum wage is about 20 percent of the average wage, and unemployment is low. In some other districts the minimum wage exceeds 50 percent of the average wage, and the unemployment rate is near 20 percent—and significantly higher (almost 80 percent) among low skill workers for which the minimum wage is more binding. Although, in general, the impact of the minimum wage on unemployment is not clearly manifest, at such a high fraction of the average wage, it is likely to be important.



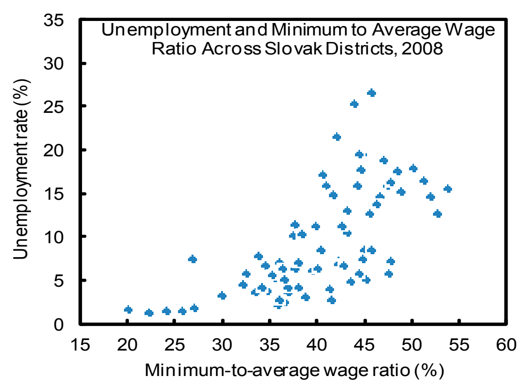

Sources: Eurostat; and IMF staff calculations.
1/ Regional dispersion is the difference between maximum and minimum unemployment rates in the regions.

**An empirical investigation suggests that a higher minimum wage raises unemployment relative to Bratislava**. For example, an increase in the minimum-to-average wage ratio by 10 percent is associated with a 1.2 percentage point rise in the unemployment rate in a region with 20 percent unemployment rate.

Regression Analysis: Minimum Wage and Unemployment

| Dependent variable: Δlog of unemployment rate | coef. | s.e. |
|---|---|---|
| Δlog of minimum-to-average wage ratio | 0.61 | (0.15) *** |
| Δlog of unemployment rate in Bratislava | 0.60 | (0.04) *** |
| Constant term | -0.04 | (0.01) *** |
| R^2 | 0.26 | |
| Sample: 79 districts, 2001-2008 | | |

Source: IMF staff calculations.
Notes: *** indicates 1 percent statistical significance.

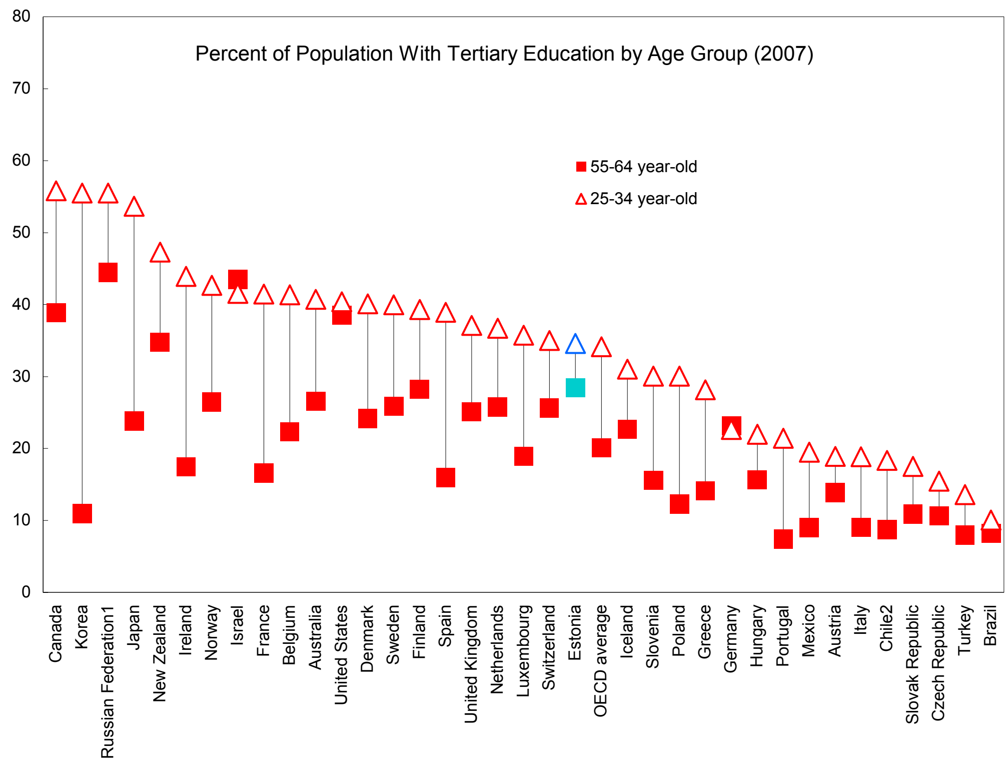



Sources: National authorities; and IMF staff calculations.

[1] Infrastructure level and FDI inflows are better in the western regions (Banerjee, Biswajit, and Mariusz Jarmuzek, 2009, "Anatomy of Regional Disparities in the Slovak Republic," IMF Working Paper 09/145).

[2] Migration flows between regions are half those in Sweden and Netherlands (Cseres-Gergely, Zsombor, 2002, "Residential Mobility, Migration, and Economic Incentives—The Case of Hungary in 1990–1999," Budapest Working Papers on the Labour Market No. 0207).

25. **Staff argued that the educational system, higher education and vocational training in particular, needed to be improved**. The share of workers with higher education is low—15 percent of the labor force compared with, on average, 21 percent in other central and eastern European (CEE) countries. Moreover, public expenditures per student, as a share of GDP per capita, are lower in Slovakia than in other CEE countries. At the same time, the pupil-teacher ratio in secondary schools is among the highest in CEE countries, and tertiary education is mostly focused on universities, with access to technical colleges lacking. Reform priorities include strengthening the orientation of education and vocational programs towards labor market needs, and improving the scope and quality of tertiary education and strengthening professional training at the tertiary level.




Source: OECD, Table A1.3a.

26. **Public sector governance needs to be strengthened, including through reforming procurement and the use of EU funds**. Cross-country indicators of public sector governance such as Transparency International's *Corruption Index* and the World Bank's *Governance Indicators* suggest a lack of improvement in recent years, both in absolute terms and relative to other CEE countries. Business environment surveys consistently express concern about corruption, which is seen as among the most severe impediments to doing business in Slovakia. Some widely publicized procurement and use of EU funds scandals appear to have contributed to this perception, and reform in these two areas is a priority. The authorities shared these concerns, and indicated that they intend to make major efforts to improve public sector governance more in general.

## VI. Staff Appraisal

27. **Slovakia is emerging steadily from a deep recession**. A large export-oriented manufacturing sector exacerbated the impact of the global downturn, but also drives the recovery as global export demand is rebounding. Following a contraction by almost 5 percent last year, real GDP is projected to expand by about 4 percent in 2010—among the highest in the European Union.

28. **Notwithstanding the overall upbeat outlook, downside risks are substantial**. In particular, external developments, especially in the rest of the euro area, could be less favorable than expected. Domestically, sluggish bank lending, a further decline in real estate prices, and loss of fiscal credibility could have a negative impact.

29. **Slovakia has maintained its external competitiveness in recent years**. CGER indicators suggest that the real exchange rate is broadly in equilibrium, real wages grew in line with productivity, and Slovakia's market share in global exports has continued to increase. Euro adoption in the middle of the crisis resulted in real exchange rate appreciation vis-à-vis neighboring countries with weakening currencies, but the impact on exports was limited. With inflation in June 2010 among the lowest in the euro area, concerns that euro adoption would raise inflation and result in real exchange rate appreciation have been alleviated for the near future. However, competitiveness cannot be taken for granted in the monetary union, and prudent fiscal and financial policies and sustained structural reforms will be needed if it is to be maintained.

30. **The underlying fiscal position has weakened considerably, and the deficit has widened to an unsustainable level**. Spending has continued to expand at its fast pre-crisis pace through the first half of 2010, while tax revenue fell by even more than output. This crisis-induced deterioration in the fiscal position is mostly structural and requires a policy response. Nevertheless, the scope for policy interventions in the remainder of the year is limited, and the focus now should be on 2011.

31. **The 2011 budget should initiate a multi-year fiscal adjustment aimed at bringing down the deficit to below 3 percent of GDP by 2013**. Anchoring the adjustment within a credible multi-year consolidation strategy will help spread the adjustment burden and enhance market confidence. With the 2011 deficit projected to exceed 7 percent of GDP without correction, an adjustment of about 2 ½ percent of GDP would offer a proper balance between the dual objectives of ensuring fiscal sustainability and not impeding the recovery. However, this adjustment will be challenging, and require a combination of expenditure and revenue measures. Expenditure cuts could focus on items that have continued to grow at high pre-crisis rates. The authorities also could hike the VAT rate, which is low relative to neighboring countries; eliminate exemptions; and lift the income ceiling on social security contributions.

32. **To anchor the fiscal consolidation strategy after 2011, expenditure growth should be capped**. An annual real expenditure growth ceiling of 2 percent or less would gradually correct the spending-revenue gap that emerged from the crisis and achieve the 2013 deficit target. An effective medium-term budget framework and program budgeting would facilitate achieving strategic expenditure policy priorities consistent with the expenditure growth norm.

33. **Additional fiscal institutional and structural reforms remain a priority**. Reforms that address unsustainable expenditure dynamics in health care, improve public investment planning and implementation, strengthen the capacity to absorb EU funds, and unify the collection of taxes and social security contributions should be high on the agenda. Finally, a stable legal and regulatory environment to match the objectives of the second pillar pension funds should be created.

34. **Long-term unemployment will remain high and require multi-pronged efforts**. These should include expediting EU funds absorption and improving capital expenditures in high-unemployment regions, strengthening the orientation of education and vocational programs towards labor market needs, and enhancing active labor market policies. In addition, a combination of reduced social security contributions and some in-job benefits for low skill workers could be considered.

35. **Broader educational reforms and steps to improve the business environment will help support medium-term growth and rapid convergence**. Improving the scope and quality of tertiary education and strengthening professional training at the tertiary level are priorities. Public sector governance issues, deficiencies with respect to public procurement in particular, also need to be addressed.

36. **The financial sector is weathering the global financial crisis generally well, as manifested in the most recent stress tests**. Reflecting a focus on traditional domestic banking activities and cautious lending practices, Slovak banks, mostly subsidiaries of foreign banks, are in the aggregate well-capitalized, liquid and profitable, and have very limited exposure to sovereign risk in peripheral euro area members. Nevertheless, further losses on lending to the corporate and commercial real estate sectors need to be carefully monitored.

37. **With mostly foreign-owned banks, strong cross-border supervisory cooperation will continue to be the key**. Slovak supervisory authorities will have to help ensure effective cooperation and coordination with to-be-established EU-level supervisory institutions in particular. However, it will be important that the authorities also continue to strengthen regulation and supervision at the national level. Both the supervisory authorities and the banking sector will have to prepare for new supra-national regulations which could be costly or restrictive for some banks, but, on balance, will benefit the sector and the country.

38. **It is recommended that the Article IV consultation with Slovakia remain on the standard 12-month cycle**.

Table 1. Slovak Republic: Summary of Economic Indicators, 2006-15

| | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
| | (Annual percentage change, constant prices, unless noted otherwise) | | | | | | | | | |
| Real GDP | 8.5 | 10.6 | 6.2 | -4.7 | 4.1 | 4.3 | 4.4 | 4.3 | 4.2 | 4.2 |
| Domestic demand | 6.6 | 6.5 | 6.0 | -6.2 | 3.3 | 3.9 | 4.2 | 4.2 | 4.1 | 4.1 |
| Public consumption | 9.7 | 0.1 | 5.3 | 2.8 | 3.3 | -1.2 | 2.0 | 2.0 | 2.0 | 2.0 |
| Private consumption | 5.9 | 6.9 | 6.0 | -0.7 | 1.3 | 3.8 | 4.1 | 4.0 | 4.0 | 4.0 |
| Gross capital formation | 6.1 | 9.7 | 6.5 | -21.4 | 7.9 | 7.6 | 6.0 | 6.0 | 5.5 | 5.4 |
| Net exports (contributions to growth) | 2.1 | 4.7 | 0.2 | 0.5 | 0.7 | 0.6 | 0.3 | 0.3 | 0.4 | 0.4 |
| Exports of goods and services | 21.0 | 14.3 | 3.2 | -16.5 | 14.0 | 8.2 | 6.6 | 6.0 | 5.5 | 5.5 |
| Imports of goods and services | 17.8 | 9.2 | 3.1 | -17.6 | 13.8 | 7.9 | 6.6 | 6.0 | 5.4 | 5.4 |
| Prices | | | | | | | | | | |
| Inflation (CPI) | 4.3 | 1.9 | 3.9 | 0.9 | 0.7 | 1.9 | 2.4 | 2.6 | 2.8 | 2.8 |
| Inflation (CPI, end of period) | 3.5 | 2.3 | 3.4 | 0.0 | 1.0 | 2.0 | 2.6 | 2.6 | 2.8 | 2.8 |
| Employment and wages | | | | | | | | | | |
| Employment | 3.8 | 2.4 | 3.2 | -2.8 | -1.8 | 2.1 | 1.5 | 1.2 | 1.0 | 1.0 |
| Nominal wages | 6.7 | 6.4 | 7.6 | 2.4 | 3.5 | 7.0 | 6.3 | 6.0 | 6.0 | 6.0 |
| Unemployment rate (percent) | 13.3 | 11.0 | 9.6 | 12.1 | 14.1 | 12.7 | 11.6 | 10.7 | 9.9 | 9.1 |
| | (In percent of GDP) | | | | | | | | | |
| Public Finance, General Government | | | | | | | | | | |
| Revenue | 33.5 | 32.5 | 32.5 | 33.5 | 30.8 | 31.9 | 32.2 | 32.3 | 32.4 | 32.5 |
| Expenditure | 36.9 | 34.4 | 34.8 | 40.8 | 38.9 | 36.6 | 35.9 | 35.3 | 34.7 | 34.2 |
| Overall balance | -3.5 | -1.9 | -2.3 | -7.3 | -8.0 | -4.7 | -3.7 | -2.9 | -2.3 | -1.8 |
| Primary balance | -2.0 | -0.5 | -1.1 | -5.8 | -6.5 | -2.8 | -1.8 | -1.0 | -0.4 | 0.1 |
| Structural balance (percent of potential GDP) | -3.9 | -2.6 | -2.8 | -5.8 | -6.9 | -4.1 | -3.4 | -2.7 | -2.3 | -1.8 |
| General government debt | 30.5 | 29.3 | 27.7 | 35.7 | 41.8 | 44.0 | 45.0 | 45.2 | 44.8 | 43.9 |
| | (In percent) | | | | | | | | | |
| Monetary and financial indicators | | | | | | | | | | |
| Credit to private sector (growth rate) | 25.2 | 25.4 | 19.2 | 4.4 | | | | | | |
| Lending rates 1/ | 9.2 | 9.3 | 8.1 | 6.9 | | | | | | |
| Deposit rates 2/ | 0.9 | 0.8 | 0.7 | 0.3 | | | | | | |
| Government 10-year bond yield | 4.4 | 4.5 | 4.7 | 4.7 | | | | | | |
| | (In percent of GDP) | | | | | | | | | |
| Balance of payments | | | | | | | | | | |
| Trade balance (goods) | -4.7 | -1.2 | -1.1 | 1.9 | 1.1 | 1.0 | 0.9 | 1.0 | 1.1 | 1.1 |
| Current account balance | -7.8 | -5.3 | -6.6 | -3.2 | -1.4 | -2.6 | -2.5 | -2.5 | -2.2 | -2.3 |
| Gross external debt | 51.0 | 54.5 | 56.1 | 71.6 | 69.1 | 66.8 | 63.9 | 61.3 | 58.8 | 56.5 |

Sources: National Authorities; and IMF staff calculations.

1/ Loans of up to one year, average to households and nonfinancial corporations.

2/ Average of interest rates on overnight deposits from households and nonfinancial corporations.

Table 2. Slovak Republic: Fiscal Operations of the Consolidated General Government with Measures, 2006-15
(In percent of GDP)

| | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
| Total revenue | 33.5 | 32.5 | 32.5 | 33.5 | 30.8 | 31.9 | 32.2 | 32.3 | 32.4 | 32.5 |
| Tax revenue | 17.2 | 17.2 | 16.6 | 16.3 | 15.4 | 16.4 | 16.5 | 16.6 | 16.7 | 16.7 |
| Taxes on production and imports | 11.2 | 11.0 | 10.4 | 10.3 | 9.7 | 10.4 | 10.5 | 10.6 | 10.6 | 10.6 |
| Taxes on income and wealth | 6.1 | 6.2 | 6.2 | 6.0 | 5.7 | 6.0 | 6.0 | 6.1 | 6.1 | 6.1 |
| Social contributions | 11.9 | 11.8 | 11.7 | 12.8 | 12.0 | 12.2 | 12.3 | 12.4 | 12.4 | 12.4 |
| Grants and transfers | 1.5 | 0.5 | 1.3 | 2.3 | 1.7 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Total expenditure | 36.9 | 34.4 | 34.8 | 40.8 | 38.9 | 36.6 | 35.9 | 35.3 | 34.7 | 34.2 |
| Current expenditure | 34.0 | 31.7 | 31.5 | 36.9 | 36.4 | 34.5 | 33.8 | 33.2 | 32.7 | 32.2 |
| Compensation of employees | 7.4 | 6.8 | 6.6 | 7.8 | 7.3 | 6.8 | 6.6 | 6.5 | 6.4 | 6.3 |
| Goods and services | 5.7 | 4.6 | 5.0 | 5.3 | 4.3 | 4.1 | 4.0 | 4.0 | 3.9 | 3.8 |
| Transfers | 14.9 | 14.3 | 14.2 | 17.0 | 23.2 | 22.1 | 21.7 | 21.3 | 21.0 | 20.7 |
| Subsidies | 1.3 | 1.2 | 1.7 | 1.6 | 1.2 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 |
| Social benefits | 11.9 | 11.6 | 11.3 | 13.6 | 13.4 | 12.8 | 12.6 | 12.3 | 12.2 | 12.0 |
| Other | 6.0 | 6.0 | 5.6 | 6.7 | 1.5 | 1.5 | 1.5 | 1.5 | 1.4 | 1.4 |
| Capital spending | 3.0 | 2.7 | 3.3 | 3.9 | 2.5 | 2.1 | 2.1 | 2.0 | 2.0 | 2.0 |
| Capital assets | 1.9 | 1.7 | 1.7 | 2.3 | 1.6 | 1.3 | 1.3 | 1.2 | 1.2 | 1.2 |
| Capital transfers | 1.1 | 1.0 | 1.6 | 1.6 | 1.0 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 |
| **Overall balance** | **-3.5** | **-1.9** | **-2.3** | **-7.3** | **-8.0** | **-4.7** | **-3.7** | **-2.9** | **-2.3** | **-1.8** |
| Primary balance | -2.0 | -0.5 | -1.1 | -5.8 | -6.5 | -2.8 | -1.8 | -1.0 | -0.4 | 0.1 |
| Gross public debt | 30.5 | 29.3 | 27.7 | 35.7 | 41.8 | 44.0 | 45.0 | 45.2 | 44.8 | 43.9 |
| Memorandum items: | | | | | | | | | | |
| Nominal GDP, million euros | 55,046 | 61,548 | 67,221 | 63,333 | 66,774 | 71,175 | 75,914 | 80,791 | 85,968 | 91,420 |

Sources: Ministry of Finance; and IMF staff estimates and projections.

Table 3. Slovak Republic: Medium-term Balance of Payments, 2006-15
(In millions of euros, unless otherwise indicated)

| | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
| Current account balance | -4,316 | -3,240 | -4,433 | -2,023 | -907 | -1,855 | -1,913 | -1,994 | -1,922 | -2,057 |
| Trade balance (goods) | -2,562 | -725 | -758 | 1,187 | 740 | 745 | 663 | 843 | 980 | 1,013 |
| Exports, f.o.b. | 40,892 | 47,351 | 49,522 | 39,716 | 46,481 | 52,087 | 56,623 | 60,902 | 65,279 | 69,899 |
| Imports, f.o.b. | -43,454 | -48,076 | -50,280 | -38,529 | -45,742 | -51,343 | -55,960 | -60,059 | -64,300 | -68,886 |
| Services balance | 727 | 424 | -457 | -1,244 | -546 | -1,850 | -1,887 | -2,167 | -2,312 | -2,480 |
| Receipts | 5,311 | 5,743 | 5,999 | 4,518 | 5,107 | 5,151 | 5,600 | 6,023 | 6,456 | 6,913 |
| Payments | -4,584 | -5,319 | -6,456 | -5,762 | -5,653 | -7,001 | -7,487 | -8,190 | -8,768 | -9,394 |
| Income balance | -2,427 | -2,571 | -2,325 | -1,291 | -1,400 | -1,450 | -1,450 | -1,450 | -1,450 | -1,450 |
| Receipts | 2,026 | 1,989 | 2,393 | 1,970 | 1,900 | 2,150 | 2,200 | 2,250 | 2,300 | 2,350 |
| Payments | -4,472 | -4,571 | -4,688 | -3,258 | -3,300 | -3,600 | -3,650 | -3,700 | -3,750 | -3,800 |
| Current transfers | -54 | -368 | -893 | -676 | 300 | 700 | 760 | 780 | 860 | 860 |
| Capital and financial account balance | 1,450 | 6,245 | 5,946 | 3,422 | 907 | 1,855 | 1,913 | 1,994 | 1,922 | 2,057 |
| Capital account | -40 | 377 | 806 | 464 | 484 | 504 | 524 | 544 | 564 | 584 |
| Direct foreign investment | 4,122 | 2,444 | 2,236 | -347 | 1,172 | 1,651 | 2,127 | 2,203 | 2,278 | 2,351 |
| Reinvested earnings | 933 | 586 | 558 | 499 | | | | | | |
| Portfolio investment | 1,601 | -585 | 1,671 | -928 | 500 | 530 | 560 | 590 | 620 | 650 |
| Other investment | -4,073 | 3,961 | 1,352 | 3,967 | -1,250 | -829 | -1,298 | -1,343 | -1,540 | -1,528 |
| Reserve assets 1/ | 2,592 | -3,186 | 113 | 567 | … | … | … | … | … | … |
| Errors and omissions | 2,866 | -3,005 | -1,436 | -1,399 | … | … | … | … | … | … |
| Overall balance | -2,592 | 3,186 | -113 | -567 | … | … | … | … | … | … |
| Financing | 2,592 | -3,186 | 113 | 567 | … | … | … | … | … | … |
| Gross reserves (negative indicates increase) | 2,592 | -3,186 | 113 | 567 | … | … | … | … | … | … |
| Memorandum items: | (In percent of GDP, unless otherwise indicated) | | | | | | | | | |
| Current account balance | -7.8 | -5.3 | -6.6 | -3.2 | -1.4 | -2.6 | -2.5 | -2.5 | -2.2 | -2.3 |
| Trade balance (G&NFS) | -3.3 | -0.5 | -1.8 | -0.1 | 0.3 | -1.6 | -1.6 | -1.6 | -1.5 | -1.6 |
| Merchandise export volume (percent change) | 22.1 | 15.1 | 3.7 | -15.5 | 12.9 | 8.2 | 6.6 | 6.0 | 5.5 | 5.5 |
| Value (percent change) | 23.5 | 14.9 | 4.6 | -20.3 | 16.6 | 11.0 | 8.7 | 7.6 | 7.2 | 7.1 |
| Merchandise import volume (percent change) | 19.0 | 8.6 | 1.5 | -18.7 | 13.8 | 7.9 | 6.6 | 6.0 | 5.4 | 5.4 |
| Terms of trade (percent change from previous year) | -5.0 | -2.7 | -6.0 | 5.5 | … | … | … | … | … | … |
| Income balance | -4.4 | -4.2 | -3.5 | -2.0 | -2.1 | -2.0 | -1.9 | -1.8 | -1.7 | -1.6 |
| Current transfers | -0.1 | -0.6 | -1.3 | -1.1 | 0.4 | 1.0 | 1.0 | 1.0 | 1.0 | 0.9 |
| Total external debt (billion euros) | 24.5 | 30.1 | 37.7 | 45.3 | 46.2 | 47.5 | 48.5 | 49.6 | 50.5 | 51.6 |
| Total external debt (in percent of GDP) | 51.0 | 54.5 | 56.1 | 71.6 | 69.1 | 66.8 | 63.9 | 61.3 | 58.8 | 56.5 |
| GDP (euro millions) | 55,046 | 61,548 | 67,221 | 63,333 | 66,774 | 71,175 | 75,914 | 80,791 | 85,968 | 91,420 |

Sources: National Bank of Slovakia; and IMF staff estimates.
1/ Does not include the transfer of reserve assets from the NBS to the ECB which took place in 2009.

Table 4. Slovak Republic: Financial Soundness Indicators for the Banking Sector, 2008-10

(In percent, unless otherwise indicated)

| | 2008 | 2009 | Mar-10 |
|---|---|---|---|
| Capital Adequacy | | | |
| Regulatory capital to risk-weighted assets | 11.1 | 12.6 | 12.7 |
| Regulatory Tier 1 capital to risk-weighted assets | 10.7 | 11.4 | 11.5 |
| Capital to assets | 8.2 | 9.6 | 9.7 |
| Asset Composition and Quality | | | |
| Nonperforming loans to gross loans | 2.5 | 5.3 | 5.8 |
| Nonperforming loans net of provisions to capital | 6.7 | 14.3 | 15.7 |
| Customer deposits to total (noninterbank) loans | 98.9 | 117.3 | 115.4 |
| Earnings and Profitability | | | |
| Return on assets (after tax) | 1.2 | 0.6 | 1.1 |
| Return on equity (after tax) | 15.4 | 6.7 | 11.5 |
| Interest margin to gross income | 65.9 | 76.8 | 73.8 |
| Noninterest expenses to gross income | 57.3 | 62.3 | 55.7 |
| Liquidity | | | |
| Liquid assets to total assets | 52.1 | 43.4 | 41.8 |
| Liquid assets to short-term liabilities | 65.0 | 57.3 | 57.9 |
| Sectoral distribution of loans to total loans | | | |
| Residents | 95.6 | 93.4 | 93.8 |
| Deposit-takers | 0.3 | 0.1 | 0.1 |
| Central bank | 22.2 | 0.0 | 0.0 |
| Other financial corporations | 4.6 | 4.2 | 3.5 |
| General government | 1.9 | 2.6 | 2.6 |
| Nonfinancial corporations | 36.1 | 44.1 | 44.3 |
| Other domestic sectors | 30.5 | 42.5 | 43.3 |
| Nonresidents | 4.4 | 6.6 | 6.2 |
| Geographical distribution of loans to total loans | | | |
| Domestic economy | 97.4 | 95.6 | 96.1 |
| Other emerging market and developing countries, including China | 2.6 | 4.4 | 3.9 |
| Central and Eastern Europe | 2.6 | 4.4 | 3.9 |
| Other indicators | | | |
| Gross asset position in financial derivatives to capital | 17.5 | 9.0 | 9.6 |
| Gross liability position in financial derivatives to capital | 17.9 | 10.4 | 11.4 |
| Trading income to total income | 12.4 | 1.5 | 5.5 |
| Personnel expenses to noninterest expenses | 38.3 | 38.5 | 39.1 |
| Spread between reference lending and deposit rates (basis points | 428.0 | 430.5 | 429.0 |
| Customer deposits to total (noninterbank) loans | 98.9 | 117.3 | 115.4 |
| Foreign-currency-denominated loans to total loans | 17.4 | 2.0 | 2.1 |
| Foreign-currency-denominated liabilities to total liabilities | 21.7 | 2.8 | 3.3 |
| Net open position in equities to capital | 9.6 | 10.5 | 10.3 |
| Net open position in foreign exchange to capital | -19.5 | 0.0 | 2.2 |

Source: National Bank of Slovakia.

INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

# Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the European Department

August 16, 2010

Contents | Page

## Appendix I. Slovak Republic: Fund Relations

(As of June 30, 2010)

I. **Membership Status:** Joined: 01/01/1993; Article VIII

| II. **General Resources Account:** | **SDR Million** | **Percent of Quota** |
|---|---|---|
| Quota | 357.50 | 100.00 |
| Fund Holdings of Currency | 289.73 | 81.04 |
| Reserve Position | 67.78 | 18.96 |
| Lending to the Fund | 20.33 | |

| III. **SDR Department:** | **SDR Million** | **Percent of Allocation** |
|---|---|---|
| Net cumulative allocation | 340.48 | 100.00 |
| Holdings | 341.68 | 100.35 |

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

| Type | Date of Arrangement | Expiration Date | Amount Approved (SDR Million) | Amount Drawn (SDR Million) |
|---|---|---|---|---|
| Stand-by | 07/22/1994 | 03/21/1996 | 115.80 | 32.15 |

VI. **Projected Obligations to Fund:** None

VII. **Exchange Rate Arrangement:**

The currency of the Slovak Republic is the euro, which was adopted on January 1, 2009.

The Slovak Republic has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The Slovak Republic maintains exchange restrictions for security reasons, based on UN Security Council Resolutions and Council of the European Union Regulations, that have been notified to the Fund for approval under the procedures set forth in Executive Board Decision No. 144–(52/51).

VIII. **Article IV Consultation:**

The consultation discussions were held in Bratislava during July 8–19, 2010. The mission met with Minister of Finance Mikloš, National Bank of Slovakia (NBS) Governor Makúch, Minister of Labor, Social Affairs and Family Mihál, other senior government and NBS officials, and representatives of financial institutions, think tanks, trade unions and employers' associations.

The mission comprised Messrs. De Broeck (head), Mehrez, Tulin and Ms. Mitra (all EUR). Mr. Kiekens (Executive Director) and Mr. Jakoby (Senior Advisor to the Executive Director) participated in the discussions.

The mission's concluding statement was published on the IMF website on July 19, 2010. The authorities have agreed to the publication of the staff report.

The previous consultation with the Slovak Republic was concluded on July 20, 2009 (IMF Country Report No. 09/221).

IX. **FSAP Participation and ROSCs:**

An FSAP was concluded with the completion of the 2002 Article IV consultation on August 7, 2002 on the basis of missions that took place in February 2002 and April 2002. The FSSA report was published (IMF Country Report No. 02/198). An FSAP update mission was held in December 2006. The FSSA update report was circulated to the Executive Board together with the staff report for the 2007 Article IV Consultation and published on the IMF website on July 17, 2007.

The report on the Fiscal ROSC was issued in August 2002 (IMF Country Report No. 02/189) and updates were issued in August 2003 (IMF Country Report No. 03/236) and in March 2005 (IMF Country Report No. 05/73). The report on the Data ROSC was issued in May 2005 (IMF Country Report No. 05/161).

X. **Technical Assistance:** See the attached table.

XI. **Resident Representative Post:** None (closed at end-April 2004).

Slovak Republic: Technical Assistance, 2000–10 1/

| Department | Timing | Purpose |
|---|---|---|
| MFD | February 2000 | Mission on pros and cons, and modalities of moving to an inflation targeting framework, operational issues (money markets and policy instruments), and dealing with potential problems posed by capital inflows for monetary operations |
| | December 2001 | Long-term resident expert on banking supervision |
| | May 2002 | Two missions on inflation modeling |
| FAD | April 2000 | Tax administration |
| | February 2001 | Tax administration (follow-up) |
| | April 2001 | Public Finance Management (follow-up) |
| | August 2001 | Tax administration: installation of resident expert to advise on establishment of Large Taxpayer Unit (LTU) |
| | August 2001–August 2002 | Regular visits by FAD consultant on establishment of LTU |
| | December 2001 | Tax administration follow-up, tax investigation/fraud issues |
| | June 2002 | Mission to prepare Report on the Observance of Standards and Codes (ROSC), Fiscal Transparency Module |
| | February 2003 | Tax policy |
| | March 2003 | Tax administration |
| | May 2003 | Expenditure policy |
| STA | February 2000 | National accounts and price statistics |
| | March 2001 | Multisector mission |
| | July 2003 | Government finance statistics |
| | February–March 2004 | Data ROSC Mission |

1/ See Appendix I of IMF Country Report No. 05/71 for technical assistance during 1991–99.

## Appendix II. Slovak Republic: Statistical Issues

1. Coverage, periodicity, and timeliness of data provided to the Fund are adequate for surveillance purposes. From the point of view of macroeconomic analysis and policy making, significant data improvements have been made in recent years, particularly in the national accounts. A data ROSC mission during February–March 2004 found that the integrity, methodological soundness, and reliability of the data were satisfactory, despite some shortcomings in the data revision policy. The main issues remaining are: (i) weaknesses in the data on prices and volumes of imports and exports; (ii) a lack of timely data on the general government operations; and (iii) slow compilation cycle of the annual national accounts and lack of proper benchmarking of quarterly data. The Slovak Republic subscribes to the Special Data Dissemination Standard (SDDS) since 1996 and observes or exceeds all related standards.

2. With regard to timeliness and public access, the authorities in general follow a free and open data publication policy. Data are promptly released to news services, and are also published regularly in various monthly and quarterly statistical publications, and on the Internet[1] according to a pre-announced schedule. Data on core surveillance variables are provided regularly to the Fund, and with minimal lags: a week or less for foreign exchange reserves; a day for monthly state budget implementation data; 10 days to a month for consumer prices, reserve money, broad money, and interest rates; two months for foreign trade data; and about three months for other fiscal, balance of payments, and national accounts data. However, the 2004 data ROSC mission reported some difficulties in fully reconciling the balance of payments with the national accounts, monetary, and government finance statistics.

### Real Sector and Prices

3. Significant progress has been made in the compilation of the national accounts statistics. However, the quarterly national accounts data on expenditures exhibit weaknesses and there is a significant statistical discrepancy between the supply side and the demand side. An important outstanding issue is the compilation of reliable price deflators for imports and exports that would enable better decomposition into volume and price changes. The unit value trade price indices—on which the national accounts trade price deflators are based—are published with long delays and are not appropriately adjusted for quality changes. The statistical authorities are aware of these issues and improvements are pending.

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[1] Data are available on the website of the Slovak Statistics Office (www.statistics.sk), the National Bank of Slovakia (NBS) (www.nbs.sk), and the ministry of finance (MoF) (www.finance.gov.sk).

4. Following the fast development of chain stores, which are not fully captured in surveys, the authorities consider that retail sales and the level of consumption might be biased (especially if compared to VAT receipts), and wage statistics also might be biased.

5. In the enterprise sector, it would be very useful if the line ministries produced systematic accounts of the financial positions of the public enterprises under their purview.

**Fiscal Sector**

6. General government statistics are compiled annually in accordance with the methodology of the ESA95, and disseminated on the Ministry of Finance (MOF) website. In accordance with the EU *acquis communautaire,* the authorities report semi-annually on general government net lending/borrowing on ESA95 basis. Monthly reconciliation of government operations above and below-the-line is restricted to state budget transactions on a cash basis. A modern treasury system has been operating since January 2004. The new system has improved fiscal control and public debt management by allowing the recording of expenditures at the planning and commitment stages.

7. The MOF has converted its fiscal accounts to ESA95 standards. The MOF compiles Government Finance Statistics according to the *Government Finance Statistics Manual 2001* (*GFSM 2001*) analytical framework; data are available and disseminated on a cash basis for 1996–2005, and on an accrual basis for 2003–09.

**External Sector**

8. External sector statistics are of good quality, and are reported on a timely basis to the Fund.

**Monetary Sector**

9. Monetary statistics are of good quality, and are reported on a timely basis to the Fund.

## SLOVAK REPUBLIC: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(as of June 30, 2010)

| | Date of latest Observation | Date received | Frequency of Data[6] | Frequency of Reporting[6] | Frequency of Publication[6] | Memorandum Items: Data Quality–Methodological soundness[7] | Memorandum Items: Data Quality–Accuracy and reliability[8] |
|---|---|---|---|---|---|---|---|
| Exchange Rates | 07/29/10 | 07/29/10 | D | D | D | | |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | 07/28/10 | 07/30/10 | W | W | W | | |
| Reserve/Base Money | 06/10 | 07/12/10 | M | M | M | LO, LO, O, LO | O, O, O, O, O |
| Broad Money | 06/10 | 06/10 | M | M | M | | |
| Central Bank Balance Sheet | 06/10 | 07/12/10 | M | M | M | | |
| Consolidated Balance Sheet of the Banking System | 05/10 | 07/10 | M | M | M | | |
| Interest Rates[2] | 06/10 | 06/10 | M | M | M | | |
| Consumer Price Index | 06/10 | 07/14/10 | M | M | M | O, O, O, O | LO, O, LO, O, O |
| Revenue, Expenditure, Balance and Composition of Financing[3]–General Government[4] | 2009 | 04/2010 | A | A | A | O, O, O, O | O, O, O, O, NA |
| Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government | 05/10 | 07/01/10 | M | M | M | | |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | 03/10 | 05/10 | Q | Q | Q | | |
| External Current Account Balance | 05/10 | 07/30/10 | M | M | M | O, O, LO, LO | O, O, O, O, O |
| Exports and Imports of Goods and Services | 05/10 | 07/12/10 | M | M | M | | |
| GDP/GNP | Q1/10 | 06/04/10 | Q | Q | Q | O, O, LO, LO | LO, O, LO, O, LO |
| Gross External Debt | 03/10 | 06/30/10 | M | M | M | | |
| International Investment Position[9] | 12/09 | 06/30/10 | Q | Q | Q | | |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC (published on May 17, 2005, and based on the findings of the mission that took place during February 18–March 3, 2004) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.
[9] Includes external gross financial asset and liability positions vis a vis nonresidents.

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September 14, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Concludes 2010 Article IV Consultation with the Slovak Republic

On September 3, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Slovak Republic.[1]

## Background

The Slovak economy is quickly recovering from a deep recession caused by the global economic downturn. After contracting sharply in the first quarter of 2009, real gross domestic product (GDP) has grown robustly over the past five quarters, along with the recovery in external demand. It is estimated that real GDP growth will exceed 4 percent in 2010—among the highest in the European Union. Inflation has fallen significantly below the euro area average.

Solid fundamentals and appropriate policies curbed the impact of the external shock. A relatively strong fiscal position with low public debt and modest deficits prior to the downturn, low debt ratios of households and companies, and a sound financial sector with internal market focus limited domestic second-round effects following the substantial external shock. Furthermore, automatic stabilizers and a discretionary fiscal stimulus provided appropriate demand support. Euro area membership helped maintain confidence and facilitated low interest rates.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Nevertheless, the unemployment rate has increased to about 15 percent. Although the continued economic recovery will help bring down conjunctural unemployment, the downturn has worsened long term structural unemployment among low skill workers, particularly in economically-lagging regions.

The general government deficit widened to 7.3 percent of GDP in 2009, and developments in the first half of 2010 indicate a further deterioration. While expenditure continued to grow at pre-crisis rates, revenue declined in tandem with output, and the structural deficit is projected to reach about 7 percent of GDP in 2010. Nevertheless, market confidence has remained broadly intact even during the recent turmoil in peripheral euro area countries, reflecting the still relatively low public debt and expectations that the new government will tackle fiscal deterioration through a credible consolidation

**Executive Board Assessment**

Executive Directors welcomed the ongoing recovery of the Slovak economy, supported by relatively strong fundamentals, while noting that the outlook is subject to high uncertainty. Directors stressed that the immediate priorities are to restore fiscal sustainability and address the high unemployment, while over the medium term maintaining external competitiveness within the monetary union should be a key objective.

Directors were concerned by the sharp deterioration in the fiscal position, which largely reflects structural weaknesses. They welcomed the authorities' strong commitment to bring the fiscal deficit down to below the Maastricht norm in 2013 and supported their plan to undertake a front-loaded fiscal adjustment of about 2½ percentage points of GDP in 2011. In view of the robust recovery, a number of Directors encouraged the authorities to use any additional fiscal space this year to pursue their fiscal targets.

Directors agreed that the planned adjustment properly balances the dual objectives of ensuring fiscal sustainability and allowing the recovery to continue. To spread the burden over time and enhance market confidence, they recommended anchoring the 2011 adjustment within a clear medium-term fiscal consolidation strategy. This could be facilitated by adopting a real expenditure growth ceiling consistent with deficit targets and expenditure policy priorities, including reforming health care and pensions. Directors noted that, in addition to containing expenditure, revenue measures, including raising indirect taxes and eliminating exemptions, will also be necessary.

Directors were encouraged by the resilience of the banking sector in the face of the global crisis. They welcomed the supervisory authority's proactive response to the crisis, and the confirmation by stress test results of the ability of the sector to absorb a variety of severe shocks. Continued close monitoring of banking sector developments, in particular lending to corporate and real estate sectors, will nevertheless remain essential. In light of the large share of foreign ownership in Slovak banks, Directors underscored the importance of enhancing cross-border supervisory coordination.

Directors regretted the increase in long-term unemployment, particularly among low skill workers. They encouraged the authorities to remove structural impediments to employment, including by strengthening higher education and vocational programs and enhancing active labor market policies. Directors welcomed the authorities' initiative to improve the labor market prospects of low skill workers through a combination of reduced social security contributions and in-job benefits.

Directors noted that external competitiveness has been preserved in recent years, with wages growing in line with productivity and Slovakia's market share in global exports continuing to expand. They considered, however, that maintaining competitiveness in the monetary union will require sustained structural reforms. In addition to labor market and educational reforms, they encouraged the authorities to enhance the business environment, and strengthen public sector governance, with a special emphasis on public procurement and the absorption of EU funds.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with Slovak Republic is also available.

Slovak Republic: Summary of Economic Indicators, 2007-2012

| | Projections |
| --- | --- |

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|
| | (Annual percentage change, constant prices, unless noted otherwise) | | | | | | |
| Real GDP | 8.5 | 10.6 | 6.2 | -4.7 | 4.1 | 4.3 | 4.4 |
| Domestic demand | 6.6 | 6.5 | 6.0 | -6.2 | 3.3 | 3.9 | 4.2 |
| Public consumption | 9.7 | 0.1 | 5.3 | 2.8 | 3.3 | -1.2 | 2.0 |
| Private consumption | 5.9 | 6.9 | 6.0 | -0.7 | 1.3 | 3.8 | 4.1 |
| Gross capital formation | 6.1 | 9.7 | 6.5 | -21.4 | 7.9 | 7.6 | 6.0 |
| Net exports (contributions to growth) | 2.1 | 4.7 | 0.2 | 0.5 | 0.7 | 0.6 | 0.3 |
| Exports of goods and services | 21.0 | 14.3 | 3.2 | -16.5 | 14.0 | 8.2 | 6.6 |
| Imports of goods and services | 17.8 | 9.2 | 3.1 | -17.6 | 13.8 | 7.9 | 6.6 |
| Prices | | | | | | | |
| Inflation (CPI) | 4.3 | 1.9 | 3.9 | 0.9 | 0.7 | 1.9 | 2.4 |
| Inflation (CPI, end of period) | 3.5 | 2.3 | 3.4 | 0.0 | 1.0 | 2.0 | 2.6 |
| Employment and wages | | | | | | | |
| Employment | 3.8 | 2.4 | 3.2 | -2.8 | -1.8 | 2.1 | 1.5 |
| Nominal wages | 6.7 | 6.4 | 7.6 | 2.4 | 3.5 | 7.0 | 6.3 |
| Unemployment rate (percent) | 13.3 | 11.0 | 9.6 | 12.1 | 14.1 | 12.7 | 11.6 |
| | (In percent of GDP) | | | | | | |
| Public Finance, General Government | | | | | | | |
| Revenue | 33.5 | 32.5 | 32.5 | 33.5 | 30.8 | 31.9 | 32.2 |
| Expenditure | 36.9 | 34.4 | 34.8 | 40.8 | 38.9 | 36.6 | 35.9 |
| Overall balance | -3.5 | -1.9 | -2.3 | -7.3 | -8.0 | -4.7 | -3.7 |
| Primary balance | -2.0 | -0.5 | -1.1 | -5.8 | -6.5 | -2.8 | -1.8 |
| Structural balance (percent of potential GDP) | -3.9 | -2.6 | -2.8 | -5.8 | -6.9 | -4.1 | -3.4 |
| General government debt | 30.5 | 29.3 | 27.7 | 35.7 | 41.8 | 44.0 | 45.0 |
| | (In percent) | | | | | | |
| Monetary and financial indicators | | | | | | | |
| Credit to private sector (growth rate) | 25.2 | 25.4 | 19.2 | 4.4 | | | |
| Lending rates 1/ | 9.2 | 9.3 | 8.1 | 6.9 | | | |
| Deposit rates 2/ | 0.9 | 0.8 | 0.7 | 0.3 | | | |
| Government 10-year bond yield | 4.4 | 4.5 | 4.7 | 4.7 | | | |
| | (In percent of GDP) | | | | | | |
| Balance of payments | | | | | | | |
| Trade balance (goods) | -4.7 | -1.2 | -1.1 | 1.9 | 1.0 | 1.0 | 0.9 |
| Current account balance | -7.8 | -5.3 | -6.5 | -3.2 | -1.4 | -2.6 | -2.5 |
| Gross external debt | 51.0 | 54.5 | 56.1 | 71.6 | 69.1 | 66.8 | 63.9 |

Sources: National Authorities; and IMF staff calculations.
1/ Loans of up to one year, average to households and nonfinancial corporations.
2/ Average of interest rates on overnight deposits from households and nonfinancial corporations.