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Slovak Republic: 2002 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of the Slovak Republic

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 2002 Article IV consultation with the Slovak Republic, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 22, 2002,** with the officials of the Slovak Republic on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 25, 2002.** 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 August 9, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of the Slovak Republic.

The document(s) listed below have been or will be separately released.

Selected Issues and Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the
2002 Consultation with the Slovak Republic

Approved by Carlo Cottarelli and Shigeo Kashiwagi

July 25, 2002

- The Article IV consultation discussions were held in Bratislava during May 9–22. The mission met with Deputy Prime Minister Mikloš, Finance Minister Hajnovič, central bank Governor Jusko, other senior officials, and representatives of private enterprises, trade unions, and financial institutions. The staff team consisted of Messrs. Fernández-Ansola (Head), Kuijs, Moore, and Ms. Guichard (all EU1), Mr. Megarbane (PDR), and Mr. Christou, Resident Representative. Mr. Coats (MAE) joined the mission to discuss the preliminary conclusions of the recent Financial Sector Assessment Program. Mr. Sipko, assistant to Mr. Kiekens (Executive Director), attended the meetings.

- In concluding the latest consultation in July 2001, Executive Directors endorsed the authorities' program of fiscal consolidation, disinflation, and structural reform, and noted that external current account pressures would be relieved by adhering to fiscal deficit targets. Directors also noted that a well articulated medium-term fiscal reform plan would strengthen the credibility of fiscal targets. They welcomed progress in strengthening the banking system but called for further enhancement of banking supervision. More labor market flexibility would help reduce unemployment.

- Slovakia has made good progress in preparing for EU accession. In the latest Regular Report, the European Commission concluded that Slovakia is a functioning market economy and, provided that it deepens medium-term fiscal consolidation and implements announced structural reforms, should be able to cope with market forces within the Union in the near term. Negotiations on 26 out of 30 chapters of the *acquis communautaire* have been provisionally closed.

- The authorities completed the Staff-Monitored Program at end-March 2002. While macroeconomic policies were broadly in line with the program in 2001, staff regarded the envisaged fiscal policy in 2002 as too loose. The staff also noted mixed progress in structural reforms.

- Parliamentary elections will be held on September 20–21, 2002.

- The authorities released the mission's concluding statement and have agreed to the publication of the staff report.

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I. Economic Background

1. ***Slovakia's macroeconomic performance was satisfactory over the past decade, although somewhat uneven***, with real GDP growth averaging 4¼ percent and inflation staying below 14 percent. Progress in restructuring the economy, the lowering of trade barriers,[1] and the reorientation of trade to OECD markets all supported economic growth. However, the unemployment rate remained above 12 percent, and stop-go macroeconomic management led to large swings in the external current account deficit. In particular, high growth during 1994–98 was accompanied by unsustainable fiscal policies and an investment boom that took place amid soft budget constraints, weak corporate governance, and widespread government-guaranteed lending. With the external current account deficit averaging 9 percent of GDP in 1996–98 and the external debt-to-GDP ratio rising, exchange rate pressures culminated in late 1998 in the abandonment of the exchange rate peg and an 8 percent depreciation. The float was followed by fiscal consolidation and a hardening of budget constraints, and resulted in a substantial reduction of external imbalances in 1999—2000. But, although net exports recovered, economic growth weakened to about 2 percent a year and unemployment surged to over 18 percent.

2. ***After two years of subdued economic activity, in 2001 strong private domestic demand—buoyed by an expansionary fiscal policy—led to an acceleration of growth*** (text box and Figure 1). Real GDP growth rose to over 3 percent. Increased profitability, enterprise restructuring, and a corporate income tax cut boosted investment, while rising real wages and employment, and a personal income tax cut underpinned vigorous private consumption. The redemption in cash of National Property Fund (NPF) bonds, amounting to 2 percent of GDP, propelled consumption further. The general government deficit widened by ½ percentage point of GDP in 2001, to 4 percent of GDP, mainly reflecting the tax cuts and the removal of an import surcharge.

GDP and its Main Components
(Real annual rates of change, in percent; contribution to GDP growth in parentheses)

	1998	1999	2000	2001
GDP	4.0	1.3	2.2	3.3
Total domestic demand	6.9	-6.2	0.0	7.2
	(7.4)	(-6.9)	(0.0)	(7.3)
Of which:				
Private consumption	5.8	2.9	-1.8	4.0
	(3.0)	(1.5)	(-1.0)	(2.1)
Gross fixed investment	11.0	-18.5	1.2	9.6
	(3.7)	(-6.6)	(0.4)	(2.7)
Net exports	(-3.5)	(8.2)	(2.2)	(-4.0)
Memorandum items, in percent of GDP:				
General government balance	-4.7	-3.3	-3.5	-4.0
External current account balance	-9.2	-4.9	-3.6	-8.6

3. ***Economic activity has since accelerated further, and unemployment and inflation have continued to ease.*** Real GDP grew 4 percent year-on-year in the first quarter of 2002, and sustained increases in employment have made a dent in the still high unemployment rate. The pickup in growth has been helped by continued fiscal expansion and favorable price developments. With unit labor costs growing modestly, limited administered price increases,

[1] Slovakia is ranked "1" on the Fund's index of trade restrictiveness, which denotes the most open regime.

and favorable food and fuel prices, core and headline inflation were 3.2 percent and 6.6 percent, respectively, in December 2001, and have since fallen further.

4. ***However, surging imports and decelerating exports led to a widening of the external current account deficit to 8½ percent of GDP in 2001—and a similar projected size in 2002*** (Figure 2). Strong domestic demand, rising over 7 percent in 2001, and the removal of the import surcharge boosted imports, while the European slowdown and Volkswagen Slovakia's restructuring works weakened exports. Although exports are expected to recover, the current account deficit is unlikely to narrow significantly in 2002. The wider deficit has been financed mainly by FDI inflows, but increasingly by debt-creating inflows, thus resulting in a slight deterioration of vulnerability indicators in 2001.

5. ***Privatization receipts have strengthened the external position, but this improvement could be short lived.*** While privatization receipts from abroad are huge this year[2] (about 17 percent of GDP, of which two-thirds have already been received), the ensuing improvement in international reserves and other vulnerability indicators may prove fleeting if the current account deficit is not reduced in the next few years.

6. ***The 2002 budget targeted a general government deficit[3] of 3.5 percent of GDP, somewhat below the 2001 level, but the actual fiscal stance is more expansionary.*** The budget included above-the-line revenues equivalent to 1 percent of GDP that should have been reclassified as financing items. Financing data suggest that the January–May general government deficit (adjusted for bank restructuring items) was 1.6 percent of annual GDP, compared with 0.8 percent of GDP in January–May 2001, partly reflecting shortfalls in nontax revenue. ***On current trends—and after reclassification—the 2002 deficit would amount to 5¼ percent of GDP***, reflecting expected expenditure overruns in the social area and shortfalls in nontax revenue.

7. ***In this environment, the central bank recently increased interest rates; nevertheless, the koruna depreciated and bond spreads widened*** (Figure 3). Citing the absence of a significant fiscal response to developments in demand, the National Bank of Slovakia (NBS) raised its policy rate by 50 basis points in late April 2002—the first such adjustment since March 2001. The koruna, which had gradually appreciated by 5 percent against the euro since October 2001, lost 7 percent of its value since April 2002, amid a difficult policy atmosphere ahead of the September elections. Although some depreciation had been expected during this period, the early shift away from the koruna has surprised the authorities and prompted central bank intervention in June to stem a further sharp depreciation. The koruna has stabilized following this intervention.

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[2] Reflecting mainly the sale of the gas company (US$2.7 billion) and of three electricity distribution companies (about US$600 million).

[3] Excluding bank restructuring interest costs and called guarantees.

8. ***Following recent progress in structural reforms, the priority remains making the economy more productive and flexible.*** The main banks and utilities have been restructured and privatized, fiscal transparency and control improved, quasi-fiscal activities curtailed, and the legislative framework has been strengthened. But the remaining agenda is considerable: even after large recent gains, productivity is still well below EU levels, and the recurrence of large external imbalances partly indicates supply-side issues. Further corporate restructuring and labor market reform are particularly needed. Moreover, banking supervision requires strengthening; the health sector is accumulating arrears; the pension system needs major reform; state-owned enterprise budget constraints should be hardened through the curtailment of government guarantees; and the state administration and the judicial system should be strengthened. These reforms will also be key to EU accession.

II. Report on the Discussions

9. Against this background, ***discussions focused on the following questions***: (a) Why is the external current account deficit so large? (b) How vulnerable is the Slovak economy in the short term, and what are its prospects? (c) Is the external deficit sustainable, and, if not, how should fiscal and monetary policies respond? (d) What should be the priorities of structural policies in the run-up to EU accession? (e) What are the risks for the financial sector?

A. Why is the External Current Account Deficit so Large?

10. ***It was agreed that the widening of the external current account deficit stems from a combination of factors—some exogenous and temporary, others more structural—exacerbated by the expansionary fiscal stance.***[4] The export slowdown mainly reflects the weak external environment and Volkswagen Slovakia's temporary break in production, while a bad harvest resulted in unusually high food imports in 2001. The staff estimates that the combination of these exogenous factors amounted to 1 percent of GDP. But staff identified other structural factors—notably rising import-intensive investment, and a secular increase in households' propensity to spend on imported goods—and the surge in domestic demand,

Current Account and Domestic Demand: Changes in 2001
(Absolute change in current prices, as percent of 2001 GDP)

Contributions to current account change	
Current account	-5.3
Net trade (national accounts)	-6.2
Exports	8.1
Imports, due to:	14.3
Higher exports 1/	4.8
Higher domestic demand	9.5
Contributions to domestic demand increase	
Domestic demand	14.4
Consumption	6.8
Total investment	7.6
Fixed investment	4.2
Inventories (including "unfinished projects")	3.4

Source: Fund staff estimates.
1/ Assumes the import content of exports is 60 percent.

[4] A selected issues paper discusses the external current account deficit.

partly reflecting the fiscal expansion,[5] as having contributed even more to the external imbalance (about 3 percent of GDP).

B. How Vulnerable is the Slovak Economy in the Near Term and What are its Prospects?

11. ***Notwithstanding the temporary factors behind the widening of the external current account deficit, staff pointed to some apparent similarities of the present situation with the 1996–98 period, which ended in a foreign exchange crisis*** (text table). As then, the last 18 months have witnessed a widening external deficit accompanied by a decline in nongovernment net savings and expansionary fiscal policy (although more contained in the recent episode). Are the latest developments revealing imbalances that could ultimately lead to a crisis similar to the one in 1998?

12. ***The authorities noted that a number of factors differentiated the recent phase from the one that preceded the 1998 crisis.***

Comparing Two Episodes of Large External Deficits

	1996-98	1999-2000	2001-02
Slovakia			
Current account balance (percent of GDP)	-8.8	-4.3	-8.6
Nongovernment saving-investment balance	-4.9	-0.9	-4.4
GDP growth	5.1	1.8	3.7
Domestic demand growth	9.5	-3.1	5.4
Unemployment rate	13.1	17.4	18.0
REER based on ULC (1998=100)	101.7	88.7	88.4
Region (simple average CEC5 excl. Slovakia)			
Current account deficit (percent of GDP)	-3.0	-4.6	-3.0
Nongovernment saving-investment balance	-0.5	-1.7	1.6
GDP growth	3.6	3.8	2.8
Domestic demand growth	4.5	3.8	2.4
Unemployment rate	8.0	9.0	9.4
REER based on ULC (1998=100) 1/	97.5	97.4	99.0

Sources: Slovak authorities; Fund staff estimates; and WEO, Summer 2002 Start Version.
1/ 2002 estimate based on data for the first four months and excludes Hungary.

- ***Official international reserves*** at end-July more than doubled their level at end-1998, reflecting massive privatization revenues.

- ***The external imbalance does not reflect cost-related competitiveness problems*** (see Figure 2). The modest appreciation of the CPI-based real effective exchange rate (REER) between 1998 and early 2002 can be explained by Balassa-Samuelson effects. Indeed, the unit labor cost based REER depreciated over the same period because of a combination of structural reform-induced productivity gains and moderate wage increases.

- ***The exchange rate system mitigates vulnerability to crises.*** Since the end of the peg in 1998, the exchange rate has remained market determined.

- The ***overall business climate has improved substantially since 1998.*** In contrast to 1996–98, the present investment boom has occurred amid hardened budget constraints, higher profitability, and enhanced corporate governance. Moreover, the restructuring of the

[5] The fiscal stimulus in 2001 is not fully captured by the change in the measured fiscal deficit. The redemption of NPF bonds—a "below the line" operation—had a significant impact on liquidity, and on demand via additional consumption. This operation is captured by the shift of the nongovernment saving-investment balance.

banking sector and improved banking supervision have lessened the risks of unsound lending. The present ***investment boom has also been led by foreign investors*** and generated entirely by private activities, without state guarantees.

- Finally, a substantial share of ***investment is now directed to tradable sectors***, with 35 percent of the increase in investment going to the manufacturing sector. Investment in nontradable sectors, such as construction and real estate, has been declining.

13. ***Against this background, staff agreed that short-term growth prospects remained positive.*** Staff projections for 2002—based on adjustment to fiscal policies[6]—assume a recovery in Europe, the full activation of new capacity at Volkswagen Slovakia, and buoyant domestic activity. Private consumption is projected to accelerate to 4½ percent as households' real income increases substantially and employment improves. On this basis, the staff projects real GDP growth of 4 percent in 2002. Data released after the mission—showing solid industrial production growth—appear to be consistent with this scenario. With credit to both households and firms picking up this year, following the completion of bank privatization, the NBS expects inflation to rise slightly during the rest of 2002. But, provided that wage settlements in the private sector remain moderate, headline inflation should remain below 5 percent at end-2002, before increasing in 2003 due to substantial expected administered price increases. Price data through June 2002 have confirmed the expectation of low inflation this year. If adjustment policies are sustained, economic growth would slow slightly in 2003, reflecting the effects of fiscal retrenchment.

14. ***Nevertheless, the staff noted that substantial risks weighed on the projections.*** First, more expansionary fiscal policies would exacerbate the external pressures from buoyant private sector demand. Indeed, on current policies the fiscal deficit would exceed the authorities' revised 2002 target by ¾ percent of GDP and approach 5½ percent of GDP in 2003 (text box), private consumption would grow faster, and the external current account deficit would remain at around 8¾ percent of GDP—well above the sustainable range (see below). Second, a weaker external environment would harm the external current account and growth. Third, lower greenfield investment—due to political uncertainty—would increase financing risk, although medium-term debt dynamics are unlikely to become a problem. Fourth, the staff saw a risk that the structural components of the external deficit could require stronger longer-term adjustment of

Macro Framework, 2002-03

	Adjustment		Current policies	
	2002	2003	2002	2003
	(Year-on-year growth, in percent)			
Real GDP	4.0	3.7	4.2	4.1
Private consumption	4.5	2.5	5.0	3.5
Gross capital formation	2.8	5.6	2.7	5.5
CPI inflation (e-o-p)	4.2	7.2	4.4	8.3
Real wages in industry	3.8	0.4	3.8	0.2
	(In percent of GDP)			
Current account balance	-8.5	-7.2	-8.9	-8.7
Fiscal balance	-4.4	-3.4	-5.2	-5.6
External debt	53.4	46.4	54.6	50.9

[6] Staff estimates that measures of at least ¾ percent of GDP in 2002 and 2 percent of GDP in 2003 are needed to attain the authorities' objectives (see below).

policies. On the upside, the authorities noted prospects for higher exports based on an early recovery in Europe.

15. ***Although short-term vulnerability is low, it could increase with a combination of adverse shocks.*** While the economy could withstand an isolated shock, a combination of high interest rates and a depreciated exchange rate could have ripple effects in the financial system by weakening the balance sheets of corporations and banks. This scenario would be possible if a new government radically alters the pro-reform policy orientation, jeopardizing the prospects for EU accession.

C. Is the External Deficit Sustainable Over the Medium Term, and, if not, How Should Fiscal and Monetary Policies Respond?

16. ***Even netting out the temporary factors, the external current account deficit remains large.*** The authorities agreed that assuming strong FDI prospects, robust GDP growth, and some trend appreciation of the koruna, an external current account larger than 6-7 percent of GDP would likely lead to an increasing external debt ratio (text box). But, even assuming an adjustment to fiscal policies, at some 7½–8 percent of GDP the underlying external deficit remains above this range, thus raising macroeconomic risks. The authorities agreed that the excessive pace of domestic demand, partly fueled by the fiscal expansion, was putting undue pressure on the external accounts.

17. ***Although the authorities concurred that demand-containing measures were required to cool domestic demand, they were less convinced about the urgency of these measures.*** Officials agreed that a fiscal response to the external pressures would be preferable to a monetary tightening, which could exert upward pressure on the exchange rate, harm competitiveness, and crowd out private activity. Despite the consensus that fiscal adjustment in 2003 would have to be sizable, discussions revealed differences of views on the required size and timing of fiscal measures for 2002. While the staff argued for an up-front fiscal adjustment, the authorities

The Sustainable External Current Account Deficit

The current account deficit is typically regarded as sustainable if the resulting ratio of net external debt[1] to GDP is not increasing (and is not "too high"). The current account deficit is financed by greenfield investment and debt-creating flows; sustainability implies that debt-creating flows result in growth of net external debt no faster than growth in GDP. According to this definition, the sustainable level of the current account deficit could be in the range of **6–7 percent of GDP**. The calculations below assume that: (i) the net debt stock remains at 36 percent of GDP; (ii) the authorities implement the reform agenda underpinning projected growth and real appreciation; and (iii) foreign direct investment responds strongly to this positive outlook.

	Based on Staff Estimates		
	3-Year Average 2001-03	5-Year Average 2002-06	
Greenfield FDI (% of GDP)	3.3	3.3	(a)
US$ GDP growth rate (%)	8.8	10.4	(b)
Real growth rate (%)	3.7	4.9	
Change in exchange rate (%)	0.5	-1.2	
Koruna GDP deflator (%)	5.4	4.1	
Sustainable current account deficit (% of GDP)	**6.4**	**7.0**	(a+b*e)
Net external debt, end-2001 (% of GDP)	36	36	(e)

[1] Net external debt is defined as total gross external debt minus official international reserves.

were more optimistic about revenue prospects, and felt that any decision about fiscal measures should await further information on revenues. The authorities suggested that the outgoing government could introduce a fiscal package immediately after the September elections.

Fiscal policy

18. ***The authorities now envisage a general government deficit of 4½ of GDP—after reclassification—for 2002***. This assumes a year-on-year reduction in nontax revenue of around 1 percent of GDP, lower net lending, and a slight increase in tax revenues offset by higher spending. In view of observed tax revenue overperformance through end-June, the authorities believed that their fiscal target can be achieved without fiscal measures. While they recognized some downward risks to their revenue projections, the authorities preferred to defer fiscal measures unless absolutely necessary. In addition, the authorities noted that if the upside risks on exports were to materialize less fiscal adjustment would be needed.

19. ***Staff stressed that on current trends, particularly on expenditures, the 4½ percent of GDP target will be very difficult to achieve, and the fiscal deficit could widen in 2003.*** Without measures to ensure budget ceilings, the staff expects overruns of over ¼ percent of GDP on social assistance and state benefits. Extra expenditures of nearly ½ percent of GDP reflect other social policies, as parliament approved an unbudgeted 5 percent increase in pensions from July 2002, and, despite initial reform steps, the health sector is likely to incur fresh arrears. In order to achieve the 4½ percent of GDP deficit target in 2002, staff suggested revisions to some expenditure items, including deferring and means-testing (starting in 2003) certain benefits, as well as measures to improve tax collection, particularly for VAT. Moreover, staff discussed additional measures, for over 2 percent of GDP, mainly on the expenditure side, that would be needed to achieve the 3½ percent of GDP deficit target in 2003.

General Government Balance, 2002-03
(In percent of GDP)

	Adjustment		Current trends	
	2002	2003	2002	2003
Revenue	33.7	33.7	33.6	33.8
Expenditure 1/	38.1	37.0	38.8	39.5
Of which: current	34.4	33.2	35.0	35.2
Balance	-4.4	-3.4	-5.2	-5.6

1/ Includes net lending.

20. ***Fiscal measures are all the more urgent because the expansion implicit in current trends is unwarranted.*** While Slovakia has the potential to grow by 4½–5 percent a year, compared with 4 percent projected for 2002 (and similar growth for 2003), the present apparent slack in the labor market masks supply-side constraints typical of an economy that still needs substantial restructuring. Hence, the excessive demand pressure resulting from loose fiscal policies is unlikely to help the labor market but will result in a large external current account deficit.

21. ***The authorities will use this year's large privatization receipts only to retire public debt, aside from those receipts allocated to pension reform***. All the receipts are being deposited in a special government account at the central bank, and kept out of the foreign exchange market. The government plans to use the bulk of the proceeds to repay domestic

debt—mainly state bonds but also old arrears in the health and transport sectors, and municipal debts. Given the high level of international reserves (over 5 months of imports of goods and services), and to minimize complications for monetary policy, staff stressed that it would be preferable to repay external debt rather than domestic debt.

22. ***A credible medium-term fiscal consolidation strategy, starting in 2003, was considered key by all.*** Government officials had started preparations for the 2003 budget, which aimed at a 3–3½ percent of GDP general government deficit. This deficit is consistent with reducing the general government deficit to 2 percent of GDP in 2005, as envisaged in the 2001 Pre-Accession Economic Program (PEP) (Box 1). However, the authorities confirmed that their preliminary estimates—on current policies—indicate significant fiscal pressures for 2003 arising from various legislative initiatives, including a new civil service act and increases in social benefits. The staff noted that given the authorities' objective to achieve the 2003–04 fiscal targets through expenditure measures only, it may be necessary to reconsider initiatives that would result in further increases in wages and social spending. In this context, forceful implementation of structural fiscal reforms (see below) will be required both to further reduce the overall expenditure to GDP ratio and to make room for increasing infrastructure spending related to EU accession, including those co-financed using pre-accession and structural funds. The staff also urged the authorities to strengthen the credibility of medium-term objectives by developing multiyear expenditure and revenue plans, and framing all fiscal decisions in that context.

23. ***While supporting the objective to reduce the expenditure ratio over time, staff cautioned against hasty tax rate reductions.*** The staff saw tangible risks that the fiscal deficit path will deviate from that agreed in the PEP, and argued that before considering further tax reductions the authorities need to ensure that they would be consistent with fiscal consolidation. In what has been a positive development for the Slovak economy, overall taxation has fallen significantly over the past four years (text box), especially in comparison with other countries in the region. Against this backdrop, staff suggested that further tax rate reductions should await evidence of a narrowing of the fiscal deficit, in line with the PEP. When these reductions become feasible, the authorities should then give priority to lowering payroll taxes, which are still high by regional standards. In the meantime, fiscal consolidation can be helped by forceful implementation of tax administration reform, in line with IMF technical assistance recommendations, and broadening the base of the VAT and curbing excessive VAT refunds—a definite priority.

General Government Revenue and Expenditure
(In percent of GDP)

	1998	1999	2000	2001	2002 Proj.
Slovakia					
Revenue	40.5	40.6	38.2	35.6	33.7
Expenditure 1/	45.3	44.0	41.7	39.5	38.2
Average Visegrad-4, excluding Slovakia					
Revenue	41.1	41.3	40.8	40.9	40.2
Expenditure	43.7	43.7	43.3	44.0	44.0

1/ Includes net lending.

Box 1. Framework for Fiscal Sustainability

The achievement of the authorities' medium-term fiscal objectives should result in sustainable fiscal balances. The "adjustment scenario" below shows a return to the path of fiscal consolidation envisaged in the government's September 2001 PEP, implying meeting the Maastricht fiscal deficit criterion by around 2005–06.[1] The scenario anticipates modest primary surpluses by 2004–05 and gradually falling public debt, consistent with fiscal sustainability. This fiscal consolidation would underpin a return of the current account deficit to around 5 percent of GDP—well within sustainable limits—by the end of the projection period.

Adjustment Scenario: Key Indicators
(Percent of GDP)

	2002	2003	2004	2005	2006
Fiscal balance[2]	-4.4	-3.4	-2.5	-2.0	-1.5
Primary balance[2]	-1.7	-1.1	0.1	0.4	0.8
Public debt	41.2	42.3	41.6	40.6	39.1
External current account	-8.5	-7.2	-6.3	-5.4	-4.7

The envisaged fiscal consolidation would leave Slovakia better placed to deal with looming policy challenges in this decade and beyond. In the medium term, Slovakia would have the option of using fiscal policy for stabilization in the event of unexpected shocks, especially important after Slovakia enters the ERM-II mechanism and partially loses recourse to monetary policy for this purpose. Further ahead, Slovakia would be better placed to accommodate the fiscal pressures arising from population aging, including additional spending on healthcare and pensions.

The authorities' aim of combining fiscal consolidation with further tax cuts might be too ambitious. The PEP envisages fiscal adjustment being achieved entirely on the expenditure side. But given existing expenditure pressures, including recent legislation mandating wage, social assistance, and state benefit expenditures and the need for resources to co-finance EU-supported infrastructure projects, the envisaged fiscal adjustment will be difficult to achieve if tax rates were cut. Indeed, should expenditure plans not be revised, tax rates may have to be raised or tax bases broadened.

[1] This scenario abstracts from the transition costs—possibly around 1 percent of GDP—associated with the expected introduction of the second pension pillar in 2004. These costs would not necessarily reflect a looser fiscal stance, but would increase the measured fiscal deficit (relevant for the Maastricht criterion). Gross public debt should remain unaffected; privatization receipts of Sk 65 billion have already been set aside for pension reform.

[2] Excluding bank restructuring interest costs and called guarantees. These expenditures are expected to account for around 1 percent of GDP each year by 2004–06, implying a fiscal deficit in 2005 of about 3 percent of GDP on an ESA95 basis.

Monetary and foreign exchange policies

24. ***The NBS will continue to gear its monetary policy towards further disinflation, while also monitoring external sustainability.*** The NBS's monetary policy decisions are aimed mainly at achieving explicit inflation objectives. Its public bands for core and headline inflation have been effective in guiding expectations, reflecting the NBS's favorable track record. Consistent with the emphasis on inflation, and the floating exchange rate regime, the NBS intervenes in the foreign exchange market only to avoid sharp oscillations of the koruna. Nonetheless, the NBS watches closely exchange rate developments (and external sustainability), if only because the exchange rate is a key channel for the transmission of monetary policy.[7]

25. ***Discussions centered on the appropriate monetary policy response to the increased macroeconomic imbalances.*** Despite low inflation, the NBS increased interest rates in April, as noted, reflecting in part concerns about the widening external current account deficit. The authorities observed that, in a small open economy like Slovakia's, demand shifts are quickly reflected in the external accounts, and that the interest rate increase was intended to slow demand in the absence of needed fiscal measures. The key question for future monetary policy will be how to respond if external pressures do not abate and no fiscal adjustment occurs.

26. ***It was agreed by all that monetary policy is not the best instrument to address the large external current account deficit.*** While further increases in interest rates would dampen domestic demand, they might also strengthen the koruna excessively, weakening competitiveness at a time when exports have also weakened. NBS officials also pointed to the impact on firms' interest costs, especially given the large increases in interest rates that would be required to slow demand.

27. ***Nevertheless, continuing or exacerbated demand pressures would eventually threaten the central bank's inflationary targets, requiring a monetary policy response.*** In particular, a significant, sustained depreciation of the koruna would warrant a further increase in interest rates. NBS officials noted, though, that the recent depreciation—reflecting to a large extent deteriorating market sentiment—could improve competitiveness and promote external adjustment, provided wage and price pressures are kept in check. They saw only a limited inflationary impact—particularly since the depreciation has been combined with a weaker dollar. While this view may well be right, the staff noted that the equilibrium real exchange rate should appreciate over time—reflecting convergence of the Slovak price structure to the EU price structure—and developments in the koruna and prices should be broadly in line with this expectation. Against this backdrop, officials concurred that too large or rapid a depreciation would threaten the achievement of the inflationary targets and warrant an interest rate increase.

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[7] L. Kuijs, *Monetary Policy Transmission Mechanisms and Inflation in Slovakia*, IMF WP 02/80/02 (Washington: International Monetary Fund).

28. ***Over the medium term, the NBS considered its key challenge to be reducing headline inflation to Maastricht levels by 2005, without hindering real convergence***, and regarded the current monetary policy framework as appropriate for the task. The noted convergence of Slovakia's relative price structure—depending on the behavior of the nominal exchange rate—might require higher inflation than in the EU over the next several years. Thus, central bank officials do not envisage reaching EU inflation levels before 2005. They acknowledged that the postponement of the increase of some key administered prices will cause an awkward jump expected in headline inflation in 2003 to 6½–7 percent, and add to the challenges for monetary policy. The staff recommended that the NBS and the government coordinate policies closely to mitigate the second-round effects of the administered price increases. Such coordination, as well as strong public commitment to a well-defined disinflation path, would support the credibility and minimize the cost of the disinflation strategy. NBS officials agreed that communication of the disinflation path to the public will be particularly important during wage negotiations.

D. What Should be the Focus of Structural Policies in the Run-up to EU Accession?

29. ***While an adjustment to macroeconomic policies along the lines suggested above remains a priority, the authorities recognized that the current situation in Slovakia also reflects the need for further structural reforms***. EU accession—and eventual adoption of the euro—requires reforms to enhance robustness and flexibility of the economy and financial markets, and continued credible disinflation and fiscal consolidation. To achieve these ends, in addition to developing and implementing the fiscal and monetary frameworks discussed above, the authorities intend to focus on enhancing labor market and enterprise flexibility, implementing pending fiscal structural reforms, and strengthening the financial sector.

- High unemployment calls for ***increased labor market flexibility*** and improved incentives to search for and provide employment. Most private sector representatives thought that the new labor code approved in April increased rigidities and reduced incentives to hire labor. Small and medium-sized enterprises (SMEs) find it particularly difficult to comply with cumbersome formal requirements. Despite some last-minute amendments, many thought that further streamlining of regulations was needed. Staff stressed that the labor code should provide a very general framework for labor relations, allowing substantial flexibility to employers and employees to agree on the specifics of work arrangements. The code should also promote a variety of such arrangements, including part-time and temporary jobs, and greater geographic mobility of the labor force. In this context, it would be appropriate to address mismatching problems through improving the employability of the labor force, as the authorities intend to do, and to support job creation by small and medium-sized entrepreneurs. At the same time, the staff emphasized the need to limit the disincentive effects of the social assistance system on job search, and to rationalize and better target the social safety net.

- Regarding policies to ***strengthen the economy's supply response and reduce its dependence on imports***, discussions with management of several enterprises brought to light the challenges faced by Slovak firms, even those that have restructured successfully. Remaining transition issues include significant amounts of bad loans still held by many companies; the challenges of supplying foreign retail chains; and the need to improve SMEs' access to financing. Such access would be essential to fund equipment investment and adapt marketing strategies to the new environment. Private sector representatives also noted the need to reduce the bureaucratic burden on enterprises.

- ***Structural fiscal reforms*** will support real convergence by improving incentives and providing public services more efficiently. Expressing some disappointment about progress so far, the staff called on the authorities to press ahead with ***civil service reform***. Given the difficulties facing the ***pension system***, the staff also called on the authorities to speed up the introduction of the second pillar (Box 2), using technical assistance from the World Bank. The staff also stressed the need for additional steps to contain healthcare costs and stop accumulating health arrears, after the encouraging first steps in reforming the ***health system***, and urged the authorities to streamline ***social assistance and state benefits***, improve ***public finance management***, and strengthen ***tax administration***. Government officials agreed that these are the priority structural fiscal reforms, but called into question the fiscal savings of reforms in areas like health and education.

- The ***financial sector requires further strengthening*** and the authorities plan to focus their efforts on the priorities identified by the recent FSAP mission.

Box 2. Pension Reform[1]

Reform is essential to address the long-term sustainability of the pension system. The existing pay-as-you-go (PAYG) system has generated small but increasing deficits in recent years, despite contribution rates among the highest in the OECD. Moreover, the long-term outlook is more worrisome, with the dependency ratio projected to double by 2040.

Some initial reform steps have been taken. Parliament approved significant changes to the PAYG system in May 2002, including tightening the link between benefits and contributions, and a gradual increase in the retirement age for women. Although a voluntary, funded (third) pillar is already in place, a mandatory, funded (second) pillar is still being planned. The institutional framework is expected to be prepared in the first half of 2003, and the second pillar could be in place as early as January 2004. Ministry of Labor officials expect the second pillar to start with an initial contribution rate of 3.7 percent, gradually rising to 6 percent.

Parliament has set aside Sk 65 billion in privatization receipts to finance the pension reform. These funds will be used exclusively to compensate for the diversion of contributions from the PAYG system to the second pillar, and will not fund the administrative costs of the second pillar (such as setting up client accounts).

[1] A selected issues paper discusses pension reform.

E. What are the Risks for the Financial Sector?

30. ***The recapitalized, restructured, and privatized banking system is now sound, if not yet very profitable.*** The FSAP mission concluded that the banking system—over 90 percent

foreign-owned—is well capitalized and provisioned, liquid, and fairly robust to exchange rate and interest rate shocks.[8] Foreign owners have introduced modern management practices, including risk management. However, with government securities constituting a large share of banking assets and fierce competition for blue chip clients, profitability has been low.

31. ***Against this background, the main banks have aggressively ventured into new areas,*** including consumer credit and mortgage lending. Although banks have improved their internal management systems, such activities imply new forms of risks that will challenge these systems as well as supervisory capabilities. The FSAP mission concluded that the profit drive will likely lead to further consolidation and/or exit in the banking industry. In anticipation, the authorities have started reviewing policies that affect the bank exit process.

32. ***In this context, the authorities are strengthening banking supervision***. The authorities explained that they have taken important steps to implement a new supervisory strategy, prepared with World Bank assistance. This strategy—based on modern supervision concepts being applied in more developed financial markets—aims at a more flexible and proactive supervision of banks, where supervision plans will be tailored to individual banks depending on the changing risk profiles of these banks. In addition, the NBS intends to revise regulations on asset classification and risks, and tighten enforcement of existing loan loss provisioning rules.

33. ***Supervision of the nonbank financial sector—modest in size, but growing rapidly—also needs strengthening.*** Public confidence in nonbank institutions has been shaken by weak standards of corporate governance, accounting and disclosure practices, and auditing, as well as weak supervision. Pending the planned integration of all financial market supervision under the NBS by 2005, the authorities agreed to enhance supervision through close cooperation between the NBS and the Financial Market Authority (FMA).

34. ***Healthy financial sector development requires addressing some legal infrastructure weaknesses***. Bank and enterprise representatives confirmed that SMEs' access to financing could be improved by strengthening creditor rights, the judicial system, and accounting standards. The authorities are implementing relevant measures with assistance from the World Bank (under the Enterprise Financial Sector Adjustment Loan).

35. ***Anti-money laundering policy implementation is being tightened***. The FSAP found the relevant legal and regulatory framework largely in line with international standards. However, implementation (especially by nonbank financial institutions) lags behind. Efforts are underway to develop procedures and training for effective implementation.

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[8] Stress tests suggested that, in the case of interest rate, exchange rate, and credit shocks systemic distress occurs only for large shocks. Exchange rate shocks affect banks mainly via the foreign exchange exposure of the corporate sector.

F. Transparency and International Standards

36. ***Slovakia's financial and economic statistics have improved.*** Slovakia conforms fully to SDDS standards on provision of data, and continues to improve the statistical base. Staff noted scope for improvement in statistics on trade prices, consolidated general government operations, and public enterprises, as well as the need to observe the new SDDS requirement to break down data on external debt of the banking sector and the nonbank private sector by maturity and instrument.

37. The recent fiscal ROSC mission found that Slovakia meets the requirements of the ***fiscal transparency code*** in the coverage of fiscal operations, and budget preparation and execution. The authorities need to extend existing good practices to the relations among general government units and the rest of the public sector.

III. Staff Appraisal

38. ***The recent performance of the Slovak economy has in many respects continued to improve.*** The policies implemented in 1999–2000 were critical to restore macroeconomic balances and strengthen the economy. Strong foreign direct investment has also improved the economy. In this context, over the past year, faster growth and lower inflation have come despite an adverse external setting and slowing demand for Slovak exports.

39. ***However, the widening of the external current account deficit threatens otherwise positive economic prospects—and could be aggravated by the ongoing fiscal expansion.*** Some temporary factors partly explain the increase in the external deficit, but continued excessive domestic demand pressures could keep this deficit large or even raise it. Although the huge privatization revenues from abroad can mitigate financing risks, policies need to be adjusted to put economic growth on a sustainable basis.

40. ***The government should return to the path of fiscal consolidation.*** On current trends the fiscal deficit will lead to an unwarranted fuelling of domestic demand and an increase in the debt ratio. Thus, a fiscal tightening is needed to address external imbalances. In order to attain the government's fiscal deficit targets for 2002 and 2003, additional measures are needed before and after the elections. Given the tension between the government's medium-term fiscal strategy and expenditures projected on current trends, most of these measures should be on the expenditure side.

41. ***Indeed, in light of the expenditure pressures, the authorities' fiscal objectives may require revising expenditure legislation or delaying its implementation.*** It will be essential that the government adhere to the fiscal deficit path agreed under the PEP. This will not be easy, though, because in addition to social spending, Slovakia faces over the coming years substantial expenditures related to NATO and EU accession, including needed infrastructure upgrading. But these expenditures can be accommodated by forceful implementation of structural fiscal reform, curtailing inefficient expenditure, revising some expenditure legislation, and introducing means testing for certain benefits. Strong implementation of tax

administration reform and curbing of excessive VAT refunds could also provide additional resources without distorting effects.

42. ***The authorities' medium-term fiscal targets are appropriate, and should be central to guiding fiscal decisions***. The envisaged fiscal targets put Slovakia on the path to meeting the Maastricht deficit criterion, and a return to medium-term fiscal and external sustainability. These targets will be particularly important in preparing upcoming budgets, including 2003, and should be considered in the preparation of any legislative initiatives that affect the budget.

43. ***Monetary policy has been well managed and the central bank should remain alert to threats to its inflation objectives***. The April increase in interest rates was an appropriate preemptive action to avoid inflationary pressures that might develop if current fiscal policies persist. Although current inflation is low, further increases in rates may be necessary to achieve the central bank's inflation objectives if the koruna again depreciates significantly vis-à-vis the euro. However, monetary policy is not the best instrument to address the excessive demand pressures stemming from inappropriate fiscal policies. Without fiscal measures, the large increases in interest rates that would be required would weaken competitiveness and crowd out private economic activity. ***This underscores the urgency of fiscal tightening***. With regard to the medium term, the authorities should keep in mind that achieving their disinflation objectives will require enhanced policy coordination, better communication to the public, and more forward-looking wage settlements.

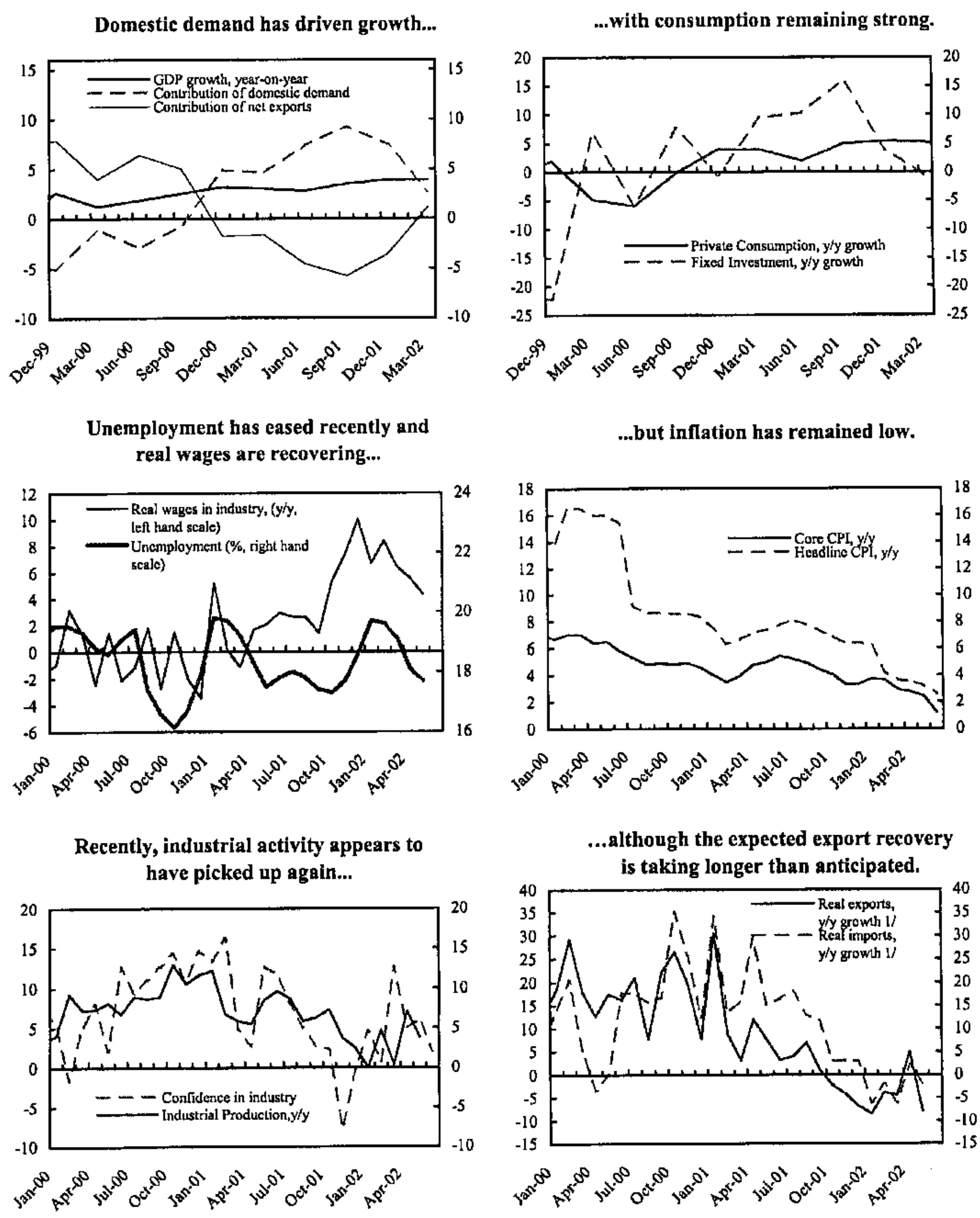
44. ***The financial sector has been strengthened substantially, but further progress is needed in supervision.*** Banks are fairly robust to macroeconomic shocks. Their entering new activities, though, particularly consumer lending, requires enhanced supervisory capabilities. Following its recent reorganization, the banking supervision department of the NBS should implement forcefully the supervisory policy agreed with the World Bank, and coordinate activities closely with the FMA. And, to become effective, the latter needs considerable institutional strengthening.

45. ***Making the economy more productive and flexible should remain the key focus of structural reforms***. The staff welcomes the steps taken so far on privatization and financial sector reform. A concerted implementation of reforms in the fiscal area is needed to achieve fiscal sustainability. But this needs to be complemented by substantial further progress in enterprise reform, removal of labor market rigidities, and continued reduction of the SMEs' administrative burden. These broad-based efforts are needed to facilitate the process of EU accession (and eventual euro adoption), which remain key strategic objectives for Slovakia.

46. ***The government and parliament that emerge from the September 2002 elections should move promptly and decisively on this extensive agenda.*** Rapid progress in reform, especially in those areas where progress has been limited over the past few years, would facilitate faster increases in living standards, and boost Slovakia's prospects for early EU accession.

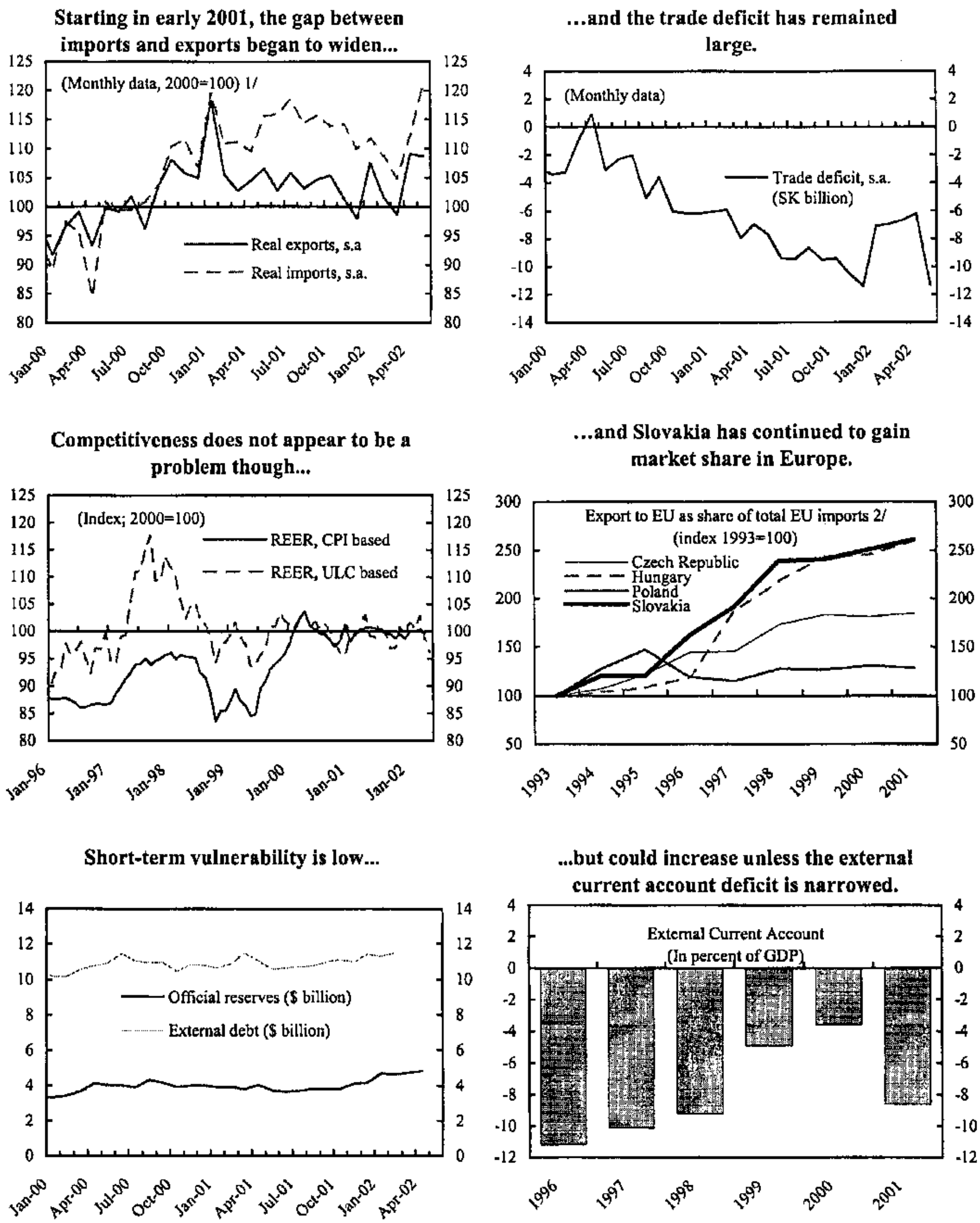
47. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Slovak Republic: Activity and Prices, 1999-2002



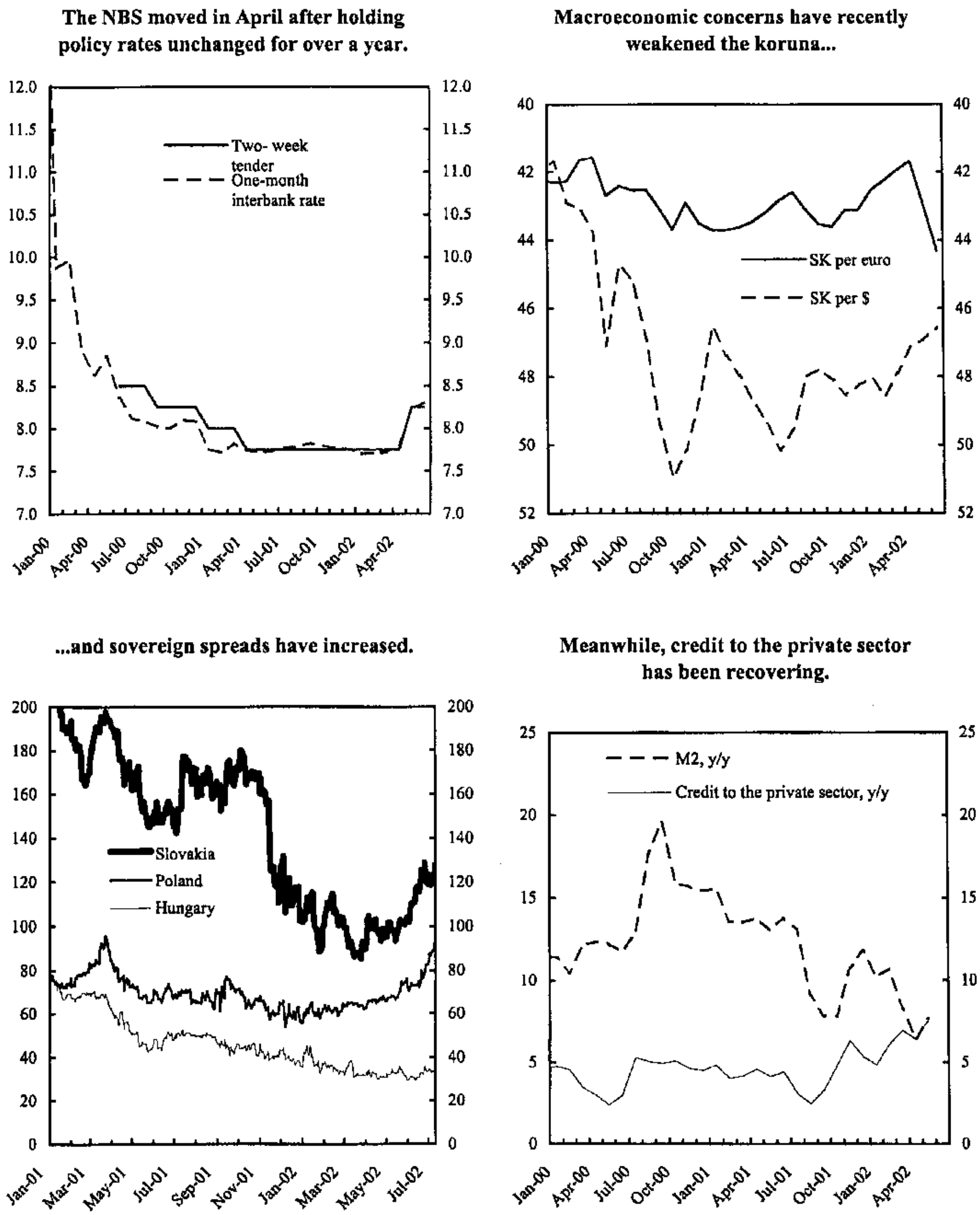
Sources: Slovak Statistical Office; and Fund staff calculations.
1/ Deflated by PPI.

Figure 2. Slovak Republic: External Indicators, 1993-2002



Sources: National Bank of Slovakia; and Fund staff calculations.
1/ Deflated by PPI.
2/ Excluding intra EU trade and oil imports.

Figure 3. Slovak Republic: Financial Market Indicators, 2000-02



Sources: National Bank of Slovakia; and Fund staff calculations.

Table 1. Slovak Republic: Selected Economic and Financial Indicators, 1998-2002

	1998	1999	2000	2001	2002 Proj. 1/
	(Percent change, period average)				
Real sector					
Real GDP	4.0	1.3	2.2	3.3	4.0
Consumer prices					
Period average	6.7	10.7	12.0	7.3	4.2
12 months to end of period	5.6	14.2	8.4	6.6	4.2
Gross industrial output (constant prices)	3.6	4.1	8.7	7.5	...
Real wages in industry					
PPI-based	4.7	4.0	0.4	3.4	...
CPI-based	1.3	-2.8	-2.9	2.2	...
Employment in industry	-4.1	-3.0	-3.0	1.1	...
Unemployment rate, period average	13.8	17.5	18.2	18.3	...
Real effective exchange rate 2/					
CPI-based	-1.4	-2.2	9.8	0.1	...
ULC-based	-6.8	-11.5	0.4	-1.8	...
	(In percent of GDP)				
General government finances					
Revenue	39.2	40.6	38.2	35.6	33.7
Expenditure 3/	43.9	44.0	41.7	39.6	38.1
Balance 4/	-4.7	-3.3	-3.5	-4.0	-4.4
State budget balance 4/	-2.1	-1.7	-1.6	-3.7	-4.8
	(Percent change, end of period, unless otherwise indicated)				
Money and credit					
Net domestic assets	10.9	9.5	6.2	16.5	-12.6
Credit to enterprises and households	5.8	4.6	4.5	5.3	11.0
Broad money	4.2	11.4	15.5	11.8	8.5
Interest rates (in percent, end-of-period)					
Lending rate (short term)	18.9	16.4	10.7	8.8	...
Deposit rate (one week)	16.2	12.1	6.0	5.8	...
Velocity	1.3	-1.9	-5.7	-2.3	-2.2
	(US$ billion, unless otherwise indicated)				
Balance of payments					
Merchandise exports	10.7	10.2	11.9	12.6	13.8
(percent change)	(11.1)	(-4.8)	(16.3)	(6.4)	(9.2)
Merchandise imports	13.0	11.3	12.8	14.8	16.0
(percent change)	(10.9)	(-12.8)	(13.2)	(15.5)	(8.5)
Trade balance	-2.2	-1.1	-0.9	-2.1	-2.2
Current account	-2.0	-1.0	-0.7	-1.8	-1.9
(percent of GDP)	(-9.2)	(-4.9)	(-3.6)	(-8.6)	(-8.5)
Official reserves, end-period	2.9	3.4	4.1	4.2	8.0
(in months of imports of GNFS)	(2.3)	(3.1)	(3.4)	(3.0)	(5.3)
(in percent of broad money)	(23.8)	(27.5)	(31.8)	(29.9)	(51.0)
Gross reserves of banking system	6.0	4.4	5.6	5.4	...
Gross external debt, end-period 5/	11.9	10.5	10.8	11.4	12.1
Gross external debt, end-period (in percent of GDP) 5/	54.1	52.1	54.9	55.8	53.3
Short-term debt (end-of-period) 6/ 7/	6.0	4.4	3.5	4.5	5.9
Short-term debt (end-of-period) 6/ 8/	4.6	2.7	2.4	3.0	3.5
Official reserves to short-term debt (in percent) 6/ 8/	63.5	126.6	168.8	139.5	229.1
Memorandum items:					
GDP, current prices (Sk billions)	775.0	835.7	908.8	989.3	1,065.1
Exchange rate (Sk/U.S. dollar)					
Period average	35.2	41.4	46.2	48.4	...
End of period	36.9	42.3	47.4	48.5	...
Public debt (percent of GDP)	28.8	40.1	44.1	43.0	41.2

Sources: Slovak Statistical Office; and Fund staff calculations.

1/ Adjustment scenario.

2/ Calculated for trade partners of Austria, Czech Republic, France, Germany, Hungary, Italy, and Poland.

3/ Includes net lending.

4/ Overall balance, excluding privatization proceeds, bank restructuring costs and guarantees.

5/ Excludes domestic currency denominated debt.

6/ Debt data are not reduced by US$2 billion in 1997 and 1998 (and US$1 billion in 1996) to take into account offsetting claims and liabilities of two Slovak subsidiaries of foreign banks with their parent companies.

7/ Short-term debt is defined so as to include medium- and long-term debt due in the subsequent year.

8/ Short-term debt is defined so as to exclude medium- and long-term debt due in the subsequent year.

Table 2. Slovak Republic: Medium-Term Macroeconomic Framework, 1998-2006

	1998	1999	2000	2001	Projection (adjustment scenario) 2002	2003	2004	2005	2006
Real GDP growth	4.0	1.3	2.2	3.3	4.0	3.7	4.7	5.4	5.3
Inflation (CPI)	6.7	10.7	12.0	7.3	4.2	7.1	5.5	4.5	4.3
Inflation (CPI, end-of-period)	5.6	14.2	8.4	6.6	4.2	7.2	5.4	4.3	3.7
Core inflation (end-of-period)	5.2	7.0	4.6	3.2	3.7	3.8	3.5	3.2	2.5
Inflation (GDP deflator)	5.2	6.4	6.4	5.4	3.5	5.5	5.5	4.5	4.3
	(In billions of koruny, current prices)								
Gross domestic product	775	836	909	989	1,065	1,165	1,287	1,416	1,556
Factor income (net)	-6	-12	-16	-15	-17	-19	-19	-18	-18
Gross national income	769	823	892	974	1,048	1,146	1,268	1,398	1,538
Current transfers (net)	13	8	5	10	9	10	10	11	11
Gross national disposable income	782	831	898	984	1,057	1,156	1,277	1,408	1,548
Net exports of GNFS	-82	-36	-22	-84	-83	-75	-72	-68	-66
Domestic demand	857	872	931	1,073	1,148	1,240	1,359	1,485	1,622
	(In percent of GDP)								
Gross national income	99.2	98.5	98.2	98.5	98.4	98.4	98.5	98.7	98.8
Gross national disposable income	100.9	99.5	98.8	99.5	99.3	99.3	99.3	99.5	99.5
Net exports of GNFS	-10.6	-4.3	-2.4	-8.5	-7.8	-6.4	-5.6	-4.8	-4.2
Consumption	75.9	76.1	76.0	76.6	76.7	76.2	75.4	74.4	73.5
Nongovernment	53.4	55.4	55.3	55.8	56.1	56.3	55.9	55.0	54.3
Government	21.8	19.8	19.8	20.0	19.9	19.2	18.7	18.6	18.4
Gross national savings	25.0	23.4	22.8	22.9	22.5	23.0	23.8	25.0	26.0
Nongovernment	24.0	23.0	22.7	22.9	23.3	22.8	22.9	23.6	24.1
Government	1.0	0.3	0.1	0.0	-0.8	0.2	1.0	1.4	1.9
Gross capital formation	34.7	28.2	26.4	31.9	31.0	30.2	30.2	30.4	30.7
Nongovernment	29.1	24.5	22.8	27.9	27.4	26.6	26.7	27.0	27.3
Government	5.7	3.7	3.6	4.0	3.7	3.6	3.5	3.4	3.3
Savings-investment gap (current account) 1/	-9.7	-4.9	-3.6	-9.0	-8.5	-7.2	-6.3	-5.4	-4.7
Nongovernment net savings	-5.1	-1.5	-0.2	-5.0	-4.1	-3.8	-3.8	-3.4	-3.3
Government net savings	-4.7	-3.3	-3.5	-4.0	-4.4	-3.4	-2.5	-2.0	-1.5
	(Annual percentage change, constant prices, unless otherwise indicated)								
GDP	4.0	1.3	2.2	3.3	4.0	3.7	4.7	5.4	5.3
Domestic demand	6.9	-6.2	0.0	7.2	3.5	2.7	3.8	4.5	4.6
Consumption	7.8	0.1	-1.0	4.2	3.7	1.5	3.2	4.0	4.0
Nongovernment	5.8	2.9	-1.8	4.0	4.5	2.5	3.5	3.7	4.0
Government	11.5	-7.7	1.3	5.1	1.8	-1.0	2.4	4.7	4.2
Gross capital formation	5.1	-20.2	2.8	15.2	2.8	5.6	5.3	5.7	5.7
Nongovernment 2/	8.0	-17.5	3.5	15.1	3.7	5.8	6.0	6.0	6.0
Government	-7.9	-34.0	-2.0	15.8	-3.0	4.3	0.0	3.4	3.5
Exports of GNFS	13.2	5.2	13.8	6.5	5.9	8.4	8.9	8.8	8.8
Imports of GNFS	16.9	-6.3	10.2	11.7	5.1	7.0	7.7	7.8	7.9
Households' disposable income	5.4	5.7	-1.5	2.0	4.1	1.4	3.9	5.2	5.0
Gross saving as percent of disposable income	8.6	10.6	11.1	9.2	8.7	7.7	7.8	8.9	9.7
Employment	-0.4	-2.2	-1.4	1.1	1.7	1.3	1.7	2.2	1.8
Nominal wages	9.0	6.7	6.4	8.3	8.7	8.0	8.5	7.7	7.8
Productivity	4.4	3.5	3.6	2.2	2.3	2.4	3.0	3.2	3.5
Unemployment rate (percent)	13.8	17.5	18.2	18.3	17.7	17.4	16.5	15.1	13.8

1/ The 1998, 1999, and 2001 S-I gaps implied by national accounts data differ from the current account reported in BOP statistics. In 2001 the discrepancy amounted to 0.4 percent of GDP.

2/ Includes changes in inventories and the statistical discrepancy.

Table 3. Slovak Republic: Fiscal Operations of the Consolidated General Government, 1999-2006 1/

(In percent of GDP)

	1999	2000	2001	2002			2003		2004	2005	2006
	Outcome	Outcome	Estimate	Budget	Proj, current policies	Adjustment scenario	Proj, current policies	Adjustment scenario	Proj, adjustment scenario		
Total revenue	40.6	38.2	35.6	33.5	33.6	33.7	33.8	33.7	33.9	33.8	33.8
Tax revenue	32.9	33.4	30.2	29.7	30.4	30.4	30.6	30.5	30.6	30.5	30.6
Personal income tax	5.5	4.5	4.5	4.3	4.4	4.4	4.4	4.3	4.3	4.4	4.4
Corporate profit tax	2.8	2.9	2.2	2.3	2.5	2.5	2.2	2.2	2.2	2.2	2.2
Social security contributions	12.1	12.7	11.9	11.4	11.8 7/	11.8 7/	12.2	11.8	11.8	11.8	11.8
VAT	7.1	7.8	7.4	7.7	7.6	7.6	7.8	8.1	8.1	8.0	8.0
Excises	3.0	3.1	2.9	2.9	2.8	3.0	3.0	3.0	3.0	3.0	3.1
Import duties and surcharge	1.5	1.5	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other	0.9	0.9	0.9	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Nontax revenue	7.8	4.8	5.4	3.8 4/ 5/	3.3 8/	3.3 8/	3.2	3.2	3.4	3.3	3.2
Total expenditure	40.9	41.1	38.9	38.2	38.8	38.1	39.3	36.8	36.2	35.6	35.0
Current expenditure	37.2	37.3	35.2	34.2	35.0	34.4	35.2	33.2	32.8	32.2	31.7
Gross wages	6.7	6.6	6.4	6.8	6.8	6.8	7.3	6.6	6.4	6.3	6.3
Other goods and services	5.4	5.3	5.3	5.0 6/	5.0	4.7	5.1	4.4	4.3	4.3	4.2
Social transfers	14.0	13.6	13.2	13.2	13.7 9/	13.5 9/	13.7	13.3	13.2	13.0	12.9
Health care	5.2	5.4	5.2	5.1 6/	5.3 10/	5.3 10/	5.3	5.2	5.2	5.2	5.2
Subsidies	3.1	3.9	2.6	1.4 4/	1.4	1.4	1.4	1.3	1.1	1.0	0.9
Interest	2.8	2.6	2.4	2.7	2.7	2.7	2.4	2.3	2.6	2.3	2.3
Investment expenditure	3.7	3.8	3.8	3.9	3.8 11/	3.7 11/	4.0	3.6	3.5	3.4	3.3
Financial balance	-0.3	-2.8	-3.4	-4.6	-5.1	-4.4	-5.4	-3.2	-2.3	-1.8	-1.3
Net lending (excluding privatization proceeds and called guarantees)	3.1	0.6	0.6	-0.2 5/	0.1 12/	0.1 12/	0.2	0.2	0.2	0.2	0.2
Overall balance (excluding privatization proceeds and called guarantees)	-3.3	-3.5	-4.0	-4.5	-5.2	-4.4	-5.6	-3.4	-2.5	-2.0	-1.5
Of which:											
State budget	-1.7	-1.6	-3.7	-4.6	-5.3	-4.8	-6.4	-4.0	-3.2	-2.7	-2.2
Rest of general government	-1.7	-1.8	-0.3	0.2	0.2	0.3	0.7	0.6	0.7	0.7	0.7
Of which:											
Local authorities	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security system	-0.9	-0.2	0.2	0.0	0.0	0.1	0.5	0.4	0.5	0.5	0.5
State funds	-0.4	-0.4	-0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
NPF and other projects	-0.1	-1.1	-0.2 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Overall balance (including guarantees and bank restructuring costs)	-3.8	-4.9	-5.7	-6.2	-7.2	-6.4	-6.9	-4.6	-3.3	-2.7	-2.1
Public debt 2/	40.1	44.1	43.0	41.2	42.0	41.2	45.3	42.3	41.6	40.6	39.1

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

1/ Excludes the impact of operations pertaining to the restructuring of the banking system, unless otherwise indicated.

2/ Includes debts assumed by the bank restructuring agencies in 1999 and 2000, and Sk 105 billion (11 percent of GDP) in bank restructuring bonds issued in the first quarter of 2001.

3/ Includes surplus of Sk 119 million from the Slovak Land Fund.

4/ The reported figure is lower by about 1 percentage point of GDP because of offsetting reclassifications to nontax revenue and subsidies associated with the consolidation of extrabudgetary funds into the state budget.

5/ Excludes privatization receipts used to retire arrears, Sk 1 billion from the sale of the Hotel Forum, Sk 4 billion from the sale of GSM licenses, Sk 4.2 billion from the sale of recovered loans by the Slovak Consolidation Agency, and Sk 1.6 billion recovered from called guarantees.

6/ Excludes payments using privatization receipts to retire arrears.

7/ Assumes additional contributions of Sk 4 billion.

8/ Assumes no NBS profit transfer (Sk 4.7 billion), shortfall in dividend payments (Sk 2 billion), but interest payments (Sk 0.7 billion) on privatization receipts.

9/ Assumes 5 percent pension increase from July 2002 (Sk 1.92 billion), overruns on social assistance and state benefits, and housing subsidies (Sk 3.6 billion), and paydown of education sector debt (Sk 0.5 billion).

10/ Assumes Sk 2.3 billion of fresh arrears incurred in the health sector.

11/ Assumes deferred motorway spending (Sk 1 billion) and cancellation of Govnet project (Sk 0.7 billion)

12/ Excludes cancelled Sk 1 billion repayment from the State Fund for Market Regulation, and Sk 1.3 billion repayment from health insurance companies.

Table 4. Slovak Republic: Balance of Payments, 1998-2006

(In millions of U.S. Dollars, unless otherwise indicated)

	1998	1999	2000	2001	Projection (adjustment scenario) 2002	2003	2004	2005	2006
Current account balance	-2,014	-979	-713	-1,756	-1,922	-1,796	-1,767	-1,676	-1,635
Trade balance	-2,235	-1,092	-917	-2,135	-2,212	-2,130	-2,150	-2,176	-2,225
Exports, f.o.b.	10,720	10,204	11,870	12,632	13,812	15,624	17,671	19,963	22,532
Imports, f.o.b.	-12,956	-11,296	-12,786	-14,766	-16,024	-17,754	-19,820	-22,139	-24,756
Services balance	20	218	439	480	456	521	592	670	756
Receipts	2,295	2,063	2,247	2,490	2,678	2,870	3,076	3,297	3,534
Payments	-2,275	-1,845	-1,807	-2,010	-2,222	-2,349	-2,484	-2,627	-2,778
Income balance	-166	-301	-353	-313	-356	-410	-422	-404	-401
Receipts	437	300	269	322	333	371	385	386	385
Payments	-603	-601	-622	-634	-688	-781	-807	-790	-785
Of which: Interest	-539	-561	-187	-267	-275	-365	-372	-350	-343
Current transfers	367	196	118	212	190	223	213	234	234
Official	-1	0	-3	-9	0	0	0	0	0
Private	368	196	121	221	190	223	213	234	234
Capital and financial account balance	1,957	2,140	1,511	1,894	5,080	558	1,865	1,377	1,239
Capital transfers	71	160	92	78	105	42	42	50	50
Direct foreign investment	314	756	2,096	1,460	4,168	808	1,343	1,131	1,168
Of which: Privatization			1,000	699	3,458	0	385	73	
Greenfield investment			1,117	776	750	850	1,000	1,100	
Portfolio investment	793	623	819	-217	746	316	373	316	316
Credit extended (net)	167	16	-159	-38	0	0	0	0	0
Credits received (net)	585	660	-429	-8	-201	-736	259	133	145
Disbursements	1,843	2,031	1,254	1,119	1,307	1,678	2,171	1,614	1,686
Amortization	-1,258	-1,371	-1,683	-1,127	-1,508	-2,415	-1,912	-1,480	-1,541
Short-term capital (net)	27	-75	-908	619	261	129	-152	-253	-439
Errors and omissions (inc. valuation changes) 1/	-171	-605	-19	-26	603	0	0	0	0
Overall balance	-229	555	779	112	3,842	-1,148	204	-173	-246
Financing	544	-555	-779	-112	-3,842	1,148	-204	173	246
Gross reserves (- = increase)	362	-502	-652	-112	-3,842	1,148	-204	173	246
Use of Fund credit	183	-53	-127	0	0	0	0	0	0
Memorandum items									
Current account balance (in percent of GDP)	-9.2	-4.9	-3.6	-8.6	-8.5	-7.2	-6.3	-5.4	-4.7
Export growth	11.1	-4.8	16.3	6.4	9.3	13.1	13.1	13.0	12.9
Import growth	10.9	-12.8	13.2	15.5	8.5	10.8	11.6	11.7	11.8
Gross official reserves (US$ million)	2,923.3	3,425.2	4,076.8	4,188.6	8,030.7	6,882.9	7,087.0	6,914.0	6,668.0
In months of imports of goods and services	2.3	3.1	3.4	3.0	5.3	4.1	3.8	3.4	2.9
Total external debt (US$ millions) 2/	11,901.9	10,498.1	10,804.3	11,421.0	12,060.0	11,603.5	11,867.3	11,904.1	11,765.9
(in percent of GDP)	54.1	52.1	54.6	55.8	53.4	46.4	42.4	38.2	34.0
Short-term external debt (US$ million) 3/	4,604.5	2,706.0	2,415.1	3,003.1	3,504.7	3,784.5	3,789.2	3,692.6	3,409.7
Short-term external debt adjusted (US$ million) 3/ 4/ 5/	5,975.9	4,389.0	3,542.3	4,510.7	5,919.3	5,696.2	5,269.4	5,233.9	5,015.1
Reserves/Short-term debt (percent) 5/	48.9	78.0	115.1	92.9	135.7	120.8	134.5	132.1	133.0
Reserves/Broad money (percent)	21.8	27.0	30.8	29.8	51.3	39.8	36.6	32.1	27.8
MLT External debt service/Exports of goods and service	14.3	16.2	14.1	9.2	10.8	15.0	11.0	7.9	7.2
GDP (US$ millions)	21,995.1	20,163.0	19,780.5	20,459.4	22,599.7	25,017.5	27,974.8	31,158.9	34,644.0

Sources: Data provided by the Slovak authorities; and Fund staff estimates.

1/ In 2002, reflects the valuation changes of the NBS gold, gold swaps, and repos.

2/ The composition of the external debt is expected to change in the medium term with medium- and long-term (MLT) debt declining as privatization receipts are used to retire public debt, and private short-term debt increasing to finance the trade balance deficit.

3/ Excludes the effects of so-called "window dressing" operations, whereby commercial banks increased both short-term external assets and liabilities. These operations account for gross debt of some US$2 billion at end-1997 and end-1998.

4/ Includes MLT amortization and the short-term debt stock.

5/ Short-term external debt is defined so as to include MLT repayments due the next year.

Table 5. Slovak Republic: Vulnerability Indicators, 1996-2002
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	2002 Proj.
Financial indicators							
Public sector debt 1/	26.4	28.8	28.8	40.1	44.1	43.0	41.2
Broad money (percent change, 12-month basis)	...	8.8	4.2	11.4	15.5	11.8	8.5
Private sector credit (percent change, 12-month basis)	...	2.2	5.8	4.6	4.5	7.5	11.0
Domestic credit to GDP	68.5	66.1	70.3	68.9	67.2	69.9	58.1
Bond yield at issue (one-five years, annual average)	8.6	18.9	23.2	17.0	9.0	7.8	...
Bond yield at issue, real (one-five years, annual average) 2/	2.8	12.8	16.5	11.0	3.2	3.5	...
External indicators							
Exports (percent change, 12-month basis in US$) 3/	2.9	9.6	11.1	-4.8	16.3	6.4	9.2
Imports (percent change, 12-month basis in US$) 3/	26.3	5.2	10.9	-12.8	13.2	15.5	8.5
Terms of trade (percent change, 12-month basis)	-2.8	-1.6	2.4	-2.1	-0.2	-2.2	-0.5
Current account balance	-10.3	-8.5	-9.2	-4.9	-3.6	-8.6	-8.5
Capital and financial account balance	10.6	9.0	8.6	9.8	7.2	8.9	22.0
Portfolio investment, net	0.5	0.1	3.6	3.1	4.2	-1.1	3.3
Medium- and long-term credits + short-term credits	9.1	8.4	3.5	3.0	-7.6	2.8	0.3
Direct investment, net	1.0	0.5	1.4	3.7	10.7	7.1	18.4
Net foreign assets (NFA) of commercial banks (in US$ billions)	0.2	0.5	0.7	0.6	1.0	1.0	...
Gross official reserves (in US$ billions)	3.5	3.3	2.9	3.4	4.1	4.2	8.0
Net international reserves (NIR) (in US$ billions)	...	...	3.8	4.1	5.3	4.8	...
Central bank short-term foreign liabilities (in US$ billions) 4/	0.0	0.2	0.0	0.0	0.0	0.0	...
Central bank foreign currency exposure (in US$ billions)	1.8	1.5	0.4	0.7	1.2	1.4	...
Short-term foreign assets of commercial banks (in US$ billions) 5/	2.2	3.2	3.1	1.1	1.5	1.2	...
Short-term foreign liabilities of commercial banks (in US$ billions) 5/	1.4	2.2	2.1	0.3	0.3	0.6	...
Foreign currency exposure of commercial banks (in US$ billions)	0.2	0.5	0.7	0.6	1.0	1.0	...
Official reserves in months of imports GS	3.2	2.9	2.3	3.1	3.4	3.0	5.3
Reserve money to (gross official) reserves (percentage)	79.2	84.0	84.2	80.9	58.8	56.0	33.7
Broad money to (gross official) reserves (percentage)	373.6	396.7	438.0	363.7	314.7	334.9	196.2
Total short-term external debt to gross official reserves (percentage) 6/	84.2	130.6	157.5	79.0	59.2	71.7	43.6
Total external debt	37.4	46.3	54.1	52.1	54.9	55.8	53.3
Of which: Public sector debt	...	8.3	11.4	13.9	17.2	17.4	...
Total external debt to exports GS (in percent)	64.9	82.6	91.4	85.6	76.5	75.5	73.2
Total external debt service payments to exports GS	14.7	12.4	14.3	16.2	14.1	9.2	10.8
Exchange rate (per US$, period average)	30.7	33.6	35.2	41.4	46.2	48.4	...
REER depreciation (-) (12-month basis; CPI-based)	0.1	6.1	-1.4	-2.2	9.8	0.1	3.3
Financial market indicators (end-year)							
Stock market index	178	183	94	77	92	121	...
Foreign currency debt rating (Moody's)	...	Baa3	Ba1	Ba1	Ba1	Baa3	...
Spread of (five-year benchmark) bond (basis points) 7/	...	...	...	248	181	56	...

1/ General government.

2/ From 1999 onward, core inflation is used to deflate nominal interest rates.

3/ Merchandise trade.

4/ Includes short-term liabilities of the government.

5/ Short-term assets and liabilities of commercial banks are affected by "window dressing" operations amounting to US$2 billion in 1997 and 1998, (and US$1 billion in 1996) involving offsetting claims and liabilities of two Slovak subsidiaries of foreign banks with their parents.

6/ Excludes medium- and long-term debt due next year.

7/ Five-year euro-denominated eurobond, over German five-year bund.

Table 6. Slovak Republic: Monetary Survey, 2000-03
(In actual exchange rates, Sk billion)

	2000	2001	2002					2003
	Dec 1/	Dec Outcome	1/1/02 Adjusted 2/	Mar	Jun Proj.	Sep Proj.	Dec Proj.	Dec Proj.
Net foreign assets, NIR definition	104.1	119.3	130.2	128.0	261.8	282.0	274.4	273.9
Position of banks vis-à-vis nonresidents in Sk	17.8	2.2	2.2	-10.8	-10.8	-10.8	-10.8	-10.8
Bonds held by nonresidents	-11.0	-20.6	-20.6	-22.8	-22.8	-22.8	-22.8	-22.8
Net foreign assets	110.9	101.0	111.8	94.4	228.2	248.4	240.8	240.3
Net domestic assets (M2)	497.1	578.9	568.1	569.6	459.2	457.2	495.9	580.1
Domestic credit	622.0	691.6	691.6	687.5	585.8	590.3	618.4	705.6
Net credit to government 3/	305.1	345.4	347.4	368.2 4/	255.1 5/	259.8 5/	279.6 5/	326.3
From banking system	159.3	190.2	190.2	211.2	98.0	102.3	123.0	210.8
Foreign financing	133.4	136.5	138.5	136.5	136.1	136.0	134.5	91.5
Nonbank domestic financing	12.4	18.5	18.5	20.5	21.0	21.5	22.0	24.0
Net credit to National Property Fund 3/	0.1	10.4	8.4	6.2	9.8	1.5	1.5	1.5
Credit to enterprises and households	316.8	335.8	335.8	313.1 6/	321.0	329.1	337.3	377.8
Other items, net (M2)	-124.9	-112.7	-123.5	-117.9	-126.7	-133.1	-122.5	-125.5
Broad money (M2)	608.0	679.9	679.9	664.0	687.4	705.6	736.7	820.5
Koruna broad money	513.7	574.8	574.8	563.0	581.6	597.2	624.4	694.9
Currency	67.0	81.0	81.0	79.6	75.2	78.5	87.0	94.2
Deposits	541.0	598.9	598.9	584.4	612.2	627.1	649.7	726.3
Of which: in foreign currency	94.4	105.1	105.1	101.0	105.8	108.4	112.3	125.5
Memorandum items (year-on-year percentage change, unless otherwise indicated)								
Nominal GDP growth	8.9	9.2	9.2	7.8	8.5	8.1	6.0	9.4
M2	15.5	11.8	11.8	8.3	10.0	10.0	8.4	11.4
Change in M2 velocity, in percent, year-on-year	-5.7	-2.3	-2.3	-0.4	-1.3	-1.8	-2.2	-1.8
Koruna M2	14.0	11.9	11.9	8.6	10.3	10.6	8.6	11.3
M2-base money multiplier	5.4	5.98	6.0	5.76	6.15	6.08	5.83	6.34
Currency-deposits ratio	0.124	0.135	0.135	0.136	0.123	0.125	0.134	0.130
Net credit to government (fiscal deficit)	34.3	36.3	36.3	5.8	7.9	22.0	42.9 7/	39.8
Bank restructuring interest costs paid by MOF	...	8.0	8.0	8.4	11.7	12.5	12.5	8.0
Government debt reduction with NPF revenues	...	...	...	0.0	57.1	66.2	66.2	0.0
Increase in pension account at NBS	...	...	0.0	0.0	66.3	67.4	68.5	1.1
Credit to enterprises and households	2.6	6.0	6.0	...	...	...	11.0	12.0

Sources: National Bank of Slovakia; and Fund staff estimates and projections.

1/ In January 2001, privatization bonds equivalent to Sk 83.7 billion were issued, to repay Sk 72.3 billion bank credit to the Slovak Konsolidation Agency (SKA, an enterprise) and Sk 11.4 billion bank credit to the Consolidation Bank. In March, a similar transaction took place, which decreased credit to enterprises by Sk 21.3 billion, and increased credit to the government by a similar amount. The December 2000 data are presented including the impact of these transactions.

2/ Revaluation of NFA amounting to Sk 10.9 bln.

3/ Includes accumulated interest payments on restructuring bonds.

4/ Includes increase of Sk 11.5 bln in February due to the merger of the Consolidation Bank into the SKA (related to an NBS credit to the SKB).

5/ Includes deposits of privatization receipts at the pension fund account at the NBS.

6/ In February, credits from SKA (Sk 31.5 bln) and Devin Bank (Sk 4 bln) were removed from the statistics.

7/ Increase in net credit to the government is Sk 4.2 billion lower than the fiscal deficit due to revenues from sales of claims of the consolidation agency.

Slovak Republic: Fund Relations

(As of June 28, 2002)

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

II. **General Resources Account**:	SDR Million	%Quota
Quota	357.50	100.0
Fund Holdings of Currency	357.50	100.0

III. **SDR Department**:	SDR Million	%Allocation
Holdings	0.53	N/A

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

V. **Financial Arrangements**:

Type	Approval Date	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 Slovak koruna, created on February 8, 1993 upon dissolution of the currency union with the Czech Republic. A single exchange rate applies to all transactions within the convertible currency area. The currency was floated on October 1, 1998. The exchange rate stood at Sk 44.955 per U.S. dollar and Sk 44.305 per euro on June 28, 2002.

VIII. **Article IV Consultation**:

Last consultation with the Slovak Republic concluded on July 27, 2001 (SM/01/220, July 13, 2001).

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

X. **Resident Representative Post**: Mr. Costas Christou assumed the post in Bratislava upon its reopening in January 2002.

Slovak Republic: Technical Assistance, 1991–2002[1]

Department	Timing	Purpose
MAE	April 1991 September/October 1991 February/March 1992	Mission to the State Bank of Czechoslovakia; design of monetary policy instruments and operating procedures; and development of foreign exchange operations and the legal framework for central and commercial banking and the reorganization of the State Bank
	May 1991 and December 1992	Staff visits on monetary instruments
	Through September 1991	Regular visits by experienced central banker
	December 1992	Mission to the newly established Slovak Central Bank: monetary instruments, operations and analysis, foreign exchange operations, and banking supervision
	Since January 1993	Several expert visits on banking supervision
	January 1993	Expert visit on foreign exchange operations
	February 1993	Staff visit on monetary operations and analysis
	March 1993	Mission on payments and clearing systems, central bank accounting, and central bank organization
	June 1993	Expert visit on monetary projections and analysis
	November 1993	Expert visit on monetary operations and analysis
	Since November 1993	Resident advisor on banking supervision, co-sponsored by the EC-PHARE
	February/March 1994	Mission on monetary analysis and operations, foreign exchange operations, banking supervision and regulation, central bank accounting, clearing and payment system, and central bank organization
	May 1994	Advise to the NBS Governor, visit by senior advisor
	September 1994	Advise to the NBS Governor, visit by senior advisor
	January 1995	Expert visit on organizations and methods
	January 1995	Mission on issues in monetary and foreign exchange operations, banking supervision, payments, accounting, legal, and organization and management
	May 1995	Mission on issues in monetary and foreign exchange operations, banking supervision, payments, accounting, legal, and organization and management
	December 1995	Expert visit on monetary operations and research
	April 1997	Mission on the banking law, monetary policy implementation, coordination between monetary operations and government debt management, and research work done by the NBS

[1]With the exception of the MAE mission in December 1992, technical assistance in 1991–92 was delivered to the Czech and Slovak Federal Republic.

Department	Timing	Purpose
	October 1997	Mission on monetary statistics compilation procedures, and classification of bank accounts in monetary statistics
	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
	February-March 2002	Financial Sector Assessment Program (FSAP)
FAD	February and July 1991	Advice on the design of new corporate and personal income taxes
	May and September 1991	Advice on policy and administrative aspects of the introduction of VAT
	Since December 1991	Regular visits by FAD consultant on VAT administration
	March 1992	Advice on administration (particularly VAT)
	April 1992	Examination of public financial management
	April 1993	Follow-up mission on public financial management
	May 1993	Mission on tax policy and administration
	June 1994	VAT administration, visit by expert
	March/April 1998	Tax and customs administration, and administration of social security contributions
	September/October 1999	Review macro fiscal management and system for monitoring and consolidating fiscal operations; review legislative and institutional setting for public expenditure management; and assess progress in establishing state treasury
	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)
	Since August 2001	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
LEG	April and July 1991	Assistance with the drafting of new corporate and personal income tax laws
	October 1991	Assistance with the drafting of income tax and VAT laws
	January 1992	Assistance with the drafting of the tax administration law

	March 1992	Follow-up visit by consultant focusing on the income tax and tax administration laws
	May 1993	Assistance with revision of tax reform legislation
	September 1993	Assistance with income tax legislation
	May 1995	Assistance with drafting of the foreign exchange act, and acceptance of Article VIII obligations
STA	June 1991	Mission on government finance statistics
	September 1991	Mission on balance of payments statistics
	May 1993	Mission on monetary statistics
	December 1993	Mission on balance of payments statistics
	January 1994	Mission on government finance statistics
	February 1994	Mission on money and banking statistics
	November 1994	Mission on money and banking statistics
	November 1995	Mission on national accounts statistics
	November/December 1995	Mission on balance of payments statistics
	October 1997	Mission on money and banking statistics
	September/October 1998	Mission on Dissemination Standards Bulletin Board
	February 1999	Mission on money and banking statistics
	February 2000	Mission on national accounts and price statistics
	March 2001	Multisector mission

Slovak Republic: Statistical Issues

1. From the point of view of macroeconomic analysis and policy making, the quality of the data, in particular of the national accounts, has improved in recent years. The main issues remaining are: (i) weaknesses in the data on prices and volume of imports and exports, (ii) a lack of timely data on the overall operations of the general government, (iii) inconsistencies between government accounts and national accounts on government consumption, and (iv) the absence of comprehensive data on public and private enterprises. Slovakia has subscribed to the Special Data Dissemination Standard (SDDS).

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. Changes in definitions and coverage, however, often diminish the usefulness of published data. Data on core surveillance variables are provided regularly to the Fund, and with minimal lags: a week or less for exchange rates and foreign exchange reserves; three weeks or less for general government financing and detailed state budget implementation data; ten 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.

Real sector and prices

3. Significant progress has been made in the elaboration of the Slovak national accounts statistics. However, output estimates for the last few years may yet have to be revised in the future. The quarterly national accounts data on expenditures exhibit weaknesses and there is a significant statistical discrepancy between the supply side and the demand side (representing almost 2% of GDP in 2000).[2] An important outstanding issue is the construction 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 currently not appropriately adjusted for quality changes. The problem is recognized by the statistical authorities; however, improvement is still 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).

[2]In line with staff recommendation the Slovak Statistics Office has started to publish data for this discrepancy, which is no longer included in inventories.

4. In the area of consumer price indices, it is important that historical data are produced on the basis of the new basket for both core inflation and CPI. The authorities plan to release data starting in 1992 in October 2002.

5. 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 underestimated (especially if compared to VAT receipts), and wages statistics might be biased.

6. 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. It would also be helpful if the authorities provided more detailed data on privatization transactions.

Fiscal sector

7. General government statistics are compiled annually in accordance with the methodology of the *1986 Manual on Government Finance Statistics (GFSM)* for internal use, publication in the *GFS Yearbook,* and dissemination on the MoF website in compliance with the SDDS. In accordance with the EU *acquis communautaire,* the authorities report semi-annually on general government net lending/borrowing. Monthly reconciliation of government operations above and below the line is restricted to budget transactions. The cash transactions of the extrabudgetary and social security funds and of municipal governments are more reliably measured from below the line, which was the method employed in monitoring the operations of general government under the Fund's SMP. The authorities have improved the coverage of central government by absorbing 10 of the 12 extrabudgetary funds in the 2002 budget, with an eleventh fund to be abolished at end-2002. The introduction of a modern treasury system includes a new budget classification, which is expected to be used in the preparation of the 2003 budget. The new system will improve fiscal control by providing a means of recording expenditures at the planning and commitment stages. This will enable the treasury to monitor and control the creation of arrears. However, the MoF has indicated that the coverage of monthly data will be difficult to improve further because of the political pressure to preserve the operational independence of the privatization funds and municipalities, and the newly established regional governments. The multi-sector STA mission in March 2001 recommended that the authorities implement the classifications and reporting concepts of the revised *2001 GFS Manual* in the new treasury system. The mission also recommended that the operations of the Slovak Consolidation Agency (SKA) and the Bratislava Consolidation Bank (KBB) be included in the coverage of general government.

External sector

8. The Slovak Republic provides balance of payments statistics in a timely manner. The balance of payment statements are presented in two formats, an analytical presentation and

the standard presentation, and are reported on a quarterly basis. Banks are now reporting their arbitrage transactions accurately. Improvements have also been made in reporting nonresidents' claims and liabilities in Slovak koruny. Information on external debt, including short-term debt, is reported on a timely basis. Weekly information on Gross International Reserves is reported timely via the reserves template. Moreover, the NBS has revised with effect from January 1, 2002 its methodology of reporting foreign exchange reserves. These changes are in line with IMF guidelines and STA technical recommendations and include the valuation of gold at market price and a change in the reporting of repo operations and gold swaps. Also, the reporting of foreign exchange reserves by commercial banks has been revised to include selected long-term assets in the item "foreign exchange reserves." Some problem areas remain, including: (i) the measurement of inward portfolio investment; (ii) the need for more detailed and timely information on publicly guaranteed external debt; and (iii) the need to improve data compilation on the composition of exports. A March 2001 STA mission recommended the adoption of a conduct survey for obtaining data on transportation, travel, and direct investment, and provided model survey forms for this purpose.

Monetary sector

9. Monetary statistics are of good quality, and are reported on a timely basis to the Fund. A STA mission that went to Bratislava in March 2001 noted that data sources for monetary statistics are being progressively adapted to meet the European Central Bank requirements, including for the valuation of financial instruments based on fair values. The mission recommended corrections in the treatment of securities that underlie repurchase agreements; in the classification of data items reported in unclassified assets and liabilities; and in the coverage of the banking systems' position with the general government. In particular, the mission recommended that monetary accounts should exclude data relating to transfer of securities used as a collateral for repurchase agreements; holdings of NBS bills in the portfolio of commercial banks should be separately identified to facilitate a consistency check of positions between NBS and the commercial banks; SKA should be classified, starting from the date of its registry, as a unit of general government rather than as a nonfinancial public enterprise; gold swaps should be treated as collateralized loans and recorded on a gross basis; and, repurchase agreements between banks and the National Property Fund, which is considered part of general government, should be treated as collateralized loans and separately identified.

Slovak Republic: Core Statistical Indicators
(as of June 28, 2002)

	Exchange Rates	Gross International Reserves	Central Bank Balance Sheet 1/	Reserve/ Base Money	Broad Money	Interest Rates 2/	Consumer Price Index	Exports/ Imports	Current Account Balance	Government Balance	GDP/GNP	External Debt
Date of Latest Observation	6/28/02	6/26/02	6/10/02	5/31/02	5/31/02	6/28/02	6/02	5/02	12/02	5/02	Q1/02	3/02
Date Received	6/28/02	6/28/02	6/27/02	6/14/02	6/14/02	6/28/02	6/06/02	6/28/02	3/28/02	6/03/02	6/13/02	6/28/01
Frequency of Data 3/	D	W	M	O 4/	M	D	M	M	M	M	Q	M
Frequency of Reporting 3/	D	W	M	O 4/	M	D	M	M	M	M	Q	M
Source of Data 5/	N	N	N	N	N	N	N	N	N	A	N	N
Mode of Reporting 6/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 7/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 3/	D	W	M	O 4/	M	D	M	M	M	M	Q	M

1/ In addition to the complete balance sheet published monthly, three times per month a 10-day return is published.
2/ Interbank rates. Deposit and lending rates are reported on a monthly basis. T-bill and government bond rates are reported at issue.
3/ D=daily; W=weekly; M=monthly; Q=quarterly; O=other.
4/ Reported three times per month.
5/ A = Central bank, ministry of finance, or other official agency; N=official publication or press release.
6/ E = Electronic data transfer.
7/ C = Unrestricted use.

Slovak Republic: Relations with the World Bank

The Slovak Republic became a member of the World Bank on January 1, 1993, by joint succession with the Czech Republic to the membership of the Czech and Slovak Federal Republic.

A Structural Adjustment Loan (SAL) (US$450 million), approved in June 1991 with Czechoslovakia, was fully disbursed. The Czech and Slovak Republics assumed repayment obligations in the ratio of 2:1. World Bank lending to Slovakia in the immediate aftermath of independence was limited to two operations. A US$55 million telecommunications loan, approved in May 1993, helped to strengthen the international and domestic long-distance networks, and, in recent years sector privatization. An Economic Recovery Loan of US$80 million, approved in November 1993, provided support to the country's fiscal and structural adjustments associated with the shocks following the breakup of the Federation. The loan supported reforms in four areas: (i) fiscal retrenchment; (ii) strengthening and diversifying the fiscal sector; (iii) continued privatization, private sector development, and enterprise restructuring; and (iv) a more efficient social safety net.

A comprehensive Country Economic Memorandum (CEM) which evaluated the transformation progress of Slovakia's economy and the main EU accession challenges was completed in early 1998.

After a period of diminished activity (1994–98), program assistance revamped in late 1998, when a new government took office. Initial support focused on reforms in the enterprise and financial sectors. An anti-corruption diagnostic was conducted to identify pocket areas of corruption and support the government's anti-corruption reform program, and the Bank provided technical support to public sector reform and undertook assessments of public procurement and financial accountability. Assistance is also undergoing in the social sectors; a *Living Standards, Employment and Labor Market Study* was finalized in August 2001, and a Social Spending Review in May 2002.

A first Bank Group Country Assistance Strategy (CAS) for Slovakia was presented to the Board in February 2001. The overall strategic objective of the CAS is to put Slovakia on a path of rapid and sustained convergence with its Western European neighbors and improve living conditions, particularly among the vulnerable segments of the population. A program of lending and nonlending support would focus on: (i) completing transformation reforms, restoring high growth, and maintaining economic stability; (ii) strengthening governance and institutions; and (iii) improving social security, enhancing human development, and meeting environmental standards. The CAS envisages IBRD/IFC commitments in the order of US$415 million for the next three years in the base case, and about US$765 million in the high case. An Enterprise and Financial Sector Adjustment Loan for € 200 million was approved by the board in August 2001 and is currently in the process of realizing the second of the three tranches. Reforms in the area of social protection are being supported through the Social Benefits Administration

Reform Project. The project (€ 26.2 million) was approved in February this year. Also, a Public Finance Reform Project and a Judicial Reform Project are underway. A Health Sector Modernization Project (US$80 million) has been already approved by the Government of Slovakia and the necessary Slovak co-financing is set to be appropriated in the 2003 budget.

The Bank is also involved in analytical work to prepare Slovakia for joining the EU; in this regard the Bank is carrying out several studies on accession impact; including a study on strategy and policy issues in agriculture. In parallel, the Bank has just started to prepare a Development Policy Review (DPR). The DPR is intended to articulate an integrated development agenda that would include policy priorities, and sequencing of key reforms taking into account linkages across sectors and policy areas. The document is intended to provide an integrated overview of medium-term policy issues to the upcoming government as Slovakia approaches the EU.

Several IDF grants are being implemented in Slovakia: Grant for Bankruptcy Reform, Grant for Capacity Building for the Roma Office, and the new IDF Grant on Legal and Judicial Reform is under preparation. Recent study: *Poverty and Welfare of Roma in Slovak Republic* has been published by the World Bank with the cooperation of the local foundations: S.P.A.C.E., INEKO, and Institute for Open Society.

The International Finance Corporation has also expanded its activities, with initial focus on the financial sector and enterprise restructuring. It is also providing advice on foreign investment and improving the business climate in general. Multilateral Investment Guarantee Agency has several guarantees outstanding.

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

IMF Concludes 2002 Article IV Consultation with the Slovak Republic

On August 9, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Slovak Republic.[1]

Background

The Slovak economy has performed solidly over the past decade, with real GDP growth averaging 4.2 percent and inflation staying below 14 percent. The lowering of trade barriers, progress in restructuring the economy, and the reorientation of trade to OECD markets, all supported economic growth. However, the unemployment rate remains high and has not fallen below 12 percent since the start of the transition.

The present government assumed office in October 1998 amidst signs of vulnerability, including a substantial depreciation of the currency upon its forced flotation. The government adopted strong policies, including an ambitious fiscal consolidation plan, to restore macroeconomic balances and lay the basis for sustainable economic growth. The narrowing of the fiscal deficit, the exchange rate depreciation, and a hardening of budget constraints led to a substantial reduction of macroeconomic imbalances in 1999–2000. But economic growth

[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.

weakened to about 2 percent a year during this period, as contracting domestic demand largely offset the remarkable recovery in net exports.

After two years of subdued domestic activity, strong private domestic demand and expansionary fiscal policy buoyed economic growth, which recovered to over 3 percent in 2001. Increased profitability, enterprise restructuring, and reduced corporate income tax boosted fixed investment, while rising real wages and employment, personal income tax reduction, and the redemption of National Property Fund (NPF) bonds underpinned vigorous growth in private consumption. The general government deficit widened by a half percentage point of GDP to 4 percent of GDP in 2001, mainly reflecting income tax cuts and the removal of an import surcharge.

Economic activity has since accelerated further, and unemployment and inflation have continued to ease. Real GDP grew by 4 percent year-on-year in early 2002, and sustained increases in employment have made a dent in the still-high unemployment rate. The sustained pickup in the pace of economic activity has been accompanied by favorable price developments. With unit labor costs growing modestly, limited administered price adjustments, and stable food and fuel prices, core and headline inflation were 3.2 and 6.6 percent, respectively, in December 2001, and have since fallen further.

However, in a weakening external environment, surging imports and decelerating exports led to a widening of the external current account deficit from 2001. Strong domestic demand and the removal of the import surcharge contributed to a surge in imports last year, while the European slowdown and Volkswagen Slovakia's restructuring works contributed to weaker exports, although exports are now recovering. The external deficit has been financed mainly by foreign direct investment (FDI) inflows, but increasingly by debt-creating inflows since the second half of 2001. However, recent large privatization receipts from abroad have strengthened the external position.

On structural reforms, following recent progress in some areas, the authorities' priority remains making the economy more productive, flexible, and resilient, in a context of preparing for accession to the European Union. The main banks and utilities have been restructured and privatized, fiscal transparency and control improved, quasi-fiscal activities curtailed, and the legislative framework strengthened. But the remaining agenda is considerable, including further corporate restructuring and labor market reform; strengthening banking supervision; preventing new health sector arrears; introducing a mandatory, funded pension pillar; and strengthening state administration and the judicial system.

Executive Board Assessment

Executive Directors were encouraged by the recent performance of the Slovak economy in a difficult external setting. The policies implemented over the past several years have helped restore macroeconomic balances and strengthen the economy, including through the attraction of sizeable FDI inflows. At the same time, Directors expressed concern about the widening external current account deficit, rooted in part in excessive fiscal expansion, and the risks this poses to economic prospects.

Directors agreed that the short-term outlook remains positive, provided the right policies are undertaken. Domestic activity is buoyant and a continuing economic recovery in Europe should help sustain it going forward; and data through mid-year confirm the expectation of low inflation in 2002. Directors expressed concern, however, that excessive domestic demand pressures could keep the external current account deficit large—or even increase it—although they acknowledged the partly temporary factors behind the deficit, and the recent strengthening in export performance. Directors saw a prompt tightening of fiscal policy as essential to put the external accounts and economic growth on a sustainable basis.

Directors urged the authorities to take all necessary measures to meet their fiscal deficit target for 2002 of 4½ percent of GDP. They expressed concern about slippages in the budget, particularly on expenditures, and noted that on current trends the general government deficit would exceed 5 percent of GDP. Directors therefore recommended timely measures, mostly on the expenditure side. They also encouraged the authorities to accelerate reforms to halt arrears in the health sector, introduce the second pillar of the pension system, and streamline the civil service and public administration. Delays in introducing measures would pose risks to the fiscal deficit targets for both 2002 and 2003, potentially compromising medium- term objectives.

Given the priority of achieving sustainable medium-term fiscal and external positions, Directors welcomed the goal of reducing the general government deficit by at least 2½ percent of GDP over the next 3 years--primarily through retrenchment of government spending. However, achieving that and other deficit targets would depend crucially on formulating the budget, the legislative initiatives that affect the public finances, and similar fiscal instruments, with these targets firmly in mind. The need for substantial expenditures related to EU and NATO accession, including infrastructure upgrading, will make achievement of the fiscal targets an even greater challenge.

Directors commended the authorities for their skillful management of monetary policy, which had delivered declining inflation in a context of economic recovery. The April 2002 increase in interest rates was an appropriate preemptive action to avoid the inflationary pressures that might develop if current external pressures persist. At the same time, monetary policy was not the best instrument to address the excessive demand pressures on the external accounts, as it might weaken competitiveness and dampen private sector activity.

Directors noted that the central bank had worked effectively within the current monetary policy framework to reduce inflation. With regard to the medium term, achieving disinflation objectives will require enhanced communication to the public and stronger policy coordination, including to mitigate the second-round effects of the 2003 administered price increases. A few Directors recommended a more transparent charting of the Slovak Republic's intended path toward ERM II and, in due course, monetary integration with the euro area.

Directors welcomed recent structural reforms—notably the restructuring and privatization of the main banks and utilities, and improvements in fiscal transparency and control. They cautioned, however, that an extensive agenda of unfinished structural reforms remains. Directors stressed the need to raise productivity and growth prospects by removing remaining labor market rigidities and improving the business environment, including continued reduction of the administrative burden on small and medium-sized enterprises.

Directors welcomed the authorities' steps to strengthen the financial sector, and their determination to complete the financial reforms identified in the Financial System Stability Assessment, including further strengthening the supervision of banks and nonbank financial institutions. They also welcomed progress in implementing anti-money laundering (AML) policies, and encouraged the authorities to ensure full implementation of AML policies in the nonbank financial sector.

Directors noted the authorities' efforts to improve the quality of economic statistics, increase transparency, and comply with international standards. They welcomed the results of the Reports on the Observance of Standards and Codes modules for the financial and fiscal sectors, which showed substantial recent improvements in transparency and fiscal management.

Finally, Directors were encouraged by the Slovak Republic's progress in preparing for EU membership, which would improve living standards and boost prospects for medium-term growth.

Slovak Republic: Selected Economic Indicators

	1998	1999	2000	2001
	(Percent change, period average)			
Real sector				
Real GDP	4.0	1.3	2.2	3.3
Consumer prices				
Period average	6.7	10.7	12.0	7.3
12 months to end of period	5.6	14.2	8.4	6.6
Gross industrial output (constant prices)	3.6	4.1	8.7	7.5
Real wages in industry				
PPI-based	4.7	4.0	0.4	3.4
CPI-based	1.3	-2.8	-2.9	2.2
Employment in industry	-4.1	-3.0	-3.0	1.1
Unemployment rate, period average	13.8	17.5	18.2	18.3
Real effective exchange rate 1/				
CPI-based	-1.4	-2.2	9.8	0.1
ULC-based	-6.8	-11.5	0.4	-1.8
	(In percent of GDP)			
General government finances				
Revenue	39.2	40.6	38.2	35.6
Expenditure 2/	43.9	44.0	41.7	39.6
Balance 3/	-4.7	-3.3	-3.5	-4.0
State budget balance 3/	-2.1	-1.7	-1.6	-3.7
	(Percent change, end of period, unless otherwise indicated)			
Money and credit				
Net domestic assets	10.9	9.5	6.2	16.5
Credit to enterprises and households	5.8	4.6	0.3	6.0
Broad money	4.2	11.4	15.5	11.8
Interest rates (in percent, end-of-period)				
Lending rate (short term)	18.9	16.4	10.7	8.8
Deposit rate (one week)	16.2	12.1	6.0	5.8
Velocity	1.0	-1.4	-5.6	-2.8
	(US$ billion, unless otherwise indicated)			
Balance of payments				
Merchandise exports	10.7	10.2	11.9	12.6
(percent change)	(11.1)	(-4.8)	(16.3)	(6.4)
Merchandise imports	13.0	11.3	12.8	14.8
(percent change)	(10.9)	(-12.8)	(13.2)	(15.5)
Trade balance	-2.2	-1.1	-0.9	-2.1
Current account	-2.0	-1.0	-0.7	-1.8
(percent of GDP)	(-9.2)	(-4.9)	(-3.6)	(-8.6)
Official reserves, end-period	2.9	3.4	4.1	4.2
(in months of imports of G & NFS)	(2.3)	(3.1)	(3.4)	(3.0)
(in percent of broad money)	(23.8)	(27.5)	(31.8)	(29.9)
Gross reserves of banking system	6.0	4.4	5.6	5.4

Slovak Republic: Selected Economic Indicators

	1998	1999	2000	2001
Gross external debt, end-period 4/	11.9	10.5	10.8	11.4
Gross external debt, end-period (in percent of GDP) 4/	54.1	52.1	54.9	55.8
Short-term debt (end-of-period) 5/ 6/	6.0	4.4	3.5	4.5
Short-term debt (end-of-period) 5/ 7/	4.6	2.7	2.4	2.8
Official reserves to short-term debt (in percent) 5/ 7/	63.5	126.6	168.8	149.3
Memorandum items:				
GDP, current prices (Sk billions)	775.0	835.7	908.8	989.3
Exchange rate (Sk/U.S. dollar)				
Period average	35.2	41.4	46.2	48.4
End of period	36.9	42.3	47.4	48.5
Public debt (percent of GDP)	28.8	40.1	44.1	43.0

Sources: Slovak Statistical Office; and IMF staff calculations.

1/ Calculated for trade partners of Germany, France, Austria, Italy, Czech Republic, Poland, and Hungary.
2/ Includes net lending.
3/ Overall balance, excluding privatization proceeds, bank restructuring interest costs, and called guarantees.
4/ Excludes domestic currency denominated debt.
5/ Debt data are not reduced by US$2 billion in 1997 and 1998 (and US$1 billion in 1996) to take into account offsetting claims and liabilities of two Slovak subsidiaries of foreign banks with their parent companies.
6/ Short-term debt is defined so as to include MLT debt due in the subsequent year.
7/ Short-term debt is defined so as to exclude MLT debt due in the subsequent year.

Statement by Johann Prader, Executive Director for the Slovak Republic
August 9, 2002

Introduction

The Slovak authorities are continuing their program of macroeconomic stabilization and comprehensive restructuring and privatization. They wish to express their special appreciation to the staff and to Mission Chief Fernández-Ansola for their advice and constructive discussion during the preparation of Slovakia's staff-monitored program (SMP).

The aim of this voluntary program was the implementation of a comprehensive economic agenda with monitoring and advice from Fund staff. No financing by the Fund was involved, but a good performance under the program was a precondition for the World Bank's Enterprise and Financial Sector Adjustment Loan (EFSAL) to Slovakia.

Since the last Article IV consultation, Slovakia's economy has been affected by the world slowdown, mostly by reducing exports to its main trading partners. Increasing imports also played a key role in the deterioration of the trade balance. The outgoing authorities agree with the staff that the external deficit can be reduced by corrective measures on the fiscal side. Both the government and the opposition parties recognize the need for measures to reduce the fiscal deficit and create conditions leading to current account sustainability, although they will not be implemented until after the elections in September 2002.

Slovakia has made significant progress towards EU accession. In November 2001 the government approved a list of "Priority Tasks for the Government" drawn from the regular report of the European Commission on the Slovak Republic's Progress Towards EU Accession issued last November. These tasks include speeding up the process of EU accession negotiations. Their implementation has enabled the Slovak Republic to catch up with the other candidate countries, having so far concluded 27 chapters out of 31.

Real Sector Development

Stabilization policy and progress with structural reforms are creating favorable conditions for economic recovery. Growth accelerated to 3.3 percent in 2001, largely impelled by a significant increase in fixed investments attracted by the improved profitability, as well as by foreign direct investments. A rebound of real wages brought a turnaround of private consumption. However, increasing domestic demand and the global slowdown reduced exports and helped widen the current account deficit. The authorities expect that economic growth in 2002 and in 2003 will be 4 percent of GDP.

Current Account Deficit

Reduced export growth, increased import-intensive investments, and higher private consumption, are the main factors responsible for the widening of the current account deficit last year and early this year. The authorities note that import–intensive investments are a positive sign of restructuring and should lead to increased export capacity in the years ahead.

The authorities regard the present increase in the current account deficit as largely temporary. It is expected to recede as Slovakia's western European trading partners recover and its household-driven domestic demand returns to trend. But the authorities agree that the current level of the current account deficit is unsustainable. The Selected Issues paper provides an excellent analysis of the sustainability of the current account deficit, which generally agrees with the views of the Slovak authorities.

Already there are signs that the deficit is starting to narrow. The latest data on the trade balance clearly shows an improvement in the export performance. Exports in June 2002 were 6.7 percent higher than in June 2001, while imports over the same period increased by 2.7 percent. At the same time, the current account deficit has been more than fully financed by capital inflows.

Monetary Policy

The National Bank of Slovakia (NBS), which bases its monetary policy on inflation benchmarks, has achieved continuous disinflation. On April 26, 2002, the Banking Board of the NBS raised its policy interest rate by 50 basis points. The change was mostly a response to the worsening external imbalances due mainly to the increased foreign trade deficit.

Currency fluctuations, and the tendency of the Slovak koruna to depreciate *vis-à-vis* the euro, led the central bank to intervene in the foreign exchange market in June, after which the koruna/euro exchange rate stabilized. The tendency toward depreciation mainly reflects political uncertainty created by the upcoming elections.

With regard to EMU strategy, the NBS expects to work with the new government on a memorandum for establishing inflation benchmarks once the process of price deregulation has been completed.

Fiscal Policy

In 2001 substantial reductions in personal and corporate income tax rates, and the phasing out of the import surcharge, were not matched by comparable declines in public spending. Expenditure arrears have spread to the health sector. The general government deficit reached almost 4 percent of GDP.

The present government is committed to holding down the fiscal deficit to 4.5 percent of GDP in 2002. In revising Slovakia's Pre-Accession Economic Program (PEP), the government envisages a fiscal deficit of 3.5 percent of GDP for 2003. There is a broad political consensus that these targets are appropriate, and the incoming government can be expected to take the necessary measures to ensure that the targets are met.

These measures will focus mainly on expenditures. On the revenue side, the focus will be on improving tax collection, particularly the VAT. This will be accomplished by an amendment to the VAT law which will become effective in January 2003. In addition, the authorities will strengthen tax administration along the lines recommended by IMF technical assistance missions.

Pension Reform

The authorities' efforts to improve the pension system have focused mainly on establishing a legal framework. Parliament passed a Social Insurance Act in May 2002, which will become effective in July 2003. This act puts in place reforms of the first pillar, including individual accounts and a gradual increase in the retirement age for women. The act is a first step toward a full reform of the pension system, and prepares the ground for introducing a second pillar.

In order to speed up the reform of the administration of social benefits, in February 2002 the authorities agreed to accept technical assistance from the World Bank. This technical assistance will assist the administrative reforms, including increasing administrative capacity and designing the second pillar.

Restructuring of the Banking Sector

To create conditions for a well-functioning financial system and ensure efficient resource allocation, the authorities have continued their restructuring of the banking sector. And as noted earlier, the authorities have signed an agreement for an EFSAL, which was approved in September last year.

Based on the World Bank's recommendations, the authorities have prepared and begun to implement a plan for improving prudential regulation. They are enforcing the new Banking Act that came into force in 2002, and the 2001 amendment to the National Bank of Slovakia Act, which brings Slovakia's legal framework closer to EU standards and the Basel Core principles. Also, based on a diagnostic evaluation, the NBS approved a multi-year "Supervisory Development Plan" in December 2001. This plan is focused on risk-oriented banking supervision and integrated off- and on-site supervision. To put this into practice, the NBS has hired new staff, created a training program, and will upgrade its supervisory information system.

The Slovak authorities have greatly appreciated the opportunity to have Slovakia's financial sector assessed by the Fund and the Bank. The Financial Sector Assessment Program has usefully reviewed the strengths, vulnerabilities, and opportunities for key improvements in Slovakia's financial system. The authorities concur with most of the views presented by the mission, and they will carry out the main recommendations.

Privatization of Banking Sector and Public Utilities Companies

Slovakia's privatization process gained significant momentum in 2001 and 2002 and is entering its final stage. The major state-owned banks have all been privatized by foreign companies. The present share of the private banks amounts to over 90 percent, and the authorities are continuing to privatize the other state-owned banks. The rest of the banking sector--consisting of small and medium-sized banks--has also been restructured and will be completely privatized.

The most important parts of the privatization process were privatizing the banking sector and privatizing the public utilities. In November, a 94.5 percent stake in Všeobecná úverová banka (VUB), Slovakia's second largest bank, was sold to Italy's IntesaBCI. And in April, a 66.8 percent stake in Slovenská Poistovňa (SP), the largest Slovak insurer, was sold to Allianz AG of Germany. And the Hungarian saving bank OTP Bank has become the owner of a 92.6 percent stake of Investičná a Rozvojová banka (IRB).

Most of the public utility companies have been sold to foreign strategic investors. The authorities sold the natural monopoly Slovenský Plynárenský Priemysel (SPP) to a consortium of Ruhrgas of Germany, Gaz de France, and Gazprom. SPP was the largest privatization in the Slovak Republic. At the end of last year a 49 percent stake in Transpetrol, the oil pipeline, was sold to a Russian company.

In May 2002, the authorities approved the sale of 49 percent shares in each of the three electricity distributors. Západoslovenská Energetika (ZE) was sold to EON of Germany, Stredoslovenská Energetika (SSE) to Electricité de France, and Východoslovenská Energetika (VSE) to RWE Plus Germany. In addition, the authorities agreed to sell to private investors 49 percent stakes in four companies of Slovenská Automobilová Doprava (SADs).

The authorities have scheduled further privatizations for the second half of this year. These will concentrate on the remaining public utilities, mostly heating companies and leftover SADs. Many of these will likewise be sold to foreign strategic investors.

Regulatory Authorities

To promote efficiency and harmonize legislation with the EU, an independent regulatory authority for the setting of administered prices has been established and a new Regulatory Council was appointed in October 2001. This regulatory body has been preparing to set energy prices based on economic criteria, beginning on January 1, 2003.

Unemployment

Though the latest data on unemployment reflect a slight improvement, the present level of unemployment is still worrisome. The excessive unemployment is structural in nature. It includes large numbers of prime-age and older workers displaced by industrial restructuring and the closure of agriculture co-operatives. The very low level of labor mobility is caused both by problems in the housing market, and by social assistance benefits that are uniform nation-wide despite large regional differences in living costs.

Partly in order to address the unemployment problem, a new Labor Code was approved last year, and became effective in April 2002. Based on broad discussions among entrepreneurs, trade unions, and officials, the authorities agreed with the staff that the Code should establish a more general framework for labor relations which would give employers and employees substantial flexibility in reaching agreement on specific work arrangements. The authorities noted an emerging consensus for amendments to this effect, and the next government is likely to act quickly to introduce such amendments.

Conclusion

The Slovak Republic's present government, which took office in the fall of 1998, has established a macroeconomic framework for medium-term development, and has restructured, and nearly completed the privatization, of the banking sector and public utility companies. Despite these accomplishments, the next government will face serious challenges, especially if the current account balance does not improve. These include the need for further fiscal consolidation, completing enterprise reforms, creating favorable conditions for small- and medium-size enterprises, improving labor market mobility, and introducing the second pillar of the pension system. Such undertakings will create the conditions for a smooth accession to the EU and prepare Slovakia for the highly competitive EU marketplace.