INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/220

SLOVAK REPUBLIC

July 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT

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 2019 Article IV consultation with the Slovak Republic, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on lapse of time basis, following discussions that ended on May 16, 2019 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 June 13, 2019.
- An **Informational Annex** prepared by the IMF staff.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND

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July 12, 2019

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IMF Executive Board Concludes 2019 Article IV Consultation with the Slovak Republic

On July 11, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Slovak Republic and considered and endorsed the staff appraisal without a meeting.[2]

Following consecutive years of favorable performance, the Slovak economy is facing deceleration. Strong domestic demand fueled by double-digit household credit growth, robust job creation, and rising wages as well as capacity expansions in the automotive industry has lifted growth to 4.1 percent in 2018. With a positive output gap and unemployment at record lows, rapid wage growth has been outpacing productivity. Strong growth, together with past reforms in health and social spending, has helped lower the fiscal deficit to below 1 percent of GDP in 2018 and public debt below the lowest limit prescribed by the national Fiscal Responsibility Act. Meanwhile, the banking system remains stable and well-capitalized, although profitability is under pressure.

Signs of deceleration in growth are becoming apparent owing to softer external demand and weaker sentiment. As one-off effects of investment in the automotive industry taper off, real GDP growth is projected to slow to 3.5 percent this year and 3.1 percent in 2020 before converging to its potential over the medium term. Private consumption is expected to remain the main propeller of economic activity supported by continued credit and wage growth. Higher exports on the back of capacity expansions in the automotive sector are expected to contribute to growth and narrow the current account deficit toward a balanced position in the medium term.

The softer economic outlook faces significant uncertainties. A turning economic cycle is unmasking several structural vulnerabilities. Slovakia's heavy dependence on exports and a concentrated export structure makes the economy highly sensitive to ongoing global trade tensions and risks of a no-deal Brexit. Meanwhile, the country's comparative advantages arising

[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

from the availability of low-cost skilled workers are being tested by rising automation of assembly jobs. Structural challenges are compounded by lingering weakness in public institutions and gaps in the quality of education and infrastructure relative to EU peers. In addition, a decade of strong credit growth has significantly raised household indebtedness and made banks vulnerable to economic downturns.

Executive Board Assessment

In concluding the 2019 Article IV Consultation with the Slovak Republic, Executive Directors endorsed staff's appraisal as follows:

With one-off effects of investment in the automotive industry tapering off, growth is projected to decelerate and gradually converge to its potential. Domestic demand, supported by robust wage and credit growth, is expected to propel economic activities, while contributions from net exports are also expected to improve on the back of recent capacity expansion in the automotive sector. Continued international trade tensions and a hard Brexit pose major downside risks to Slovakia's export-led economy. With still-high credit growth, households and banks are vulnerable to possible labor and property market downturns.

Slovakia's continued success in export-led growth strategy hinges on capturing higher-value activities. Recent policy efforts to ensure an adequate supply of qualified teachers and strengthen dual-track vocational training should be complemented by improving the quality of tertiary education and aligning higher education with technical skills needs. Improving the coordination of public research system, strengthening linkages between businesses and universities, and ensuring full use of EU funds for R&D would help enhance innovative capacity, which are important to move beyond assembly activities in exports. To increase the role of domestic firms, reforms should target a more predictable and enabling business environment, competitive and transparent public procurement system, independent judiciary, and well-developed infrastructure and logistics networks.

With the population set to experience fast ageing, efforts to ensure optimal use of the domestic labor force are appropriate. An insufficiently inclusive education system combined with a lack of affordable early childcare facilities is contributing to the still-high gender gap and regional disparities in labor market participation. Legislative proposal to make schooling mandatory starting at age 5, efforts to reintegrate the long-term unemployed into the labor market and increasing availability of affordable childcare are welcome. This should be complemented by active labor market policies to invest in skills and increase employability of the marginalized groups, including through better absorption of EU funds.

With above-potential growth, a balanced budget target for 2019 and 2020 is appropriate but will require additional efforts. Recent fiscal consolidation, driven by strong growth and policy efforts, has created some fiscal space under the SGP. However, the public debt trajectory is vulnerable to sizable economic downturns given strict escape clauses and debt brakes prescribed under the national FRA. Sustained fiscal consolidation will require fending

off pressures to increase discretionary stimulus, which has absorbed a good part of the revenue windfall in recent years. The proposal to introduce multi-year expenditure ceilings to anchor budget planning and execution, while being consistent with the FRA and the SGP, would serve as an important step to instill durable fiscal discipline. Overly strict escape clauses may need to be revisited to avoid pro-cyclical fiscal tightening.

Higher revenue and spending efficiency are needed to create resources for growth-enhancing social and infrastructure investment. Planned measures to improve tax compliance through online electronic cashiers and electronic taxpayer services should be sustained through further strengthening of audit capacity in all core tax areas. Strong political will and better inter-ministerial coordination are needed to push through reforms outlined in the spending reviews. Strengthening the mandate of the implementation unit and incorporating actionable measures in the medium-term budget would help actualize savings. Additionally, a more robust public investment framework can improve the efficiency of public investment and absorption of EU funds, including through better project selection and prioritization at a national level.

The banking sector is stable and well-capitalized, but profitability is under pressure and segments of vulnerability exist. A prolonged period of low interest rates, a too benign credit risk assessments by banks, the regulatory cap on mortgage refinancing fees, and the strong market intermediation role of mortgage brokers result in the compression of the lending margin. A sustained period of high credit expansion by banks, especially to low income segments, has nearly doubled household debt relative to disposable income. Moreover, rapidly rising flat prices in urban areas and appreciating house price-to-income ratio indicate growing vulnerabilities of households and banks, in particular, smaller banks with less capital buffers.

Proactive macro-prudential measures have moderated credit growth and reduced credit risks of new loans. The incremental use of CCyB and supervisory capital requirements have been appropriate in ensuring adequate capital buffers for banks. Strong vigilance of smaller banks, including through reduction of NPLs, is important and further increase in capital buffers may be needed given their higher vulnerability. Allowing the bank levy to expire as scheduled in 2021 should help the smaller banks build more capital buffers. Given historically low default rates, considerations should be given to impose add-on risk weight on mortgages loans to ensure better internalization of credit risks. To complement macro- and micro-prudential policies, consideration should be given to reducing preferential tax treatments for housing investment and removing obstacles to develop the rental housing market.

Slovak Republic: Summary of Economic Indicators, 2016–24

	2016	2017	2018	2019	2020	2021	2022	2023	2024
			Est.	Projections					
	(Annual percentage change, constant prices, unless noted otherwise)								
Output/Demand									
Real GDP	3.1	3.2	4.1	3.5	3.1	2.9	2.7	2.7	2.5
Domestic demand	1.2	2.6	4.2	3.0	2.5	2.4	2.3	2.6	1.4
Public consumption	1.6	1.7	1.9	1.8	1.7	1.5	1.5	1.5	1.5
Private consumption	2.9	3.5	3.0	3.0	2.4	2.2	1.9	1.9	1.9
Gross fixed capital formation	-9.4	3.4	6.8	3.4	3.5	3.5	3.8	5.0	0.3
Exports of goods and services	5.5	5.9	4.8	5.4	5.2	5.0	4.5	4.4	4.4
Imports of goods and services	3.4	5.3	5.3	5.0	4.7	4.7	4.2	4.4	3.6
Potential Growth	2.5	3.4	4.1	3.7	3.6	3.1	2.9	2.9	2.6
Output gap	1.0	1.2	1.2	1.0	0.6	0.4	0.3	0.2	0.1
Contribution to growth									
Domestic demand	1.0	2.3	4.2	2.8	2.3	2.2	2.1	2.4	1.3
Public consumption	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.2
Private consumption	1.5	1.8	1.6	1.5	1.2	1.1	1.0	0.9	0.9
Gross fixed capital formation	-2.3	0.7	1.5	0.8	0.8	0.8	0.8	1.1	0.1
Inventories	1.5	-0.6	0.8	0.1	0.0	0.0	0.0	0.0	0.0
Net exports	2.2	0.9	-0.1	0.8	0.9	0.7	0.7	0.4	1.2
Prices									
Inflation (HICP)	-0.5	1.4	2.5	2.4	2.2	2.1	2.1	2.1	2.1
Inflation (HICP, end of period)	0.2	2.0	1.9	2.2	2.1	1.8	1.9	2.0	2.0
Core inflation	0.3	1.8	2.3	2.1	2.0	2.0	2.0	2.1	2.1
GDP deflator	-0.5	1.2	2.1	2.7	2.2	2.4	2.2	2.1	2.1
Employment and wages									
Employment	2.4	2.2	2.0	1.0	0.6	0.6	0.6	0.5	0.4
Unemployment rate (Percent)	9.7	8.1	6.6	6.0	5.9	5.8	5.7	5.7	5.7
Nominal wages	3.2	4.6	6.2	6.4	5.8	5.1	4.8	4.8	4.8
	(Percent of GDP)								
Public Finance, General Government									
Revenue	39.2	39.4	39.9	39.4	39.4	39.2	39.1	39.9	38.1
Expenditure	41.5	40.2	40.6	39.7	39.5	39.2	39.5	40.7	38.7
Overall balance	-2.2	-0.8	-0.7	-0.3	0.0	0.0	-0.4	-0.7	-0.7
Primary balance	-0.6	0.6	0.6	0.9	1.0	1.1	0.6	0.3	0.3
Structural balance									
(Percent of potential GDP)	-2.7	-1.2	-1.2	-0.7	-0.3	-0.1	-0.6	-0.8	-0.7
General government debt	51.8	50.9	48.9	47.3	45.8	44.3	42.9	41.7	40.4
	(Percent)								
Monetary and financial indicators									
Credit to private sector (Growth rate)	9.7	9.7	9.2	8.9	8.3	6.5	6.1	5.9	5.7
Lending rates[1]	2.0	1.8	1.5	...	...	...	...	...	...
Deposit rates[2]	0.7	0.4	0.4	...	...	...	...	...	...
Government 10-year bond yield	0.5	0.9	0.9	...	...	...	...	...	...
	(Percent of GDP)								
Balance of payments									
Trade balance (goods)	2.0	0.8	0.1	0.7	1.3	1.8	2.1	2.1	2.8
Current account balance	-2.2	-2.0	-2.5	-1.7	-1.0	-0.8	-0.3	0.0	0.4
Gross external debt	92.2	111.0	113.3	113.7	114.3	114.9	115.3	115.3	114.8
Saving and investment balance									
Gross national savings	20.8	20.6	21.1	21.9	22.8	23.7	25.0	25.9	26.6
Private sector	19.8	19.4	19.7	20.5	21.4	22.4	23.8	24.7	25.5
Public sector	1.0	1.2	1.4	1.4	1.4	1.3	1.2	1.2	1.1
Gross capital formation	23.0	22.5	23.6	23.6	23.8	24.5	25.2	26.0	26.3
Memo item									
Nominal GDP (Millions of euros)	81,226	84,851	90,202	95,918	101,132	106,547	111,859	117,303	122,701

Sources: National Authorities; and IMF staff calculations.

[1]Average of interest rates on new housing loans to households and loans of less than EUR 1 million to nonfinancial corporations (all maturities).

[2]Average of interest rates on new deposits with agreed maturity (up to 1 year) from households and nonfinancial corporations.

INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

June 13, 2019

KEY ISSUES

Context: Leveraging its location and low-cost skilled labor, Slovakia has attained a very high level of integration with the global value chains, which has proved pivotal to exports growth and income convergence with the European Union. After half a decade of robust growth, the Slovak economy is decelerating. With rising trade tensions and a turning economic cycle, several vulnerabilities are coming to the fore. High dependence on exports combined with a concentrated export structure makes Slovakia particularly vulnerable to external developments. On the domestic front, a prolonged period of double-digit mortgage credit growth and declining bank profit margins have made households and the financial sector susceptible to labor and property market downturns.

Key Policy Recommendations

Structural Policies. To maintain long-term competitiveness, policies should support domestic firms to move up the value chains through enhanced skills and innovation, adequate physical and digital infrastructure, and better institutions.

Fiscal Policies. With a positive output gap, the authorities' objective to reach a balanced budget in 2019 and in the medium-term is appropriate. Expansionary measures currently under consideration and beyond what is already budgeted should be avoided. To accommodate large investment needs in infrastructure and education and increase social inclusion, policy space should be created through higher efficiency of public spending and tax collections and full and effective absorption of EU funds. In view of considerable downside risks to the outlook, considerations should be given to revisiting the growth-related escape clause under the national fiscal rule to avoid pro-cyclical tightening.

Financial Policies. The authorities' proactive macro-prudential policies are welcome, but additional capital buffers in weaker banks are needed. Introducing a risk weight add-on on housing loans would require banks to better reflect credit risks in lending decisions. Preferential tax treatments for housing investment should be reduced and obstacles to developing the rental housing market should be addressed.

Approved By
Enrica Detragiache (EUR) and Nathan Porter (SPR)

Discussions were held in Bratislava, May 6–16, 2019. The mission met with Finance Minister Kamenický, State Secretary Kuruc, other senior officials from Finance, Education, Economy, and Labor ministries, the Prime Minister's office, the NBS, and the Council for Budget Responsibility, and representatives from the private sector, the European Union, and trade unions.

The staff team comprised Ms. Rahman (head), Messrs. El Ashram, Stepanyan, and Muraki (all EUR). Mr. Harvan (OED) attended the meetings. Messrs. Park and Smith assisted in the preparation of the staff report.

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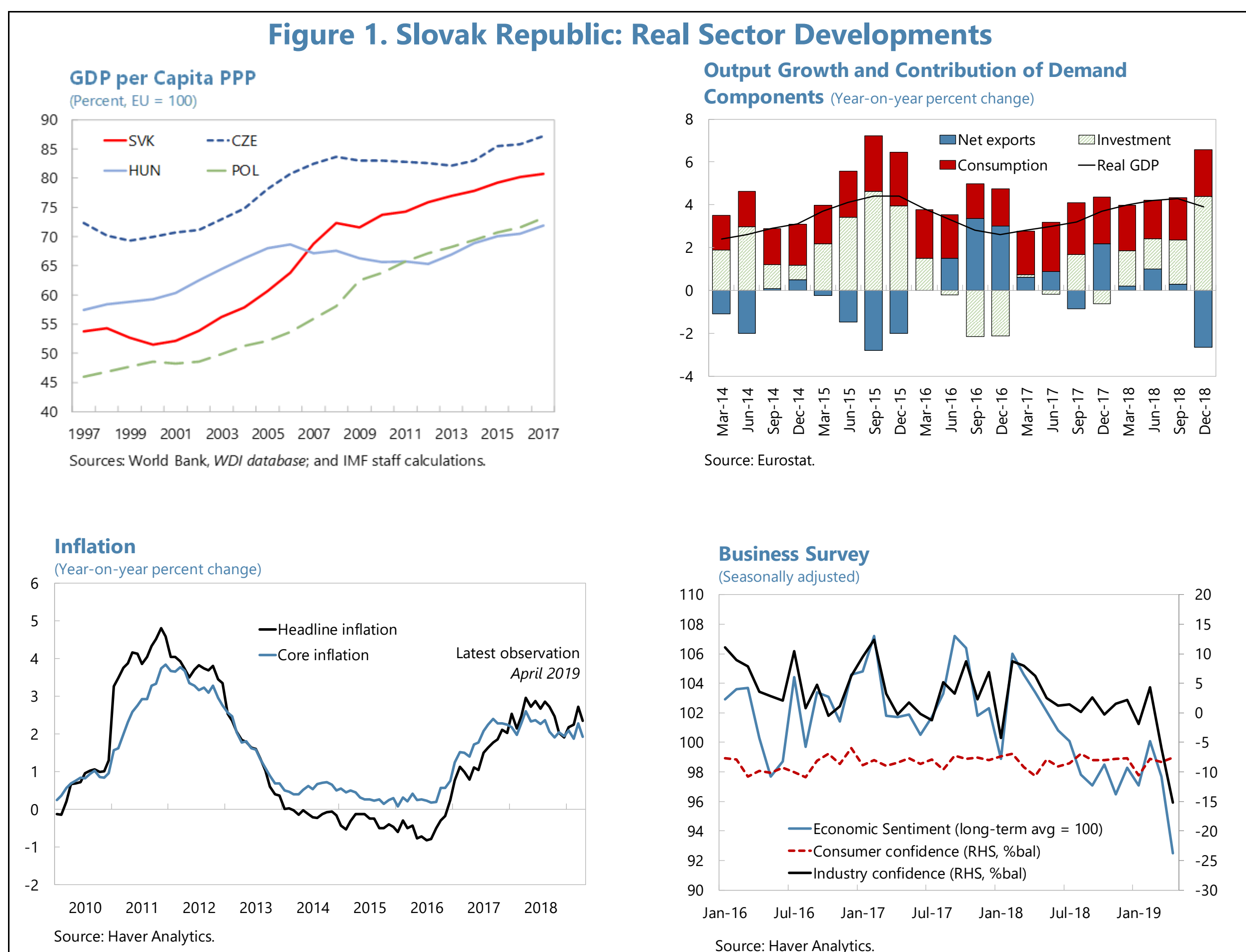
CONTEXT

1. After half a decade of robust growth, the economy is showing signs of deceleration. Slovakia is an economic success story that has witnessed sustained income convergence during the last two decades with per capita income rising from around 45 percent of the EU average to 75 percent (Figure 1). Income distribution has also improved, though regional disparities remain sizable. Supported by strong household credit growth and labor market dynamics as well as investments in the automotive industry, real GDP growth accelerated in recent years reaching 4.1 percent in 2018 (Table 1). Wage growth, reflecting capacity constraints, has surpassed productivity growth for the last 5 years pushing both core and headline inflation rates to above 2 percent in 2018. Signs of growth deceleration are becoming apparent owing to softer external demand and weaker sentiment.

Figure 1. Slovak Republic: Real Sector Developments

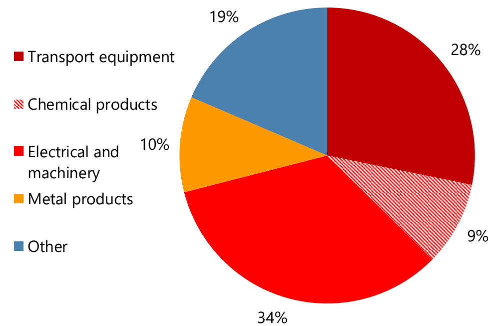


2. With the growth cycle having passed its peak and ongoing international trade tensions, several vulnerabilities are coming to the fore. The economy's heavy dependence on exports, combined with a concentrated export structure, where the top four product categories and EU destinations count for over 80 percent of total exports, makes Slovakia highly sensitive to external developments (Figure 2). With rising automation of assembly jobs, the country is at risk of

losing its comparative advantage arising primarily from the availability of low-cost vocationally-trained industrial workers that have made it a magnet for foreign direct investment over the years. Unfavorable perception of institutional quality, if not addressed, may become more detrimental going forward. On the domestic front, pressed by declining lending margins, the banks have expanded mortgage loans aggressively for a prolonged period of time, including to more risky segments. As a result, both households and banks are vulnerable to labor and property market downturns.

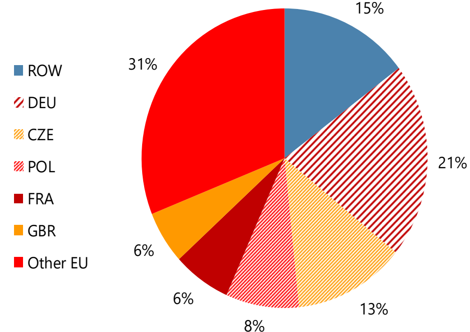
Figure 2. Slovak Republic: Real and Financial Sector Vulnerabilities

Slovakia: Export Composition
(Percent of total)



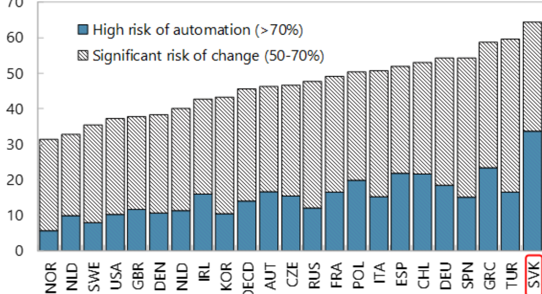
Source: Eurostat.

Slovakia: Export Destinations
(Percent of total)



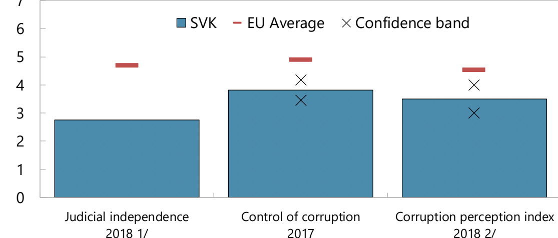
Source: IMF, DOTS database.

Jobs at Risk of Automation
(Percent)



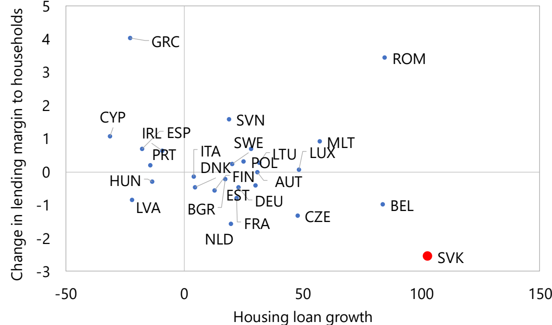
Source: Nedelkoska, L and G. Quintini (2018), "Automation, skills use and training", OECD Social, Employment and Migration Working Papers.

Governance Perception Indictors
(Index: 1-7(best))



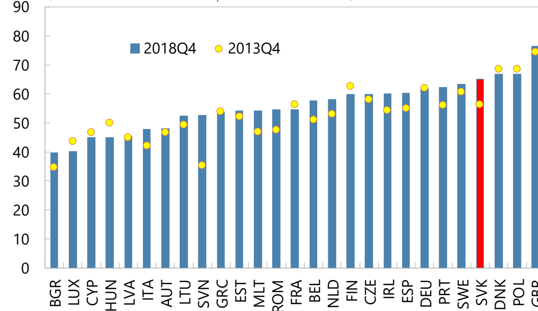
Sources: World Economic Forum (WEF); Transparency International (TI); and World Governance Indicators (WGI).
Note: These are perception based indicators and, therefore, might be more subjective.
1/ Judicial independence confidence band not calculated.
2/ The CPI focuses only on the level of corruption in the public sector in the past two years.

Changes in Lending Margin and Loan Growth
(Percent, from 2013Q1 to 2018Q4)



Sources: Haver Analytics; and IMF staff calculations.

Share of Household Loans
(Percent of non-financial private sector loans)



Sources: Haver Analytis; and IMF staff calculations.

3. Policy efforts have largely been devoted to addressing structural weaknesses and financial sector vulnerabilities, in line with staff's past recommendations. Traction has been more mixed for fiscal policies (text box). This year's consultation focuses on how to tackle growing vulnerabilities that could have a cascading negative effect on growth.

Text Box. Implementation of Recent IMF Policy Advice

Structural policies. The authorities have made considerable progress on recommendations to ease the hiring process of foreign workers and are in the process of reorienting spending on active labor market policies (ALMP) toward enhancing employability and mobility. In line with staff advice, the authorities are expanding childcare facilities to boost female labor force participation and are scaling up efforts to increase the social inclusion of disadvantaged groups. Measures to address governance weaknesses are ongoing, yet tangible results are needed to improve public perception.

Fiscal policies. The authorities and staff have been in broad agreement on the medium-term objectives. Revenue collection efficiency has picked up owing to authorities' strong efforts; however, the implementation of reforms identified in spending reviews has been patchy. Changes to tax policy, such as raising property taxation, have been politically challenging. The authorities have also reversed some of the 2012 pension reforms against staff recommendations.

Financial sector policies. Staff has strongly supported the authorities' pro-active macro-prudential policies. Consistent with staff advice, the authorities have taken important steps to build buffers in the financial system.

OUTLOOK AND RISKS

4. Real GDP growth is projected to moderate beginning this year. The completion of large investment projects in the automotive sector is expected to reduce real GDP growth to 3½ percent in 2019, while robust wage and credit growth will support private consumption (Table 1, Figure 3). In the medium term, growth is projected to further moderate to its potential level owing to slowing domestic demand while contributions from net exports are projected to improve on the back of recent capacity expansion in the automotive sector, which is expected to more than compensate for weaker external demand. With above-potential growth and one-off adjustments in administrative prices likely to offset the projected decline in oil prices, both headline and core inflation are expected to remain above 2 percent in the near term.

5. The labor market tightened further in 2018 but is expected to ease gradually starting this year. Employment grew by 1.7 percent annually in 2018: Q4 with strong support from services sector that brought down the unemployment rate to 6.1 percent (Figure 4). Recent measures to reduce time required for issuance of work permits and allow hiring of foreign workers via EU-based employment agencies, including from non-EU countries, have begun to stabilize the number of firms facing labor shortages in the industrial sector. The tight labor market generated a major inflow of workers to Slovakia, including a return of Slovak expatriates. This, together with a higher

participation of the elderly, helped increase labor force in 2018: Q4. Going forward, moderating economic growth and higher labor force participation, including due to recent expansion of childcare facilities, is projected to slow wage growth. Overall, the labor income share in Slovakia remains comparable to peers in Central Europe.

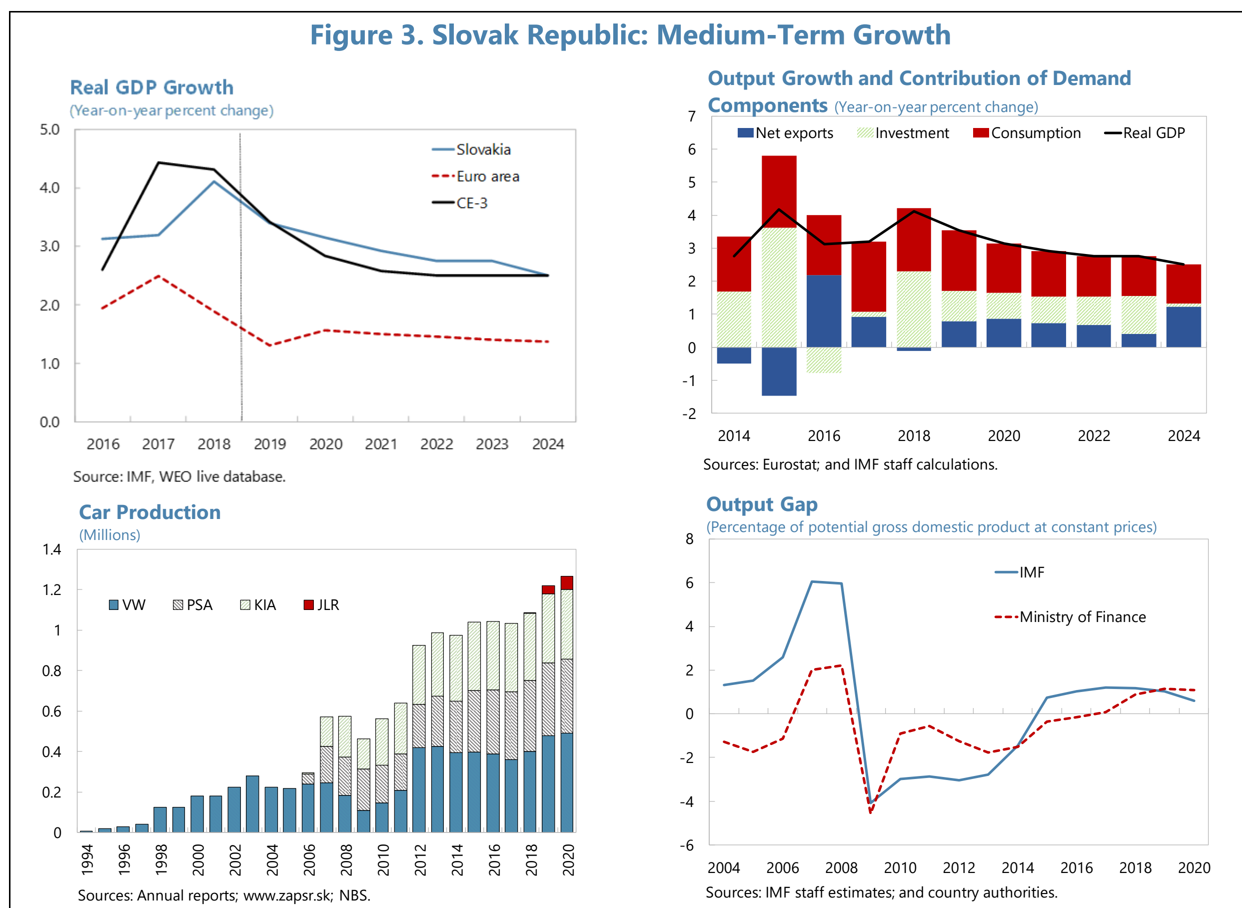


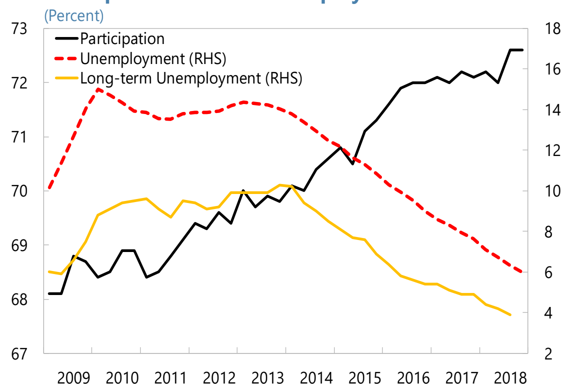
Figure 3. Slovak Republic: Medium-Term Growth

6. External balances are projected to improve in the medium term. The current account deficit (CAD) deteriorated in 2018 to 2½ percent of GDP largely due to a temporary spike in imports related to automotive investments while services and income balances remained roughly unchanged (Figure 5). Going forward, higher exports are projected to narrow the CAD to a balanced position helping to improve Slovakia's net international investment position (IIP) and keeping gross external debt roughly unchanged relative to GDP (Table 3). The large negative net IIP, which is driven by net FDI inflows, has remained broadly stable since 2009. The cyclically-adjusted CAD is slightly above the norm estimated at 1 percent, suggesting a marginal overvaluation of 1 percent of the real effective exchange rate (Figure 5 and Table 4). The estimated policy gap is 2.5 percent, which is mostly driven by health expenditure. Despite the recent acceleration in wage growth, productivity-adjusted average compensation of employees remains roughly in line with peers as does the CPI-based real effective exchange rate. Slovakia's external position is in line with economic fundamentals and desirable policies.

Figure 4. Labor Market Developments and Outlook

Participation Rate and Unemployment Rate

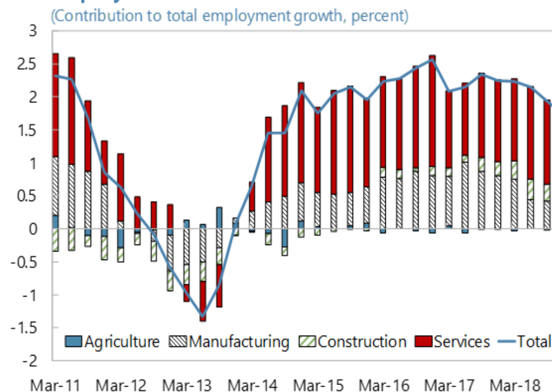
(Percent)



Source: Haver Analytics.

Employment Growth

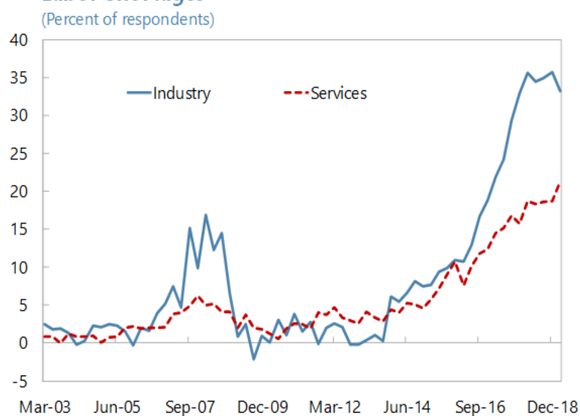
(Contribution to total employment growth, percent)



Source: Haver Analytics.

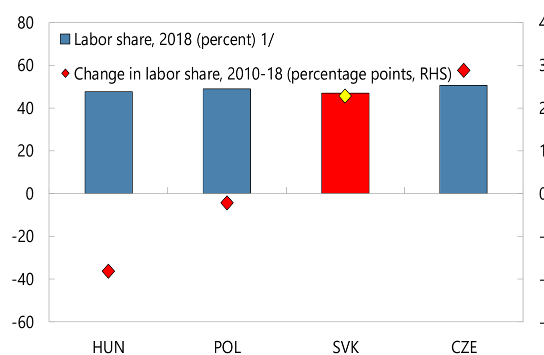
Labor Shortages

(Percent of respondents)



Sources: Eurostat; and IMF staff calculations.

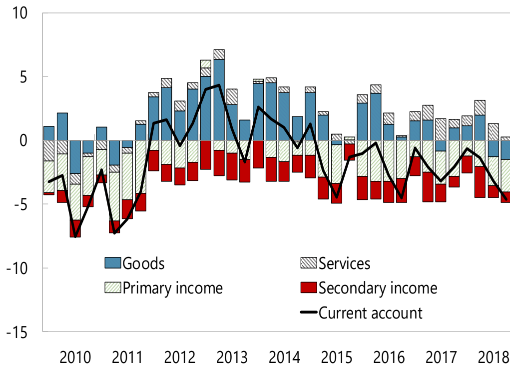
Labor Income Share: Slovakia and Peers



Sources: AMECO database; and IMF staff calculations.
1/ Labor share is calculated as compensation of employees adjusted for wages of self-employed relative to GDP.

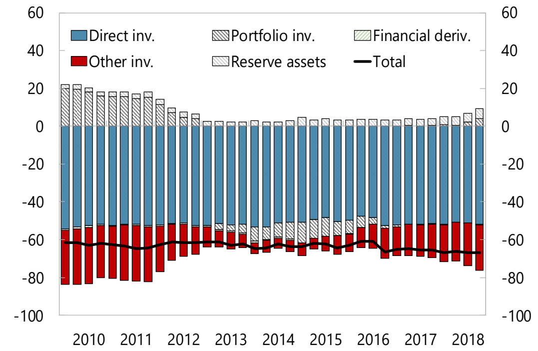
Figure 5. Slovak Republic: External Competitiveness

Current Account Balance
(Percent of GDP)



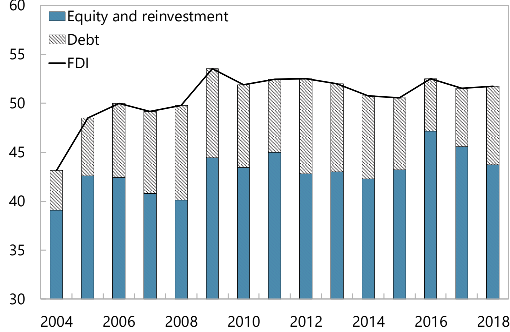
Sources: Eurostat; NBS; and IMF staff calculations.

Net International Investment Position
(Percent of GDP)



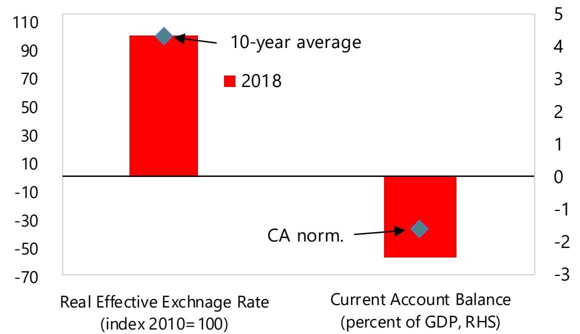
Sources: Eurostat; NBS; and IMF staff calculations.

Stock of Foreign Direct Investment
(Perent of GDP)



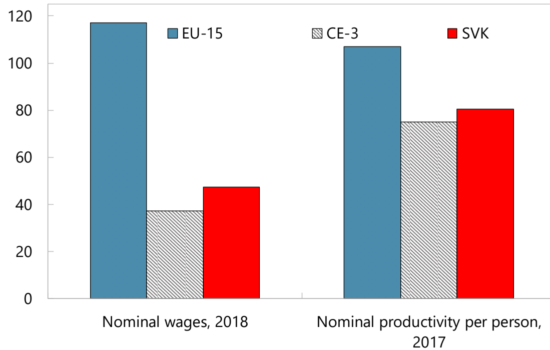
Sources: Haver Analytics; and IMF staff calculations.

External Position



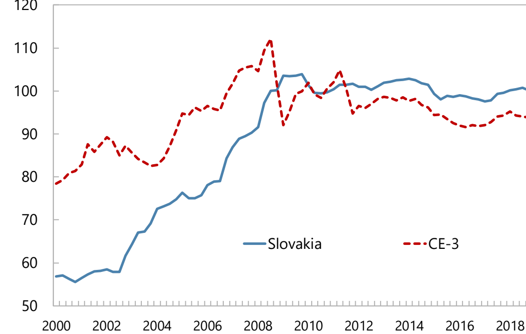
Sources: IMF INS database; and IMF staff calculations.

Wages and Productivity
(Index: EU-28 = 100)



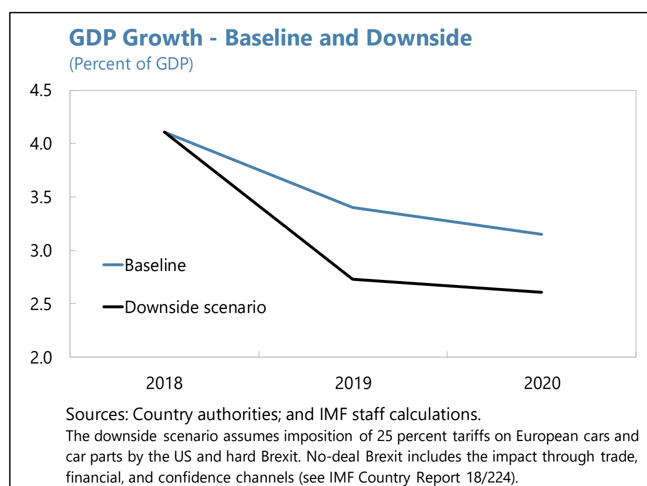
Sources: Eurostat; and IMF staff calculations.

REER CPI Based
(Index: 2010=100)



Source: IMF, International Financial Statistics.

7. There are significant downside risks to the outlook (Table 5). On the external front, escalating trade tensions and a no-deal Brexit could weigh on Slovakia's growth both directly and indirectly through their adverse impact on main trading partners. This could reduce real GDP growth by 1 percentage point in the near term relative to the baseline. The output loss could be larger if existing supply chain links are disrupted. In addition, the ongoing structural changes in the automotive sector and a shift in demand in favor of electric cars could erode Slovakia's competitiveness as the limited fragmentation in electric car production processes may give rise to reshoring of production, curtailing the scope for supply-chain-based expansion. On the domestic front, the still-high credit growth continues to pose risks to households and banks from possible labor and property market downturns. There are some upside risks from higher and more effective absorption of EU funds that can increase investment.



Sources: Country authorities; and IMF staff calculations.
The downside scenario assumes imposition of 25 percent tariffs on European cars and car parts by the US and hard Brexit. No-deal Brexit includes the impact through trade, financial, and confidence channels (see IMF Country Report 18/224).

Authorities' Views

8. The authorities broadly agreed with staff's assessment of the outlook. They also consider the economy to have passed its cyclical peak and is facing a slowdown driven by lower domestic demand. Although slowing, domestic demand is expected to remain the key driver of medium-term growth while the automotive sector is projected to prop up net exports. In outer years, higher absorption of EU funds is expected to support investment and domestic demand. The authorities shared staff's view on the inflation path as well, which is projected to remain above 2 percent in the medium term due to rising wages and services price inflation. The authorities' estimate of the economy's cyclical position in 2019 is broadly in line with that of staff, although they envisage a more gradual narrowing of the output gap (Figure 3).

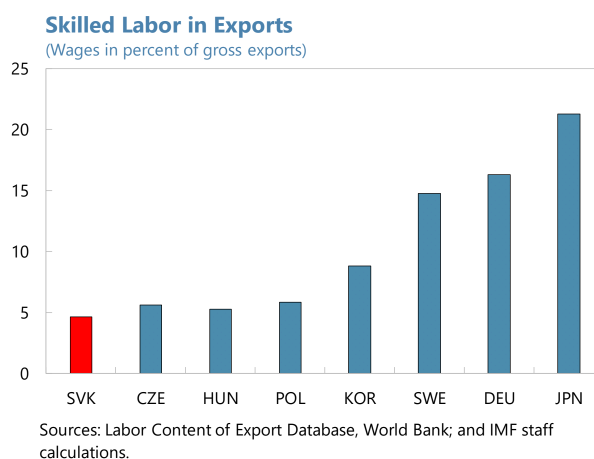
9. The authorities viewed risks to be mostly on the downside, while highlighting several mitigating factors. They highlighted a no-deal Brexit and slowdown in the euro area to be the main risks but deemed the likely impact on the automotive exports to be limited reflecting the experience of 2012–13, when the capacity expansion in VW held up automotive exports despite the slowdown in the euro area. In addition, the internal flexibility of exporting firms to adapt to changing external demand could act as a mitigating factor. The authorities expressed that Slovakia has the oldest tradition of producing alternative cars among CEE peers and expect the automotive sector to adjust to market needs as the demand for electric cars increases.

POLICY DISCUSSION

A. Structural Reforms: Reaping the Full Benefits of Global Value Chain Integration

10. Strong integration with the global value chains (GVCs) has led to sizable gains for the economy. Slovakia has the highest GVC integration among Central European countries with the share of GVC-related exports accounting for close to 90 percent of gross exports (Figure 6). There have been multiple benefits from this integration in terms of significant productivity gains and important advances made through process innovation (Annex I). Over time, the quality of exports has also improved with Slovakia moving into production of higher-end cars.

11. However, after more than two decades of GVC integration, Slovakia remains engaged mostly in assembly activities, where value-added is limited. GVC integration over time has taken place mostly through increased backward linkages, whereby components are sent to Slovakia for final product assembly, while forward linkages—whereby intermediate inputs are sent to other countries to be assembled into final products—have remained relatively unchanged (Figure 6). For example, the share of Slovakia's exports of transport equipment that subsequently feed into final products assembled in other countries has declined since 2000—contrary to the experience of its peers (Figure 6). Moreover, despite having a well-established network of suppliers in the country, Slovakia is a net importer of car parts contrary to its peers. Not surprisingly, the value of exports going to skilled workers is also low relative to peers (text chart).

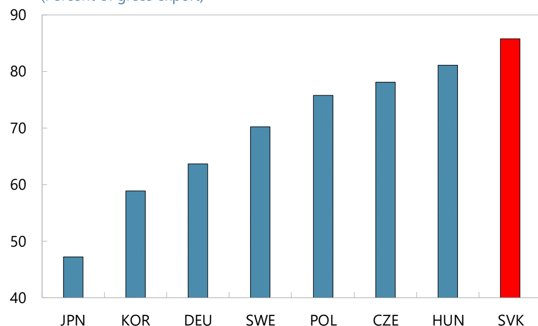


Sources: Labor Content of Export Database, World Bank; and IMF staff calculations.

12. The export sector plays a pivotal role in the economy. Transport, electrical and machinery, chemicals, and metals sectors account for over 80 percent of exports and have significant linkages to other sectors in the economy, affecting 30 percent of domestic employment and 40 percent of output (Annex I, Figure 6). This highlights the Slovak economy's high exposure to sector-specific external shocks, which is likely to ripple through a large part of the domestic economy.

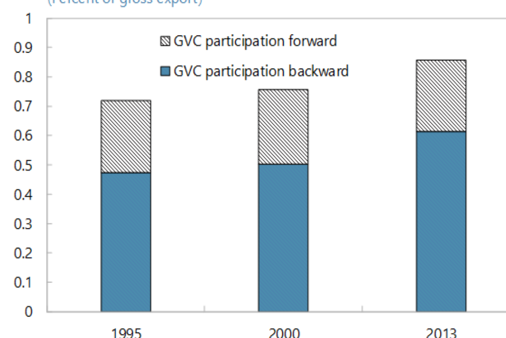
Figure 6. Slovak Republic: GVC Linkages and Spillovers into Domestic Economy

GVC Participation
(Percent of gross export)



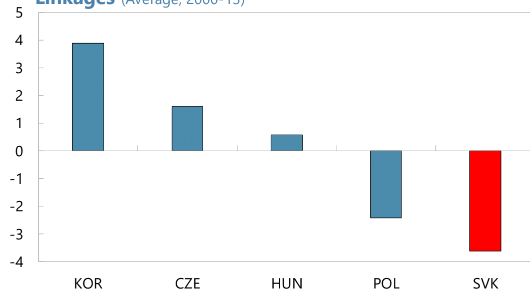
Sources: EORA database; WEO; and IMF staff calculations.

GVC Participation
(Percent of gross export)



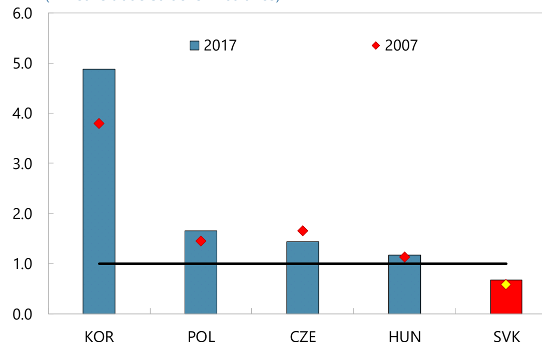
Sources: EORA database; WEO; and Slovakia's input-output tables.

Transport Equipment Exports: Change in Forward Linkages (Average, 2000-13)



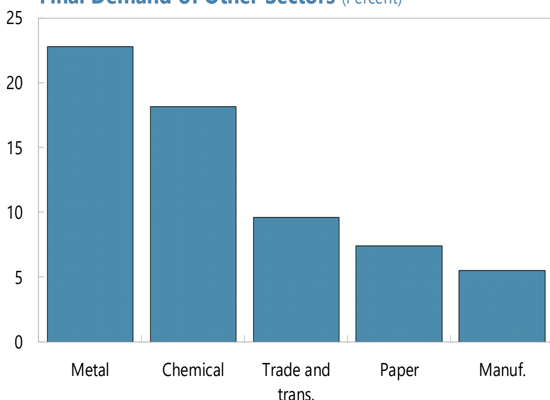
Sources: EORA database; and IMF staff calculations.
Note: Forward linkage is the share of Slovak's exports that subseuently get re-exported by other countries.

Car Parts: Export to Import Ratio, 2017
(1 means trade Saldo is in balance)



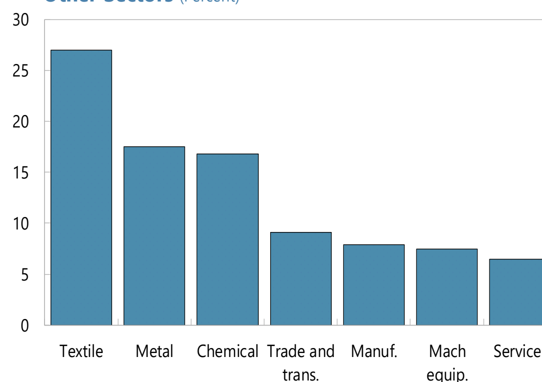
Sources: Comtrade; and IMF staff calculations.

The Machines and Equipment Sector's Share in Final Demand of Other Sectors (Percent)



Sources: OECD; and IMF staff calculations.

The Automotive Sector's Share in Final Demand of Other Sectors (Percent)



Sources: OECD; and IMF staff calculations.

13. Continued success in the GVC-led growth model hinges on expanding activities beyond assembly and developing competitive domestic firms. Making an inroad in GVC is a difficult task, which explains the scarcity of successful cases (Annex II). This is particularly true for the automotive value chain, which is characterized by heavy investments, high demand for technical expertise, and a long product development cycle. Thus, options for small open economies are limited to either becoming an assembly hub with relatively low domestic value-added activities, as has been the case for Slovakia, or develop domestic suppliers with an eventual objective to move up the value chain and directly serve global lead firms. The experience of countries that have successfully pursued the second route demonstrates that a confluence of factors is required to make this move, which includes a highly-educated workforce, strong innovative capacity, top-notch connectivity, and a high level of domestic investment (Annex II). Above all, the government has played a key role in providing strategic direction and supportive environment for the exporting firms. The empirical literature also corroborates this and highlights the importance of institutional quality.[1]

14. To retain export competitiveness, the following measures are recommended.

- **Skills and Innovation.** The removal of disincentives to enter dual vocational education, which has substantially increased the number of apprentices, is welcome. To counter automation risks and facilitate upward movement in the GVCs, policies should ensure a steady supply of skilled labor along with investment in innovation. The share of tertiary graduates in Slovakia is comparable to peers, but the composition shows a shortage for those with engineering and mathematical skills (Figure 7). There should be greater synergy between higher education and future skill needs and the importance of strengthening science-business linkages. Consolidating the fragmented public research system to improve coordination and ensuring the full use of EU funds for R&D would also help the capacity to absorb technology.

- **Institutional quality and business environment.** The implementation of the new Civil Service Act is expected to help improve human resource management in the civil service. Recent measures to build administrative capacity in public procurement, including through training and technical support are welcome. Going forward, focus needs to be on providing a more enabling government through increasing regulatory predictability, creating a more competitive and transparent public procurement system, raising the independence of the judiciary, and minimizing conflict of interest in the public administration. A greater use of impact assessment tools prior to adoption of regulatory changes would also be helpful.

- **Transport and digital infrastructure.** Slovakia ranks relatively unfavorably to peers in the efficiency of customs clearance, timeliness of shipments, and the quality of trade and transport-related infrastructure (Figure 7). Staff underscored the need to invest in transport and digital infrastructure that are important to diversifying trade partners and products as well as meeting just-in-time requirements of global firms.

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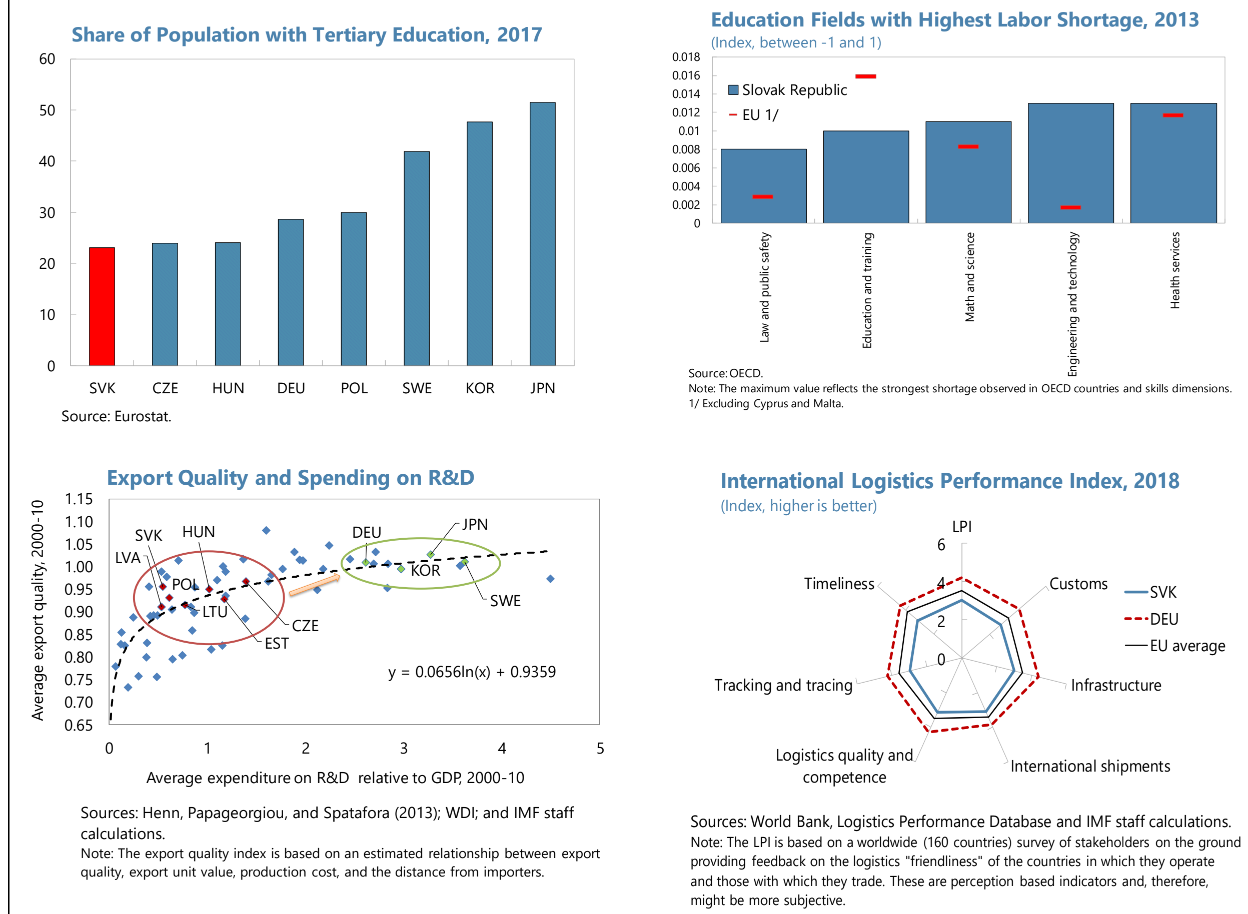
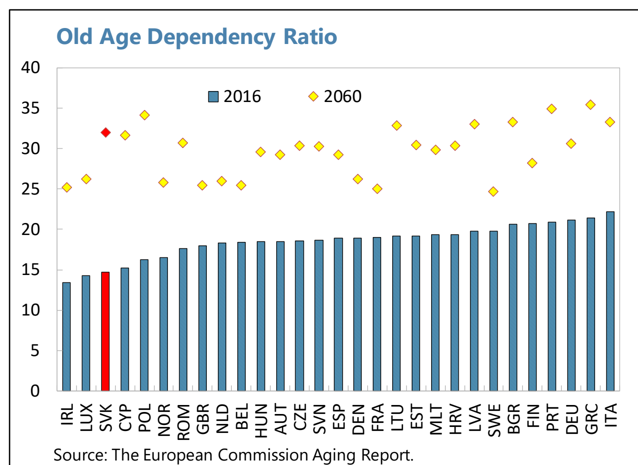
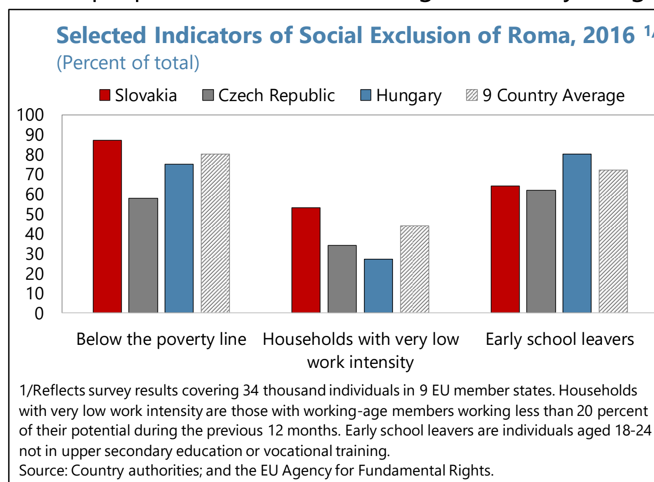
[1] See Kummritz, V., D. Taglinoi, and D. Winkler, 2017, "Economic Upgrading through Global Value Chain Participation", World Bank Group, Policy Research Working Paper No. 8007.



15. Recent initiatives to improve the utilization of domestic labor force are critical given projections for rapid population ageing. The authorities' efforts to reintegrate the long-term unemployed into the labor market, including through customized counselling and profiling of jobseekers is appropriate. This should be complemented by active labor market policies to invest in skills and increase employability of the long-term unemployed, including through better absorption of the EU funds. Expanding allowances for commuting and relocation will help support labor mobility and reduce regional disparities in employment. Staff supported plans to increase availability of affordable childcare, which will further improve participation of women in the labor force.



16. To improve social inclusion and ensure adequacy of future labor supply, the authorities are undertaking several schemes to better integrate the Roma Population. In 2019, they approved a comprehensive set of measures in the areas of employment, education, healthcare, and housing. In addition to standard ALMP, pilot activation strategies in the form of additional wage support and peer mentorship programs for Roma workers are delivering results. A legal provision for debt relief has also been introduced to help indebted Roma workers pursue employment without having their wages garnished. The legislative proposal to make schooling mandatory at age five and the expansion of childcare facilities closer to Roma communities are expected to improve school participation. To increase educational integration of Roma children, facilitating participation in early childhood education is also important. Dedicated health assistants fluent in the Romani language should improve access to quality healthcare, while a multi-stage social housing scheme, funded through EU grants, is intended to help support the desegregation of Roma households.



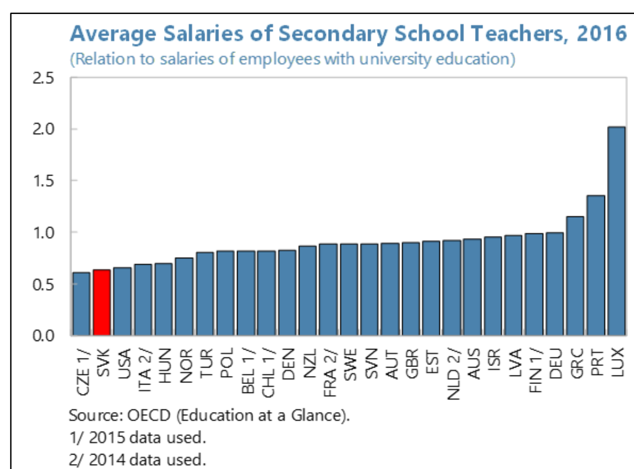
Selected Indicators of Social Exclusion of Roma, 2016 1/
(Percent of total)

1/Reflects survey results covering 34 thousand individuals in 9 EU member states. Households with very low work intensity are those with working-age members working less than 20 percent of their potential during the previous 12 months. Early school leavers are individuals aged 18-24 not in upper secondary education or vocational training.
Source: Country authorities; and the EU Agency for Fundamental Rights.

Authorities' Views

17. The authorities agreed broadly with staff's assessment of structural challenges and highlighted the following.

- ***Education:*** The government's top priority is to improve the quality of primary and lower secondary education by increasing the attractiveness of the teaching profession, including through higher salaries, more training, and better working conditions. The new law on pedagogical and expert employees in the education sector strengthens the link between remuneration, career promotions, and the quality of teachers. To increase labor market absorption of the tertiary-educated, the authorities intend to support professional bachelor's degree programs, including through financial incentives granted to universities. With the newly created accreditation agency becoming operational in 2020, they expect a further improvement in the quality of tertiary education.



Average Salaries of Secondary School Teachers, 2016
(Relation to salaries of employees with university education)

Source: OECD (Education at a Glance).
1/ 2015 data used.
2/ 2014 data used.

- ***Research and Innovation:*** The authorities intend to improve the selection process of government-funded research projects through tighter standards and more involvement of

foreign experts in the selection committees for assessing university research. They plan to increase the R&D tax allowance for companies to 150 percent of qualifying expenditure in 2019 and to 200 percent in 2020. They see the small size of domestic firms as a key obstacle to upward movement in the value chain.

- ***Institutions:*** The authorities have adopted an anti-corruption strategy and established a new government unit to coordinate anti-corruption issues within each ministry. They are also contemplating expanding the mandate of the Special Prosecutor to include money laundering activities. The authorities are in the process of establishing a specialized office to protect whistleblowers that will further strengthen their fight against corruption. The requirement for public procurement contracts to be processed through electronic invoices beginning in 2021, is expected to improve transparency.

B. Fiscal Policy: Creating Adequate Space

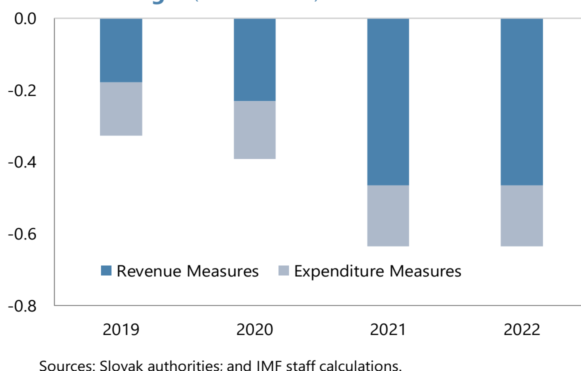
18. Strong job-rich growth and policy efforts have supported fiscal consolidation in recent years. The headline deficit narrowed significantly to reach 0.7 percent in 2018.[2] On the revenue side, consolidation was mainly driven by higher social security contributions on the back of strong wage and employment growth and earlier reforms (Text Table 1). On the expenditure side, savings from earlier pension and health sector reforms, lower non-wage current spending and falling debt service costs have more than countered the higher public wage bill and capital spending.

Text Table 1. Sources of Fiscal Consolidation, 2015–18
(In Percent of GDP)

Overall balance	**1.9**
Of which:	
Revenues	
Social contributions	0.9
Taxes	0.1
Expenditures	
Social benefits and Subsidies	0.9
Other non-wage current spending	0.7
Interest payments	0.4
Wages and compensation	-0.4
Capital spending, net of grants	-0.5
Other	-0.2

Source: Country Authorities; IMF staff calculations.

19. Staff supported the authorities' target to reach a balanced budget in 2019 but highlighted the need for additional measures. With a positive output gap, the objective to reach a balanced budget this year and maintain such position over the medium term is appropriate. However, staff's baseline projections for 2019 show a deficit of 0.3 percent of GDP mainly driven by lower non-tax revenues and rising public sector



[2] A change of methodology for certain expenditures incurred by some budgetary entities of up to 0.3 percent of GDP is currently under review by Eurostat, which may result in an upward revision of the fiscal deficit in 2018.

wage bill (Table 2). Achieving a balanced budget would require containing expenditure on subsidies and goods and services and possibly higher excise taxes on tobacco and energy products. There are also downside risks to these projections arising from lower growth, possible upward revision of the 2018 fiscal deficit, and higher spending ahead of March 2020 Parliamentary elections. Staff stressed the importance of avoiding pro-cyclical loosening and cautioned against introducing any new discretionary expansionary measures given the already significant commitments built in the current year's and medium-term budget (text figure).

20. For 2020, achieving a balanced budget seems more challenging than this year. Staff's preliminary baseline projection shows a close to balanced budget in 2020. However, this projection does not reflect a package of measures currently under discussion by the coalition partners that is expected to be submitted to the Parliament in June for a first reading. This package includes a range of measures covering family benefits and several tax reductions. While the full details and cost estimates of these measures are not yet available, the measures could noticeably increase the overall fiscal deficit in 2020 if implemented in their current form (Text Table 2). In addition, several of the new measures seem regressive and run counter to the objective of increasing social inclusion. There is also no need for fiscal stimulus at a time when growth is significantly above potential and there is still a need to build up fiscal space (see below). To achieve a balanced budget, the size of the package would need to be quite small given limited room to cut current spending. Reducing capital spending to make room for this package would not be appropriate.

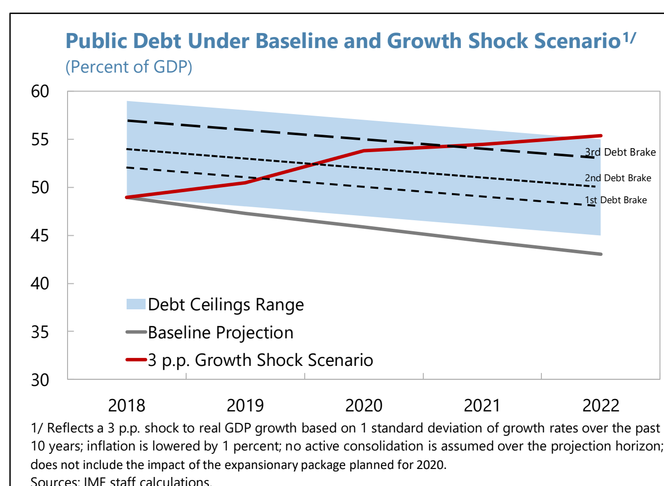
Text Table 2. Tentative Package of Discretionary Measures Under Negotiation for Implementation in 2020

1	Increase in monthly parental allowance by EUR150 for working parents and EUR50 monthly to non-working parents.
2	Additional paternal leave to fathers of newborns
3	One time EUR100 benefit for first graders in elementary schools
4	Increase in the non-taxable portion of the PIT tax base
5	Doubling of the R&D tax allowance for CIT
6	Lower CIT rate of 15 % for small companies and self-employed individuals
7	Lower VAT rate of 10% on news media and select items

Source: News Reports.

21. The fiscal space created by recent consolidation is rather modest given strict provisions prescribed by the constitutional Fiscal Responsibility Act (FRA). A declining and low fiscal deficit, single-digit gross financing needs, and a stable access to financing support Slovakia's public debt sustainability and leave adequate fiscal space to maneuver in economic downturns without violating the European Union's Stability and Growth Pact (SGP) rules (Annex III). Thanks to the stronger fiscal position, the authorities' medium-term budgetary objective (MTO) has also been recently relaxed from a structural deficit of

Public Debt Under Baseline and Growth Shock Scenario[1/]
(Percent of GDP)



1/ Reflects a 3 p.p. shock to real GDP growth based on 1 standard deviation of growth rates over the past 10 years; inflation is lowered by 1 percent; no active consolidation is assumed over the projection horizon; does not include the impact of the expansionary package planned for 2020.
Sources: IMF staff calculations.

½ percent of GDP to 1 percent of GDP.[3] Nonetheless, under the stricter national rules (debt brakes and sanctions under the constitutional FRA) fiscal room to counter large but plausible shocks is limited. The FRA escape clause allows the sanctions to be suspended only in the event of a very severe recession (a decline in nominal GDP growth rates of at least 12 percentage point over two fiscal years). In the event of less drastic shocks, for example a drop in real GDP growth rate by 3 percentage points (equivalent to one standard deviation of historical average), pro-cyclical consolidation would likely be triggered by the need to abide by the debt brake (text figure, Box 1).

22. Staff discussed options for creating further policy space working within the current FRA. To avoid pro-cyclical consolidation, consideration should be given to recalibrate the growth-related escape clause to accommodate less drastic shocks. With the FRA's lower debt limit no longer binding, the authorities are contemplating the introduction of multi-year expenditure ceilings which are to be set for a 4-year cycle based on forecasted structural revenues targeting a long-term public debt-to-GDP ratio of 40 percent while ensuring, at a minimum, the fulfillment of the MTO (Table 6). The proposed expenditure ceilings are expected to serve as a useful operational tool to anchor medium-term budget planning and execution, but a transparent and parsimonious framework is needed to ensure effective monitoring and full consistency with the SGP and the FRA.

23. Considerable fiscal resources are needed to accommodate social and infrastructure investment and higher pension spending. Significant new investments and higher spending on maintenance are needed to expand and improve transport infrastructure, which falls behind EU peers. Realigning and improving the quality of education to meet future labor market needs and integrating disadvantaged groups will also require public resources. Moreover, the constitutional law passed in March 2019 that reversed earlier pension reforms by capping the retirement age at 64 for men, with early retirement options for women with children, will also raise long-term pension expenditure.[4]

24. Additional fiscal resources should be made available by boosting revenue and expenditure efficiency. Staff's estimates show that these measures can create additional fiscal space of up to 3 percent of GDP over the medium term to accommodate growth-enhancing social and infrastructure investment.

Text Table 3. Estimated Yields from Proposed Measures
(Cumulative, 2019–2024)

	Billions of euros	Percent of 2024 GDP
Proposed measures		
Implementing savings measures identified in spending review	0.9	0.7
Increasing public investment efficiency[1]	1.7	1.4
Reducing the VAT gap[2]	1.4	1.1
Total	4.0	3.2
Full EU funds absorption in education and transport[3]	2.6	2.1
Grand total	6.5	5.3

Source: IMF staff calculations.
[1] Assumes Slovakia closes a quarter of its investment efficiency gap with respect to Germany.
[2] Assumes Slovakia closes a quarter of its VAT efficiency gap with EU-28 average.
[3] Assumes 95 percent ESIF funds allocated to educational and vocational training and network infrastructures and transport and energy will be absorbed; and shows amounts net of what is already budgeted and of needed co-financing.

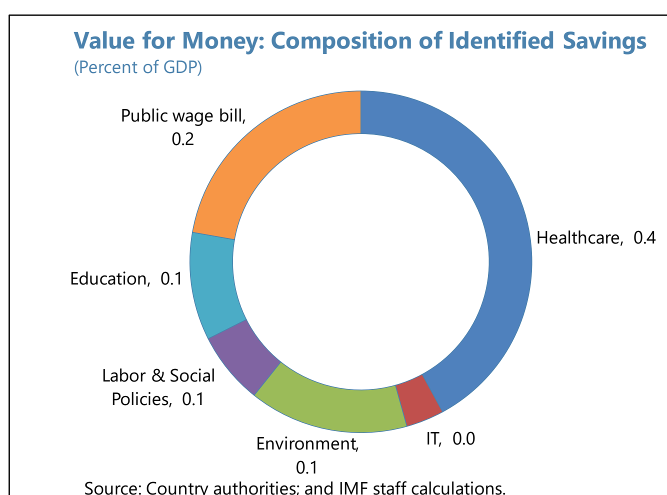
[3] The new MTO, starting 2020, is agreed based on the European Commission's assessment of Slovakia's ageing profile and fiscal risks consistent with the preventive arm of the SGP.

[4] Women who raised one, two, or three and more children are eligible to retire at the age of 63.5, 63, and 62.5, respectively.

Full absorption of the EU funds programmed for education and infrastructure for the current programming period would make available an additional 2 percent of GDP in funding for priority spending.

- **Revenue efficiency.** A new tax reliability index and implementation of e-filing and pre-filled tax returns are expected to improve compliance by corporate taxpayers, while the planned adoption of online-electronic cashiers will help improve VAT collection efficiency where significant progress has been recorded in recent years (Figure 8). Additional efforts to strengthen audit capacity in all core tax areas, including through upskilling of staff and better identification and assessment of non-compliance risks, would be welcome; the latter is expected to benefit from the anticipated launch of a Unified Analytical Center. Recent assessment by IMF staff shows that improving fiscal institutions, including tax compliance, helps improve control of corruption (Figure 8).

- **Expenditure efficiency.** The authorities have completed thematic expenditure reviews of two-thirds of public spending under the Value for Money program identifying total savings of 0.9 percent of GDP in 2019. So far, implementation has been limited to the health sector, where there has been cost savings from central procurement of prescription drugs and medical equipment but rising operational costs of public hospitals are yet to be addressed. Strong political will is needed to push through reforms in other sectors and press for concrete action plans to be included in the budget. Strengthening the mandate of the Value for Money implementation unit would also help reforms gain traction.

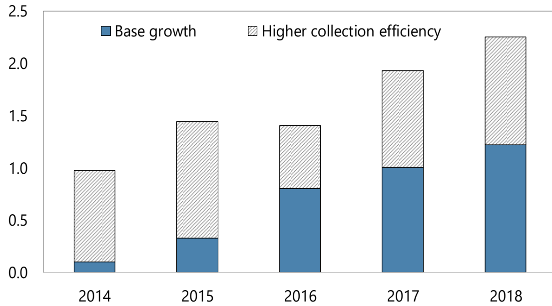


Source: Country authorities; and IMF staff calculations.

- **Public investment efficiency.** The recently completed Public Investment Management Assessment (PIMA) suggests a broadly effective framework with room for improvement in project selection, procurement practices, and oversight of state-owned enterprises that carry out half of public investment. An integrated pipeline of major projects should be created and monitored by a dedicated central unit, together with a specialized unit to strengthen financial oversight of major SOEs, including their annual budgets and investment plans. Further strengthening of administrative capacity in project planning and public procurement would help reduce volatility of investment and improve EU funds absorption, which remains weak relative to peers and last programming period (Figure 8).

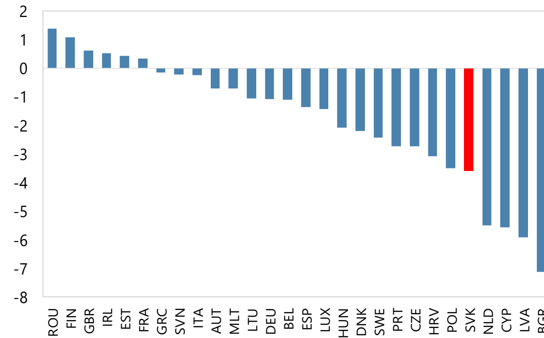
Figure 8. Raising Fiscal Efficiency

Composition of VAT Growth, 2014-2018 [1/]
(Cumulative nominal growth relative to 2013, in percent of GDP)



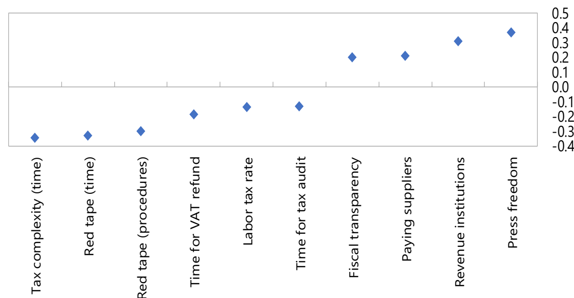
Sources: Country authorities; and IMF staff calculations.
1/Reflects IMF staff estimates based on authorities' historical ETR data. Does not provision for any discretionary measures affecting VAT over the period.

Change in VAT Tax Gap in the EU, 2016
(Percent)



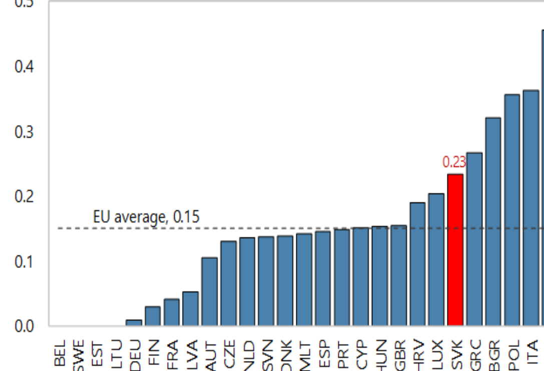
Source: European Commission

Fiscal Institutions and Control of Corruption[1/]
(Coefficient for each institution against control of corruption)



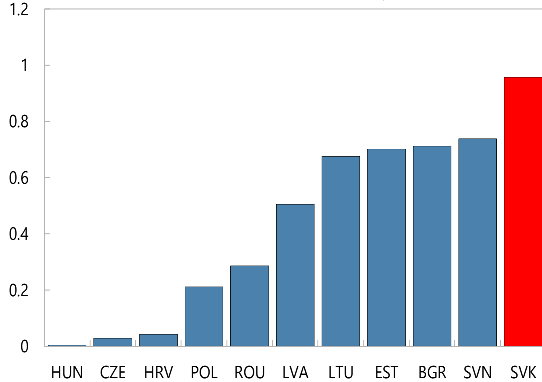
1/ Depicts coefficients (significant at the 5 percent level) from a cross-country regression of control of corruption against standardized series of different fiscal institutions, while controlling for GDP per Capita and oil exports. Higher values indicate higher influence on control of corruption. Control of corruption is reflects the perception-based index from Worldwide Governance Indicators. For additional details see online annex 2.1 of April 2019 Fiscal Monitor.
Source: April 2019 Fiscal Monitor; IMF staff estimates.

Public Infrastructure Investment Efficiency Gap
(Coverage and Quality of Infrastructure, Compared to the Best Performer)



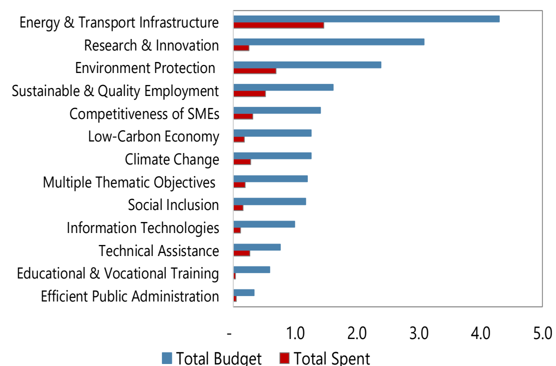
Sources: IMF Capital Stock and Investment Database; and IMF staff calculations.
Note: High number represent a lower efficiency.

Volatility of Public Investment in Selected EU Countries, 2012-18
(Standard deviation in percent of GDP)



Sources: Eurostat; and IMF, WEO database.

EU Funds Absorption By Operational Program
(In percent of GDP)



Source: European Commission, 2018.

Authorities' Views

25. The authorities emphasized their intention to reach a balanced budget this year. They noted positive risks to the fiscal position with monthly data pointing to continued strength in revenue collections, including from the still-strong labor market. They agreed, however, that fiscal space under the national FRA is limited and that sustained consolidation is key to building adequate space for counter-cyclical policy. They also expressed their intention to contain the cost of the coalition package to minimize its impact on the 2020 fiscal balance.

26. They are committed to continue efforts to raise revenue and spending efficiency. On the revenue side, they highlighted progress achieved thus far in lowering the VAT gap and agreed on the need to reduce it further. They pointed to ongoing work on a bottom-up approach for CIT gap assessment in collaboration with Fund staff, which is expected to be finalized in 2019: H2. To strengthen the audit function, they have centralized selection of audit cases, increased the share of spot investigations, and approved a new Act on Financial Administration effective July 2019. They also noted that a soft warning system for tax debtors implemented in 2018 has positively influenced compliance. On the expenditure side, the authorities underscored their commitment to follow through with implementation of measures identified in the thematic expenditure reviews. They recognized challenges in inter-ministerial coordination and the absence of a direct link between reform progress and budgetary allocations. They expressed their intention to sustain progress in the health sector to preserve realized cost-efficiency gains.

C. Financial Sector: Guarding Against Vulnerabilities

27. Credit growth to households has moderated. The authorities have been implementing a series of macroprudential policies, which have tightened credit standards and contributed to moderating household credit growth (Figure 9, Text Table 4). Nonetheless, mortgage loan growth

Text Table 4. Overview of Macroprudential Policy Measures

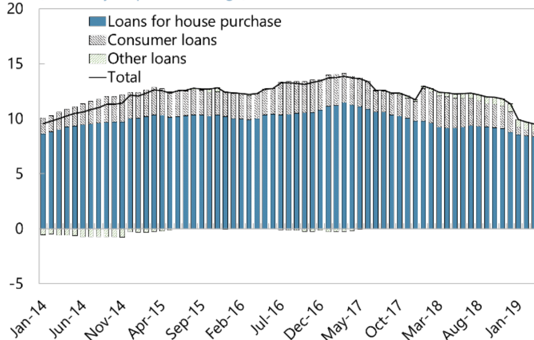
	Introduction of measures (2014–2015) (non-binding)	1st revision (2016–2017) (binding)	2nd revision (2018-2019) (binding)
LTV limit	Maximum: 100 % Share of 90+: 10 % (phase-in applies)	Additional limit for 80+: 40 % (phase-in applies)	Maximum: 90 % Share of 80%+: 20% (phase-in applies)
DSTI limit	100 %	80 % (phase-in applies)	No change
Interest rate sensitivity test	Applies to new loans only	Applies to all customer´s loans with variable interest rates	No change
Maturity limit	RRE-secured loans: 30Y (excep. 10 %) Unsecured loans: 8Y (phase-in applies)	No change	No change
Amortization rule	Mandatory amortization with annuity	No change	No change
DTI	Not set	Not set	Share of 8+: 10% (phase-in applies)

Source: National Bank of Slovakia.

(10.9 percent in March 2019) remains the highest in the EU, which, together with rising house prices and house price-to-income ratio, indicates continued accumulation of cyclical imbalances. Household debt has also risen steadily, albeit from low levels, nearly doubling relative to disposable income since 2009. Compared to other EU countries, mortgage borrowers in Slovakia are relatively more concentrated in the low-income segment, who are more likely to be exposed to income and employment shocks. Furthermore, the level of household financial assets is among the lowest in the EU, indicating limited buffers against financial stress.

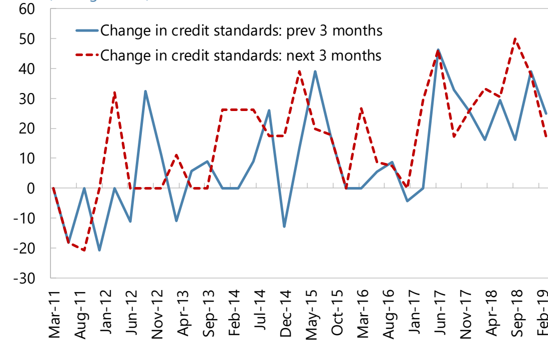
Figure 9. Slovak Republic: Credit Growth and Household Vulnerabilities

Household Loan Growth
(Year-on-year percent change)



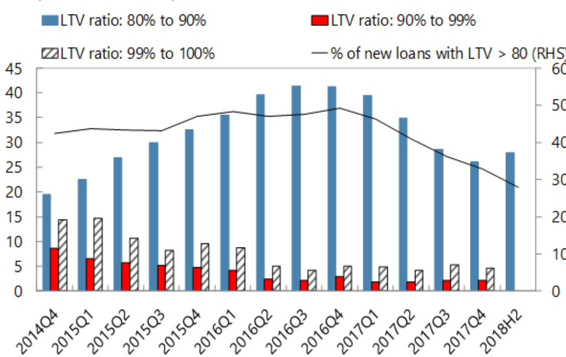
Source: Haver Analytics.

Credit Standards for Housing Loans
(0+=tightened)



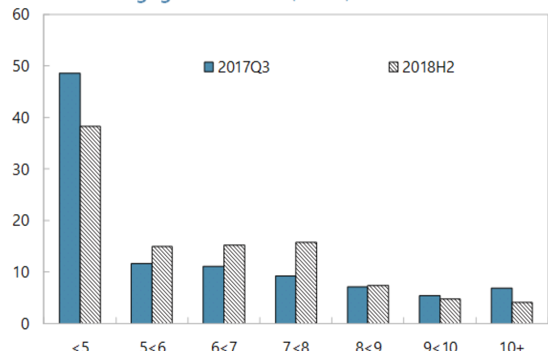
Sources: Haver Analytics; and IMF staff calculations.

New Lending, by Loan-to-value Ratio
(Percet of new loans)



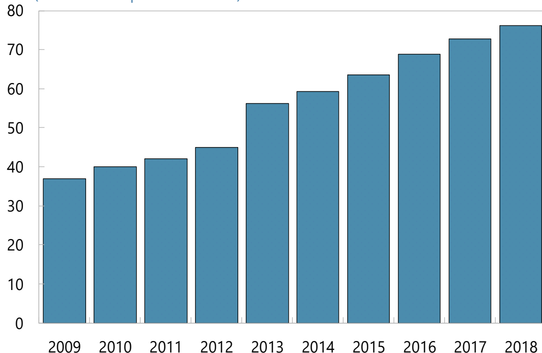
Sources: National Bank of Slovakia; and IMF staff calculations.

Distribution of Household Debt-to-income in New Mortgage Borrowers (Percent)



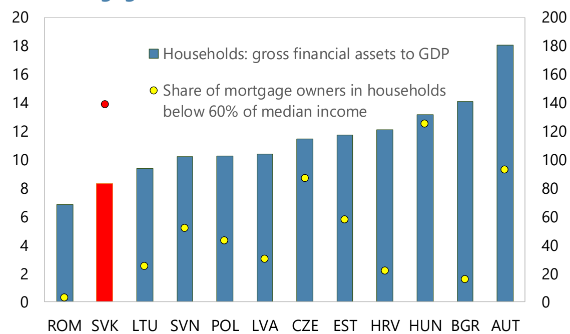
Sources: National Bank of Slovakia; and IMF staff calculations.

Household Indebtedness
(Percent of disposable income)



Source: Haver Analytics.

Household Financial Assets and Low Income Mortgage Holders, 2017 (Percent)

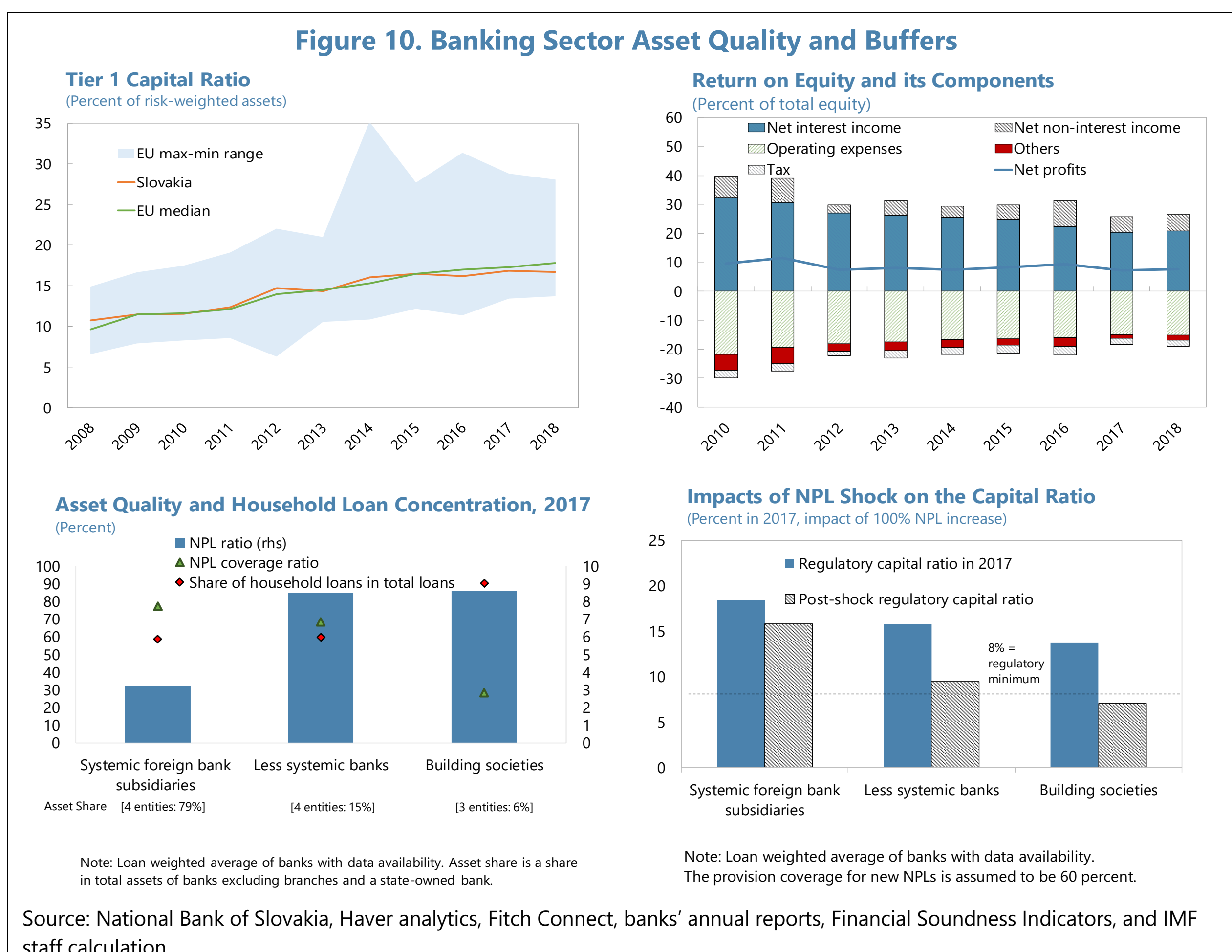


Soruces: Eurostat and IMF staff.

28. The banking sector is stable and well-capitalized, but less systemic institutions are vulnerable to economic downturns. Overall capital levels are well above the regulatory minimum (Table 7, Figure 10). The liquidity position remains comfortable with most banks still largely relying on deposits for funding. The overall NPL ratio has declined to a post-crisis low of 3 percent at end-2018 on the back of favorable economic conditions. However, less systemic banks and building societies show higher average NPL ratios as well as lower coverage ratios. Staff analysis shows that these institutions, which constitute roughly a fifth of banking sector assets, could lose all or a large part of the capital buffers should their NPL ratios double (i.e. the average NPL ratio of less systemic institutions becomes 17 percent).

29. Profitability has been robust but faces risks from compressed lending margins (Box 2). A prolonged period of low interest rates, strong profit pressures from parent companies and intense competition have caused banks to aggressively expand their lending portfolio, especially to the household sector, doubling it in six years. Furthermore, declining risk-weight estimates in the internal models and low credit risk spreads, reflecting historically low default rates on mortgages, have resulted in significant compression of lending margins in the mortgage market—the largest in the EU. Margin compression on mortgages was further accelerated by the regulatory cap on early repayment penalties introduced in 2016 and the strong intermediation role of mortgage brokers.

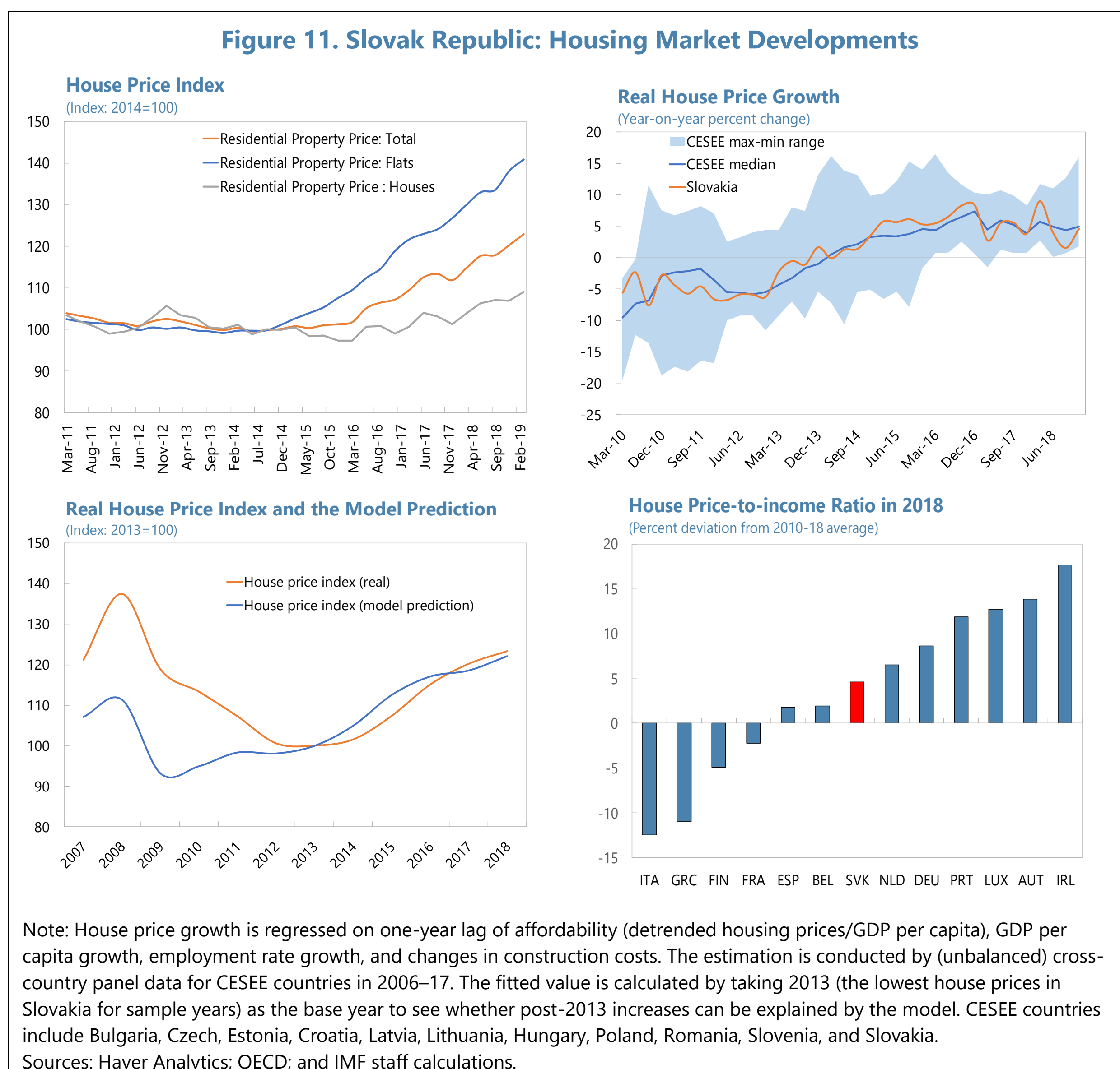
Figure 10. Banking Sector Asset Quality and Buffers



Source: National Bank of Slovakia, Haver analytics, Fitch Connect, banks' annual reports, Financial Soundness Indicators, and IMF staff calculation.

30. There are early signs of a buildup of imbalances in the housing market. Overall house prices have increased in line with peers in the region. A regression-based assessment also shows that overall price increases since 2013 can largely be explained by economic fundamentals (Figure 11). Nonetheless, rising house price-to-income ratio shows a mild deviation from the historical average. Flat prices in urban areas have increased much more than the average house price, reflecting strong demand from domestic investors and migrant rural workers as well as supply constraints resulting from limited plot availability and lengthy processes to obtain construction permits. The underdevelopment of the rental housing market—counting only around 10 percent of the housing market— contributes to higher property prices.

Figure 11. Slovak Republic: Housing Market Developments



Note: House price growth is regressed on one-year lag of affordability (detrended housing prices/GDP per capita), GDP per capita growth, employment rate growth, and changes in construction costs. The estimation is conducted by (unbalanced) cross-country panel data for CESEE countries in 2006–17. The fitted value is calculated by taking 2013 (the lowest house prices in Slovakia for sample years) as the base year to see whether post-2013 increases can be explained by the model. CESEE countries include Bulgaria, Czech, Estonia, Croatia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, and Slovakia.
Sources: Haver Analytics; OECD; and IMF staff calculations.

31. The authorities' pro-active macroprudential policy stance is welcome and could be strengthened as follows.

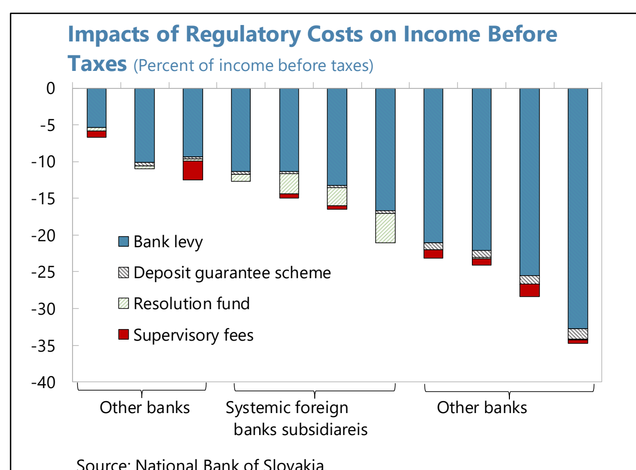
- **Reduce NPLs of less systemic institutions.** The authorities' initiative to require banks with high NPL ratios to develop an NPL reduction strategy is welcome and their efforts to reduce NPLs should be sustained. To contain credit risks, building societies should be required to increase the NPL coverage ratio. The recently introduced regulatory cap on the share of long-maturity loans in new loans extended by building societies (20 percent for loans with 20–30 years of maturity and 10 percent for loans with 25–30 years of maturity) should be complemented by a cap on the share of uncollateralized loans in total loans.

- **Enhance capital buffers of weaker banks.** Staff supported incremental use of the counter-cyclical capital buffers (CCyB) and supervisory (Pillar II) capital requirements to enhance resilience of banks to shocks and the authorities' readiness to further increase the CCyB. In addition, considering the uneven asset quality across banks, the authorities should strongly consider imposing non-zero Pillar II capital guidance for less systemic institutions in 2019 taking into account supervisory stress test results.

- **Allow the bank levy to expire.** The bank levy, imposed on liabilities (less equity) of banks, weighs heavily on unprofitable banks—in some cases, claiming more than 30 percent of pre-tax income. As the initial targeted amount (EUR 750 million) has already been collected, the levy should be allowed to expire in 2021 as legislated to help these banks safeguard profitability and accumulate buffers.

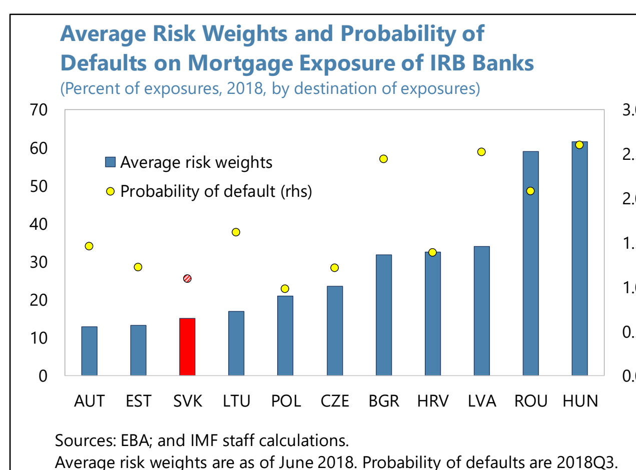
- **Better internalize mortgage credit risks.** The average risk weights in the internal models of systemic foreign bank subsidiaries in Slovakia are lower than in most other EU peers reflecting historically low default rates. To discourage excessive risk taking, the authorities should strongly consider introducing a risk weight add-on on housing loans to require banks to better internalize credit risks, which can be complemented with a floor on risk weights on housing loans. The authorities should also be vigilant about possible risks that mortgage brokers may facilitate loosening lending standards of banks.

Impacts of Regulatory Costs on Income Before Taxes (Percent of income before taxes)



Source: National Bank of Slovakia.

Average Risk Weights and Probability of Defaults on Mortgage Exposure of IRB Banks (Percent of exposures, 2018, by destination of exposures)



Sources: EBA; and IMF staff calculations.
Average risk weights are as of June 2018. Probability of defaults are 2018Q3.

32. Considerations should be given to remove preferential tax treatment of housing-related capital gains and link real-estate taxation to the market value of the property. These measures are expected to curb demand for real estate, particularly demand related to investment reasons, and add to fiscal revenues. Staff welcomed efforts to streamline regulatory procedures for construction permits, which could improve housing supply and ease price pressures. Legal frameworks governing the rental house market in Slovakia discourage the development of long-term rental market given strong protection of tenants' rights for contracts beyond two years. Introducing a more balanced regulation of landlord-tenant rights could reduce demand for home ownership from over-leveraged or low-income households.

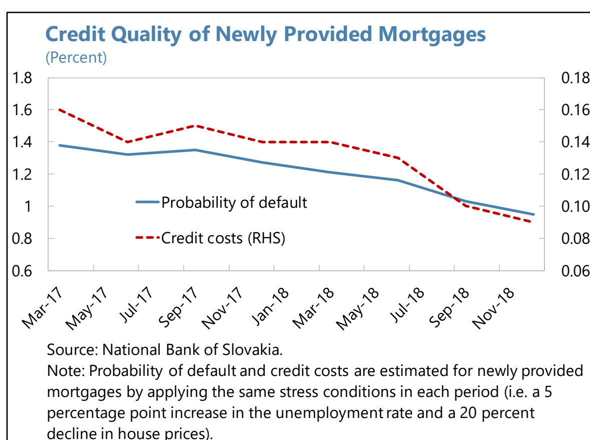
33. Continued efforts are needed to implement a robust AML/CFT framework. The authorities made efforts to transpose EU 4th AML Directive in 2018 and are now preparing the AML/CFT Action Plan 2019–22, based on the National Risk Assessment carried out in 2017–18. Sustained efforts are needed, including to improve disciplinary processes, step-up bank employee trainings, strengthen measures to support anti-corruption efforts, and enhance operational independence and effectiveness of the Financial Intelligence Unit.

34. Strong home-host cooperation should continue. Given the dominance of foreign banks in Slovak banking system, strong home-host cooperation including close engagements in Joint Supervisory Teams in SSM is critical. With limited domestic capacity to absorb bail-inable bonds, encouraging banks to have higher non-regulatory capital buffers may also help them meet minimum requirement for own funds and eligible liabilities (MREL). To fill the gaps identified at European level regulations by the recent euro area FSAP, the domestic regulatory regime should require banks to obtain authorities' pre-approval in acquiring qualifying holdings of non-bank entities and to periodically report the ultimate beneficial owners of their qualifying holdings.

Authorities' Views

35. The authorities viewed that the macro-prudential policies taken so far as effective and stand ready to raise capital buffers as necessary. The measures have not only moderated credit growth but also improved credit quality of new loans. Nonetheless, they saw mortgage borrowers in Slovakia to be more vulnerable to labor and property market shocks than other EU countries. They fully agreed with staff's assessment on vulnerabilities of smaller banks and expressed their readiness to increase CCyB further to what is already announced and impose non-zero Pillar II capital guidance on smaller banks as necessary. The authorities viewed that the expiration of the bank levy should help weaker banks to build more buffers.

Credit Quality of Newly Provided Mortgages
(Percent)



Source: National Bank of Slovakia.
Note: Probability of default and credit costs are estimated for newly provided mortgages by applying the same stress conditions in each period (i.e. a 5 percentage point increase in the unemployment rate and a 20 percent decline in house prices).

36. The authorities are considering broad measures to expand rental housing market. They broadly agreed with staff's assessments on housing market developments and underscored that a working group has been set up to draft a strategy by 2020 to develop the rental housing market, which should include measures to seek more balanced regulations for tenants and landlords and expand public rental houses. The national authorities expressed their reservations on removing preferential treatment of capital gains from housing investment, arguing that it is inefficient to change the national tax-regime to address possible house price overvaluations in large cities.

37. The authorities acknowledged strong profitability pressures on smaller banks and rising risks. For the moment, they did not see any material flaws in internal models of systemic foreign bank subsidiaries but showed interest in the mission's assessment that compressed default risks in large banks' internal models, together with strong intermediation roles of mortgage brokers, are contributing to build-up of risks and indicated that they would analyze these issues further.

STAFF APPRAISAL

38. With one-off effects of investment in the automotive industry tapering off, growth is projected to decelerate and gradually converge to its potential. Domestic demand, supported by robust wage and credit growth, is expected to propel economic activities, while contributions from net exports are also expected to improve on the back of recent capacity expansion in the automotive sector. Continued international trade tensions and a no-deal Brexit pose major downside risks to Slovakia's export-led economy. With still-high credit growth, households and banks are vulnerable to possible labor and property market downturns.

39. Slovakia's continued success in export-led growth strategy hinges on capturing higher-value activities. Recent policy efforts to ensure an adequate supply of qualified teachers and strengthen dual-track vocational training should be complemented by improving the quality of tertiary education and aligning higher education with technical skills needs. Improving the coordination of public research system, strengthening linkages between businesses and universities, and ensuring full use of EU funds for R&D would help enhance innovative capacity, which are important to move beyond assembly activities in exports. To increase the role of domestic firms, reforms should target a more predictable and enabling business environment, competitive and transparent public procurement system, independent judiciary, and well-developed infrastructure and logistics networks.

40. With the population set to experience fast ageing, efforts to ensure optimal use of the domestic labor force are appropriate. An insufficiently inclusive education system combined with a lack of affordable early childcare facilities is contributing to the still-high gender gap and regional disparities in labor market participation. Legislative proposal to make schooling mandatory starting at age 5, efforts to reintegrate the long-term unemployed into the labor market and increasing availability of affordable childcare are welcome. This should be complemented by active labor market policies to invest in skills and increase employability of the marginalized groups, including through better absorption of EU funds.

41. With above-potential growth, a balanced budget target for 2019 and 2020 is appropriate but will require additional efforts. Recent fiscal consolidation, driven by strong growth and policy efforts, has created some fiscal space under the SGP. However, the public debt trajectory is vulnerable to sizable economic downturns given strict escape clauses and debt brakes prescribed under the national FRA. Sustained fiscal consolidation will require fending off pressures to increase discretionary stimulus, which has absorbed a good part of the revenue windfall in recent years. The proposal to introduce multi-year expenditure ceilings to anchor budget planning and execution, while being consistent with the FRA and the SGP, would serve as an important step to instill durable fiscal discipline. Overly strict escape clauses may need to be revisited to avoid pro-cyclical fiscal tightening.

42. Higher revenue and spending efficiency are needed to create resources for growth-enhancing social and infrastructure investment. Planned measures to improve tax compliance through online electronic cashiers and electronic taxpayer services should be sustained through further strengthening of audit capacity in all core tax areas. Strong political will and better inter-ministerial coordination are needed to push through reforms outlined in the spending reviews. Strengthening the mandate of the implementation unit and incorporating actionable measures in the medium-term budget would help actualize savings. Additionally, a more robust public investment framework can improve the efficiency of public investment and absorption of EU funds, including through better project selection and prioritization at a national level.

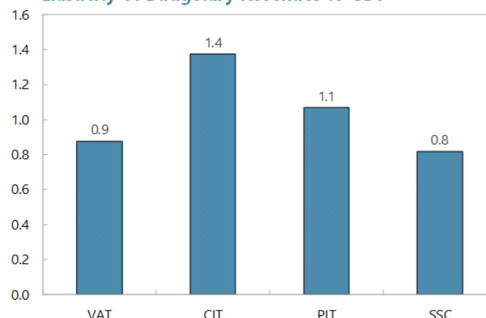
43. The banking sector is stable and well-capitalized, but profitability is under pressure and segments of vulnerability exist. A prolonged period of low interest rates, a too benign credit risk assessments by banks, the regulatory cap on mortgage refinancing fees, and the strong market intermediation role of mortgage brokers result in the compression of the lending margin. A sustained period of high credit expansion by banks, especially to low income segments, has nearly doubled household debt relative to disposable income. Moreover, rapidly rising flat prices in urban areas and appreciating house price-to-income ratio indicate growing vulnerabilities of households and banks, in particular, smaller banks with less capital buffers.

44. Proactive macro-prudential measures have moderated credit growth and reduced credit risks of new loans. The incremental use of CCyB and supervisory capital requirements have been appropriate in ensuring adequate capital buffers for banks. Strong vigilance of smaller banks, including through reduction of NPLs, is important and further increase in capital buffers may be needed given their higher vulnerability. Allowing the bank levy to expire as scheduled in 2021 should help the smaller banks build more capital buffers. Given historically low default rates, considerations should be given to impose add-on risk weight on mortgages loans to ensure better internalization of credit risks. To complement macro- and micro-prudential policies, consideration should be given to reducing preferential tax treatments for housing investment and removing obstacles to develop the rental housing market.

45. It is recommended that the next Article IV consultation with the Slovak Republic take place on the standard 12-month consultation cycle.

Box 1. Revenue Cyclicality and Buffers Under the Fiscal Responsibility Act

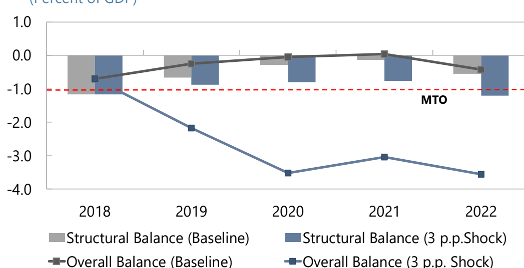
We used a simple econometric model to estimate growth elasticities of different revenue categories while controlling for changes in revenue administration and the policy rate.[1/] Results suggest that CIT and PIT have higher elasticities compared to VAT and Social Contributions (SC), which may be explained by different behavior of relevant macroeconomic bases in response to growth shock as well as the structure of the individual tax.



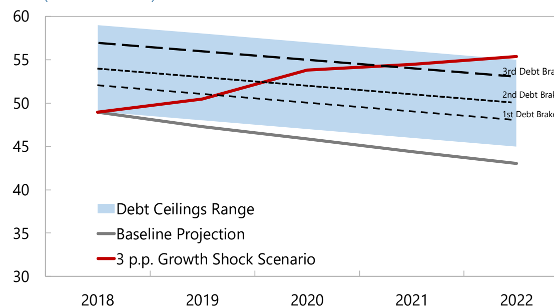
Source: IMF staff calculations.

To assess vulnerabilities from cyclicality, we simulated the impact of a standard DSA growth shock on the fiscal balance and public debt path through 2022. The shock consists of a fall in the growth rate by one standard deviation of GDP growth rates in past 10 years lowering real GDP growth rate by 3 percentage points in 2019 and 2020 before rebounding to baseline. Estimated elasticities were used to simulate the impact on revenues, while baseline expenditure levels were maintained assuming no fiscal adjustment. Additional spending on automatic stabilizers of about 1 percent of GDP was assumed over 2019-20.

The structural balance remains broadly in line with the MTO of -1 percent of GDP, but a larger overall deficit increases risks to the public debt trajectory. Cyclical-adjustment limits the deterioration in the structural balance, but the overall balance weakens to -3½ percent of GDP by 2020 reflecting the full revenue loss as well as the impact of automatic stabilizers. The larger nominal deficit, together with adverse debt dynamics from lower nominal GDP growth, results in public debt being 12 percentage points above the baseline trajectory by 2022 exceeding the third debt brake and mandating a public wage freeze and other consolidation measures. While the SGP's fiscal rules are sensitive to the cyclical position, the FRA debt ceilings are invariant to the cycle and are set to decline over time. Pro-cyclical fiscal consolidation, either through FRA sanctions or efforts to avoid them, could prove self-defeating by prolonging the slowdown, lowering public investment, and worsening debt dynamics.



1/ No active consolidation is assumed over the projection horizon; does not include the impact of the expansionary package planned for 2020.
Sources: IMF staff calculations.

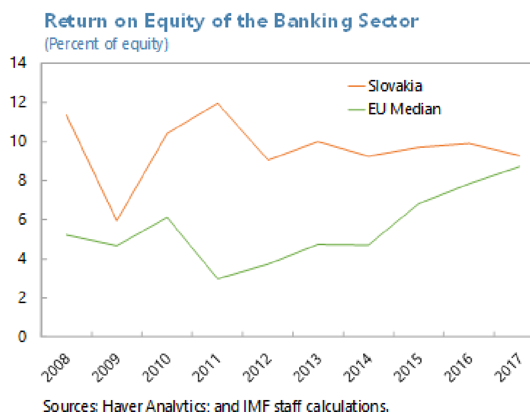


1/ Reflects a 3 p.p. shock to real GDP growth based on 1 standard deviation of growth rates over the past 10 years; inflation is lowered by 1 percent; no active consolidation is assumed over the projection horizon; does not include the impact of the expansionary package planned for 2020.
Sources: IMF staff calculations.

[1/] A disaggregated approach is used to estimate elasticities of each revenue category (VAT, PIT, CIT and SC) to real GDP. The model is fitted using annual data over 1997-2018 in the following form: $\Delta T_{it} = c_{it} + \Delta Y_t + \Delta \pi_t + \Delta \rho_{it} + \Delta \lambda_{it} + \epsilon_{it}$; where T is the log of specific revenue, Y is the log of real GDP, π is the log of GDP deflator, and ρ is the official tax/contribution rate. The sub-index i refers to tax type. Parameter λ was introduced to disentangle the impact of GDP growth shocks from unobservable changes in tax administration or discretionary measures, including exemptions. The index captures changes in the effective tax rate with respect to each revenue base which do not result from a change in the policy rate. In addition, adjustments were made to the CIT data series to filter the impact of special levies on industrial and financial sectors since 2012, and the social contributions data series to offset large one-off collections in 2018.

Box 2. Profitability and Pressures from Lending Margin Compression

Overall profitability of the Slovak banking system has been robust. Taking advantage of a low cost-to-income ratio, Slovak banks have recorded around 10 percent of average return on equity during post-crisis years, which is on the high side among EU countries. Profitability has been particularly strong for systemic foreign bank subsidiaries.



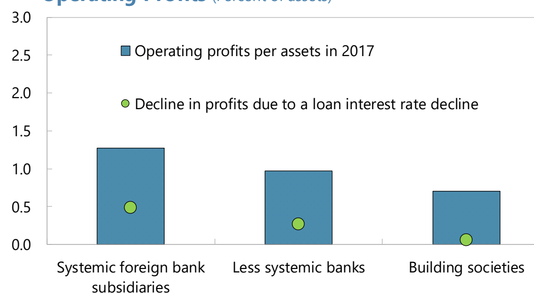
However, smaller banks are facing strong downward pressures on profitability due to drastic compression in the lending margin. While low interest rates are affecting lending margins across the euro area, banks in Slovakia are particularly affected due to a combination of factors**:**

Simple business model and small market size. The interest rate decline hit Slovak banks especially hard due to their high reliance on interest income. Pressured by parent banks, they expanded their portfolio aggressively to ensure a certain level of profitability. Low reliance of large corporates in Slovakia on domestic funding also drove Slovak banks to concentrate on household lending.

Low credit costs. Historically low default rates (Slovakia has not had major banking crises for decades) compressed credit costs of banks and risk-weights used in internal models allowing systemic banks to lower lending rates. This, in turn, pushed smaller banks to offer even lower lending rates to gain market share contributing to the compression of lending margins.

Dominant role of mortgage brokers**.** Traditionally, the use of mortgage brokers has allowed banks to expand their client base in a cost-effective way. Yet, when interest rates started to fall and demand for refinancing surged following the introduction of regulatory cap on refinancing fee, mortgage brokers' strong market power, owing to their large presence (over half of mortgage loans are intermediated with the help of brokers) and detailed customer knowledge, enabled them to negotiate lower lending rates.

A further decline in interest rates could significantly reduce profit buffers of less-sytemic banks and building societies. Sensitivity analysis shows that, all other things being equal, a decline in the loan interest rate by the same amount experienced during 2014–17 (about 108 basis points) would reduce operating profits per asset by between 0.6–0.8 percentage points. The systemic foreign bank subsidiaries would remain the most profitable, while smaller banks would feel more pressure on their profitaility. It should be noted that profitability pressures facing smaller banks may be mitigated if their relatively high deposit interest rates declined futher along with their lending rates.



Sources: Fitch Connect; and IMF staff calculations.
Note: Results are shows in the weighted average by assets. Less systemic banks exclude a publicly owened bank.

Table 1. Slovak Republic: Summary of Economic Indicators, 2016–24

	2016	2017	2018	2019	2020	2021	2022	2023	2024
			Est.	Projections					
	(Annual percentage change, constant prices, unless noted otherwise)								
Output/Demand									
Real GDP	3.1	3.2	4.1	3.5	3.1	2.9	2.7	2.7	2.5
Domestic demand	1.2	2.6	4.2	3.0	2.5	2.4	2.3	2.6	1.4
Public consumption	1.6	1.7	1.9	1.8	1.7	1.5	1.5	1.5	1.5
Private consumption	2.9	3.5	3.0	3.0	2.4	2.2	1.9	1.9	1.9
Gross fixed capital formation	-9.4	3.4	6.8	3.4	3.5	3.5	3.8	5.0	0.3
Exports of goods and services	5.5	5.9	4.8	5.4	5.2	5.0	4.5	4.4	4.4
Imports of goods and services	3.4	5.3	5.3	5.0	4.7	4.7	4.2	4.4	3.6
Potential Growth	2.5	3.4	4.1	3.7	3.6	3.1	2.9	2.9	2.6
Output gap	1.0	1.2	1.2	1.0	0.6	0.4	0.3	0.2	0.1
Contribution to growth									
Domestic demand	1.0	2.3	4.2	2.8	2.3	2.2	2.1	2.4	1.3
Public consumption	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.2
Private consumption	1.5	1.8	1.6	1.5	1.2	1.1	1.0	0.9	0.9
Gross fixed capital formation	-2.3	0.7	1.5	0.8	0.8	0.8	0.8	1.1	0.1
Inventories	1.5	-0.6	0.8	0.1	0.0	0.0	0.0	0.0	0.0
Net exports	2.2	0.9	-0.1	0.8	0.9	0.7	0.7	0.4	1.2
Prices									
Inflation (HICP)	-0.5	1.4	2.5	2.4	2.2	2.1	2.1	2.1	2.1
Inflation (HICP, end of period)	0.2	2.0	1.9	2.2	2.1	1.8	1.9	2.0	2.0
Core inflation	0.3	1.8	2.3	2.1	2.0	2.0	2.0	2.1	2.1
GDP deflator	-0.5	1.2	2.1	2.7	2.2	2.4	2.2	2.1	2.1
Employment and wages									
Employment	2.4	2.2	2.0	1.0	0.6	0.6	0.6	0.5	0.4
Unemployment rate (Percent)	9.7	8.1	6.6	6.0	5.9	5.8	5.7	5.7	5.7
Nominal wages	3.2	4.6	6.2	6.4	5.8	5.1	4.8	4.8	4.8
	(Percent of GDP)								
Public Finance, General Government									
Revenue	39.2	39.4	39.9	39.4	39.4	39.2	39.1	39.9	38.1
Expenditure	41.5	40.2	40.6	39.7	39.5	39.2	39.5	40.7	38.7
Overall balance	-2.2	-0.8	-0.7	-0.3	0.0	0.0	-0.4	-0.7	-0.7
Primary balance	-0.6	0.6	0.6	0.9	1.0	1.1	0.6	0.3	0.3
Structural balance (Percent of potential GDP)	-2.7	-1.2	-1.2	-0.7	-0.3	-0.1	-0.6	-0.8	-0.7
General government debt	51.8	50.9	48.9	47.3	45.8	44.3	42.9	41.7	40.4
	(Percent)								
Monetary and financial indicators									
Credit to private sector (Growth rate)	9.7	9.7	9.2	8.9	8.3	6.5	6.1	5.9	5.7
Lending rates[1]	2.0	1.8	1.5	...	...	...	...	...	...
Deposit rates[2]	0.7	0.4	0.4	...	...	...	...	...	...
Government 10-year bond yield	0.5	0.9	0.9	...	...	...	...	...	...
	(Percent of GDP)								
Balance of payments									
Trade balance (goods)	2.0	0.8	0.1	0.7	1.3	1.8	2.1	2.1	2.8
Current account balance	-2.2	-2.0	-2.5	-1.7	-1.0	-0.8	-0.3	0.0	0.4
Gross external debt	92.2	111.0	113.3	113.7	114.3	114.9	115.3	115.3	114.8
Saving and investment balance									
Gross national savings	20.8	20.6	21.1	21.9	22.8	23.7	25.0	25.9	26.6
Private sector	19.8	19.4	19.7	20.5	21.4	22.4	23.8	24.7	25.5
Public sector	1.0	1.2	1.4	1.4	1.4	1.3	1.2	1.2	1.1
Gross capital formation	23.0	22.5	23.6	23.6	23.8	24.5	25.2	26.0	26.3
Memo item									
Nominal GDP (Millions of euros)	81,226	84,851	90,202	95,918	101,132	106,547	111,859	117,303	122,701

Sources: National Authorities; and IMF staff calculations.

[1]Average of interest rates on new housing loans to households and loans of less than EUR 1 million to nonfinancial corporations (all maturities).

[2]Average of interest rates on new deposits with agreed maturity (up to 1 year) from households and nonfinancial corporations.

Table 2. Slovak Republic: Statement of Operations of the General Government, 2016–24

	2016	2017	2018	2019	2020	2021	2022	2023	2024
			Est.			Projections			
				(Millions of euros)					
Revenue	**31,864**	**33,444**	**36,017**	**37,839**	**39,892**	**41,819**	**43,759**	**46,834**	**46,708**
Taxes	14,573	15,489	16,382	17,617	18,627	19,403	20,305	21,207	22,183
Personal income tax	2,680	2,856	3,208	3,472	3,713	4,002	4,217	4,422	4,625
Corporate income tax	2,818	2,933	2,891	3,078	3,233	3,269	3,426	3,593	3,758
VAT	5,420	5,917	6,326	6,626	7,000	7,320	7,703	8,077	8,449
Excises	2,394	2,512	2,567	2,698	2,793	2,845	2,894	3,008	3,147
Other taxes	1,262	1,272	1,390	1,742	1,887	1,967	2,065	2,107	2,204
Social contributions	11,617	12,525	13,357	14,237	14,925	15,621	16,407	17,103	17,853
Grants	1,517	1,141	1,806	1,774	1,880	2,224	2,360	3,609	1,530
o/w EU Grants				863	1,112	1,428	1,566	2,815	736
Other revenue	4,157	4,288	4,472	4,211	4,460	4,571	4,687	4,915	5,141
Expenditure	**33,669**	**34,103**	**36,646**	**38,082**	**39,941**	**41,780**	**44,231**	**47,691**	**47,540**
Expense	30,862	31,343	33,386	35,321	37,041	38,658	40,170	42,290	43,573
Compensation of employees	7,401	7,804	8,395	9,183	9,928	10,361	10,797	11,322	11,843
Use of goods and services	4,459	4,802	4,893	5,300	5,443	5,737	6,020	6,513	6,373
Interest	1,336	1,179	1,176	1,122	1,079	1,080	1,119	1,173	1,227
Subsidies	376	363	399	432	443	420	441	463	484
Grants and transfers	1,358	1,217	1,716	1,784	2,256	2,544	2,629	2,757	2,663
Social benefits	15,520	15,715	16,334	17,183	17,589	18,197	18,829	19,746	20,654
Other expense	412	264	473	317	303	320	336	317	329
Net acquisition of nonfinancial assets	2,806	2,760	3,260	2,762	2,901	3,122	4,060	5,400	3,967
o/w Defense spending 1/				368	171	128	844	1,254	1,709
Gross Operating Balance	1,002	2,100	2,630	2,518	2,851	3,161	3,588	4,544	3,135
Net lending(+)/borrowing(-) 2/	**-1,805**	**-659**	**-629**	**-244**	**-50**	**40**	**-472**	**-856**	**-832**
				(Percent of GDP)					
Revenue	**39.2**	**39.4**	**39.9**	**39.4**	**39.4**	**39.2**	**39.1**	**39.9**	**38.1**
Taxes	17.9	18.3	18.2	18.4	18.4	18.2	18.2	18.1	18.1
Personal income tax	3.3	3.4	3.6	3.6	3.7	3.8	3.8	3.8	3.8
Corporate income tax	3.5	3.5	3.2	3.2	3.2	3.1	3.1	3.1	3.1
VAT	6.7	7.0	7.0	6.9	6.9	6.9	6.9	6.9	6.9
Excises	2.9	3.0	2.8	2.8	2.8	2.7	2.6	2.6	2.6
Other taxes	1.6	1.5	1.5	1.8	1.9	1.8	1.8	1.8	1.8
Social contributions	14.3	14.8	14.8	14.8	14.8	14.7	14.7	14.6	14.6
Grants	1.9	1.3	2.0	1.8	1.9	2.1	2.1	3.1	1.2
o/w EU grants				0.9	1.1	1.3	1.4	2.4	0.6
Other revenue	5.1	5.1	5.0	4.4	4.4	4.3	4.2	4.2	4.2
Expenditure	**41.5**	**40.2**	**40.6**	**39.7**	**39.5**	**39.2**	**39.5**	**40.7**	**38.7**
Expense	38.0	36.9	37.0	36.8	36.6	36.3	35.9	36.1	35.5
Compensation of employees	9.1	9.2	9.3	9.6	9.8	9.7	9.7	9.7	9.7
Use of goods and services	5.5	5.7	5.4	5.5	5.4	5.4	5.4	5.6	5.2
Interest	1.6	1.4	1.3	1.2	1.1	1.0	1.0	1.0	1.0
Subsidies	0.5	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Grants and transfers	1.7	1.4	1.9	1.9	2.2	2.4	2.4	2.4	2.2
Social benefits	19.1	18.5	18.1	17.9	17.4	17.1	16.8	16.8	16.8
Other expense	0.5	0.3	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Net acquisition of nonfinancial assets	3.5	3.3	3.6	2.9	2.9	2.9	3.6	4.6	3.2
o/w Defense spending 1/				0.4	0.2	0.1	0.8	1.1	1.4
Gross Operating Balance	1.2	2.5	2.9	2.6	2.8	3.0	3.2	3.9	2.6
Net lending(+)/borrowing(-) 2/	**-2.2**	**-0.8**	**-0.7**	**-0.3**	**0.0**	**0.0**	**-0.4**	**-0.7**	**-0.7**
Memorandum items:									
Primary balance	-0.6	0.6	0.6	0.9	1.0	1.1	0.6	0.3	0.3
Structural primary balance	-1.1	0.1	0.1	0.5	0.8	0.9	0.4	0.2	0.3
Cyclically-adj. structural balance (Percent of potential GDP)	-2.7	-1.2	-1.2	-0.7	-0.3	-0.1	-0.6	-0.8	-0.7
Gross public debt	51.8	50.9	48.9	47.3	45.8	44.3	42.9	41.7	40.4
GDP at current market prices (Millions of euros)	81,226	84,851	90,202	95,918	101,132	106,547	111,859	117,303	122,701

Sources: National Authorities; and IMF staff estimates and projections.

1/ Reflects the accrual recording for the acquistion of military equipment in line with ESA methodology with delivery starting 2022.

2/ In 2018, overall deficit may be higher by up to 0.3 percent of GDP pending a review by Eurostat. These relate to a change of methodology for recording certain expenditures incurred by some budgetary entities.

Table 3. Slovak Republic: Balance of Payments, 2016–24

	2016	2017	2018	2019	2020	2021	2022	2023	2024
		Est.			Projections				
				(Millions of euros)					
Current account	**-1,757**	**-1,690**	**-2,251**	**-1,613**	**-1,050**	**-866**	**-300**	**-53**	**446**
Trade balance (goods)	1,637	690	47	685	1,350	1,931	2,362	2,502	3,469
Exports, f.o.b.	67,164	71,479	76,412	83,309	87,017	91,831	96,433	101,286	106,389
Imports, f.o.b.	65,527	70,789	76,365	82,624	85,667	89,900	94,071	98,784	102,920
Services balance	469	880	774	919	1,035	1,153	1,250	1,315	1,481
Receipts	8,350	9,214	9,825	10,711	11,188	11,807	12,399	13,023	13,679
Payments	7,881	8,334	9,050	9,792	10,153	10,655	11,149	11,707	12,198
Primary income balance	-2,494	-1,977	-1,835	-1,917	-2,200	-2,582	-2,740	-2,912	-3,209
Credit	2,888	3,355	3,628	3,750	3,785	3,771	3,860	3,945	3,995
Debit	5,382	5,332	5,462	5,668	5,985	6,353	6,600	6,857	7,204
Secondary income balance	-1,369	-1,282	-1,238	-1,300	-1,236	-1,367	-1,173	-959	-1,297
Credit	326	618	676	706	720	708	772	854	763
Debit	1,695	1,901	1,914	2,006	1,955	2,075	1,944	1,813	2,060
Capital account	**1,631**	**790**	**1,459**	**1,638**	**1,811**	**1,580**	**1,539**	**1,604**	**1,633**
Financial Account	**-1,740**	**-2,067**	**-1,677**	**25**	**761**	**714**	**1,239**	**1,551**	**2,079**
Direct investment, net	-642	-1,710	-204	-2,521	-2,503	-2,459	-2,417	-2,373	-2,330
Assets	3,685	3,603	1,954	767	809	852	895	938	982
Liabilities	4,326	5,313	2,158	3,289	3,312	3,312	3,312	3,312	3,312
Portfolio investment, net	3,962	923	3,488	4,650	5,210	5,183	5,206	5,003	5,318
Assets	4,381	3,678	4,486	5,582	5,909	5,821	5,760	5,583	5,509
Liabilities	419	2,755	998	932	699	638	554	580	191
Other investment, net	-5,249	-1,981	-6,608	-2,128	-1,972	-2,035	-1,577	-1,105	-935
Assets	-1,589	12,195	2,005	3,741	3,944	4,155	4,363	4,575	4,540
Liabilities	3,659	14,176	8,612	5,868	5,916	6,191	5,939	5,680	5,475
Financial derivatives, net	231	231	231	24	25	25	26	26	26
Reserve assets 1/	-43	471	1,415	0	0	0	0	0	0
Errors and omissions	**-1,614**	**-1,167**	**-885**	**0**	**0**	**0**	**0**	**0**	**0**
Net International Investment Position	**-54,112**	**-55,631**	**-60,388**	**-60,363**	**-59,602**	**-58,889**	**-57,650**	**-56,099**	**-54,020**
External Debt	**74,917**	**94,188**	**102,229**	**109,029**	**115,644**	**122,473**	**128,967**	**135,227**	**140,893**
					(Percent of GDP)				
Current account	**-2.2**	**-2.0**	**-2.5**	**-1.7**	**-1.0**	**-0.8**	**-0.3**	**0.0**	**0.4**
Trade balance (goods)	2.0	0.8	0.1	0.7	1.3	1.8	2.1	2.1	2.8
Exports, f.o.b.	82.7	84.2	84.7	86.9	86.0	86.2	86.2	86.3	86.7
Imports, f.o.b.	80.7	83.4	84.7	86.1	84.7	84.4	84.1	84.2	83.9
Services balance	0.6	1.0	0.9	1.0	1.0	1.1	1.1	1.1	1.2
Receipts	10.3	10.9	10.9	11.2	11.1	11.1	11.1	11.1	11.1
Payments	9.7	9.8	10.0	10.2	10.0	10.0	10.0	10.0	9.9
Primary income balance	-3.1	-2.3	-2.0	-2.0	-2.2	-2.4	-2.4	-2.5	-2.6
Credit	3.6	4.0	4.0	3.9	3.7	3.5	3.5	3.4	3.3
Debit	6.6	6.3	6.1	5.9	5.9	6.0	5.9	5.8	5.9
Secondary income balance	-1.7	-1.5	-1.4	-1.4	-1.2	-1.3	-1.0	-0.8	-1.1
Credit	0.4	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.6
Debit	2.1	2.2	2.1	2.1	1.9	1.9	1.7	1.5	1.7
Capital account	**2.0**	**0.9**	**1.6**	**1.7**	**1.8**	**1.5**	**1.4**	**1.4**	**1.3**
Financial Account	**-2.1**	**-2.4**	**-1.9**	**0.0**	**0.8**	**0.7**	**1.1**	**1.3**	**1.7**
Direct investment, net	-0.8	-2.0	-0.2	-2.6	-2.5	-2.3	-2.2	-2.0	-1.9
Portfolio investment, net	4.9	1.1	3.9	4.8	5.2	4.9	4.7	4.3	4.3
Other investment, net	-6.5	-2.3	-7.3	-2.2	-1.9	-1.9	-1.4	-0.9	-0.8
Financial derivatives, net	0.3	0.3	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	-0.1	0.6	1.6	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	**-2.0**	**-1.4**	**-1.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net International Investment Position	**-66.6**	**-65.6**	**-66.9**	**-62.9**	**-58.9**	**-55.3**	**-51.5**	**-47.8**	**-44.0**
External Debt	**92.2**	**111.0**	**113.3**	**113.7**	**114.3**	**114.9**	**115.3**	**115.3**	**114.8**

Sources: National Bank of Slovakia; and IMF staff estimates.

1/ Does not include the transfer of reserve assets from the NBS to the ECB which took place in 2009.

Table 4. Slovak Republic: External Sector Assessment

Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) of the Slovak Republic stood around -67 percent of GDP in 2018. Growth in both gross asset and liability positions accelerated recently, driven by FDI and other investments. Gross assets were at 94 percent of GDP, while gross liabilities at 161 percent of GDP in 2018. **Assessment**. The negative NIIP does not imply risks to external sustainability. The projected narrowing of the current account deficit, driven by stronger exports, combined with robust nominal GDP growth are expected to bring the NIIP down to 44 percent of GDP by 2024. In addition, mostly long-term and local-currency-denominated and FDI-heavy external liabilities provide a cushion against capital outflows.	**Overall Assessment**: The external position of Slovakia is assessed to be broadly in line with the level implied by its medium-term fundamentals and desirable policies in 2018. Low external demand, particularly for automobiles in the second half of 2018 weighed on Slovakia's exports, which combined with a temporary increase in imports resulted in a narrowing of the trade surplus of about 0.7 percent of GDP. This increased the current account deficit slightly below the estimated norm in 2018. Going forward, the current account deficit is expected to narrow considerably as automotive exports increase owing capacity expansion.
Current account	**Background**. The current account deficit has seen significant reduction since 2010 currently standing at 2½ percent of GDP driven by strong trade surpluses while primary income account has seen rising outflows reflecting returns on past foreign investments. The projected pick up in export growth, supported by recent capacity expansion in the automotive sector, is expected to narrow the CA deficit beginning this year and bring it closer to a balanced position by 2024. **Assessment**. The EBA light CA model suggests a cyclically adjusted norm of -1 percent of GDP for 2018, which is higher than the observed cyclically-adjusted CA balance (-1.9 percent of GDP). This suggests only a small CA gap (-0.9 percent of GDP) implying marginal REER overvaluation of 1 percent. A policy gap of 2.5 percent is mostly driven by health expenditure. Slovakia's external position is broadly consistent with medium-term fundamentals and desirable policy settings.	
Real exchange rate	**Background**. Both CPI- and ULC-based real effective exchange rate (REER) appreciated slightly in 2018 compared with 2017 reflecting higher inflation and wage growth in Slovakia relative to trading partners. **Assessment**. The REER EBA-lite approach suggests only 0.1 percent gap and a policy gap of 0.9 percent, which is mostly driven by health expenditure and the real interest rate. This suggests that Slovakia's real exchange rate is in line with medium-term fundamentals and desirable policies, which is consistent with the results obtained from the EBA light CA model.	
Capital and financial accounts: flows and policy measures	**Background**. Mirroring the 2018 CA deficit, the Slovak Republic experienced net capital inflows, largely driven by FDI. **Assessment**. Slovakia enjoys high investor interest. The dominance of FDI in capital inflows mitigate risks from any sudden changes in the market sentiment.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.	
Technical Background Notes		

Table 5. Slovak Republic: Risk Assessment Matrix

	Source of Risks	Relative Likelihood	Time Horizon	Impact	Policy Response
Global	**Rising protectionism and retreat from multilateralism**	High	Short to Medium Term	Medium/High • Slovakia's exports and growth could be negatively affected by rising protectionism.	• Implement structural reforms that helps country to move up the value chain and diversify exports products and destinations • Improve labor market, business environment, and institutions to attract new and more diversified FDI.
	Intensification of the risks of fragmentation/ security dislocation, incl. in parts of Europe leading to socio-economic disruptions	High	Short to Medium Term	Medium/High • Socio-economic disruptions among European trading partners could slow exports or impact FDI.	• Diversify exports products and destination, and increase value added in exports. • Improve business environment to attract new and more diversified FDI.
	Sharp tightening of global financial conditions: • **Market expectation of tighter U.S. monetary policy** triggered by strong wage growth and higher than expected inflation. • **Sustained rise in risk premium** in reaction to concerns about debt levels in some euro area countries or a disorderly Brexit.	Low Medium	Short to Medium Term	Low • A depreciation of the euro could positively impact exports and external debt. • A sharp tightening of global financial conditions could affect some parent banks through sovereign and financial sector stress but spillovers to domestic subsidiaries would be contained.	• Continue to monitor financial developments. • Use active debt management to pre-finance fiscal needs.
	Weaker-than-expected global growth: • **Abrupt closure of the output gap in the US rather than a smooth landing.** • **Lower growth in Europe including due to lower external demand and a disorderly Brexit.** • **Significant China slowdown and its spillovers.**	Medium High Medium	Short to Medium Term Short to Medium Term Short to Medium Term	Medium /High • Exports and growth would be strongly hit by a slowdown in Europe, especially Germany. • Impact of weaker China growth would be mostly indirect, to the extent key trading partners are affected. • Debt ceilings could be breached in the event of a large adverse growth shock. • Weaker growth and higher unemployment would worsen banks' asset quality.	• Allow automatic stabilizers to work. • Consider revising the escape clause related to growth under the FRA. • Create fiscal space through efficiency-based consolidation and broadening of the tax base (see discussion in Section B). • Improve labor market and business environment to boost productivity and potential output and increase high value-added exports (see discussion in Section A). • Draw on banks' capital buffers.
Local	**Property market downturn in the event of a worsening economic situation**	Medium /High	Medium Term	Medium • Weakening of banks' balance sheets	• Continue using pro-active macro-prudential policies and close supervision of lending practices.

Table 6. Slovak Republic: Key Features of the Proposed Expenditure Ceiling Framework	
Area	**Description**
Ceilings horizon	Ceilings are to be set for 4 years at the beginning of the electoral cycle.
Determination of the Medium-term Budgetary Objective (MTO)	The government's MTO—expressed in structural terms—will be at a minimum consistent with SGP rules while considering national specifics like costs of aging. The adopted MTO will be based on the Council for Budget Responsibility (CBR)'s recommendation of a sustainable structural balance that achieves a long-term safe level of debt—currently assessed at 40 percent of GDP in line with the lower limit of the Fiscal Responsibility Act (FRA) by 2027.
Fiscal adjustment path over chosen horizon	If not within the MTO, the required adjustment in the structural balance will be determined based on the EC's recommendation prescribed by the corrective or preventative arm of the SGP and national FRA rules—whichever is more binding.
Revenue forecast	Structural revenues are calculated based on the 4-year nominal forecasts of the Tax Forecast Committee, net of the cyclical component and one-off factors. An independent analytical body will determine the non-tax revenue forecast.
Formulation and expression of the ceilings	Based on the revenue forecast, multi-year aggregate expenditure ceilings are set to achieve the target structural balance ex-ante. The expenditure limit is then expressed and fixed in nominal terms (and divided by ministerial chapter) with contingency reserves to absorb small macroeconomic forecast errors. If the forecast is fulfilled, the reserve can finance one-off capital investments in year t+1.
Corrective mechanism and technical updates to the ceilings	Based on the recommendation of the CBR, large macroeconomic or revenue forecast errors (above the contingency reserves) that result in significant deviations from set ceilings should be compensated for in subsequent years. Ceilings can also be updated during the 4-year horizon to reflect: - The impact of new legislative revenue measures (expansionary or consolidatory) not included when determining the ceiling. - Ex-post changes in tax collection efficiency that increase structural tax revenues as confirmed by the Tax Committee. - Measures that impact long-term sustainability beyond ceilings' horizon. - Inclusion of new entities in the definition of general government.
Scope of the ceilings and excluded expenditure items	The ceilings apply to general government entities including SOEs but excluding local governments governed by their own fiscal rules and autonomous entities like the CBR and the Supreme Audit Office. The ceilings exclude items not under government control like EU-financed expenditure (including co-financing); EU budget contribution; interest costs; and automatic stabilizers.
Escape clauses	Escape clauses are based on the FRA stipulations which cover extraordinary events including banking crises, natural disasters etc. as well as large macroeconomic shocks that reduce the y-o-y GDP growth rate by 12 percentage points over two consecutive years. Activation requires the CBR's approval.
Transfers between years	Transfer of expenditures are allowed between years up to 1% of the limit, to be approved individually by government without affecting the next year ceiling.
Legal liability of the ceilings	The ceilings (and their updates) are to be approved by Parliament and enacted in law within the context of the constitutional FRA.

Table 7. Slovak Republic: Financial Soundness Indicators for the Banking Sector, 2011–18

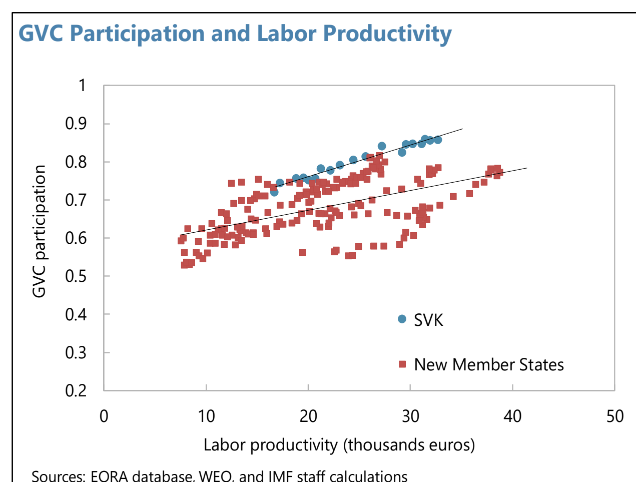
	2011	2012	2013	2014	2015	2016	2017	2018
Capital adequacy								
Regulatory capital to risk-weighted assets	13.4	15.7	16.5	17.3	17.8	18.0	18.8	18.4
Regulatory Tier 1 capital to risk-weighted assets	12.4	14.7	14.4	16.0	16.5	16.2	16.8	16.7
Capital to assets	10.5	11.0	11.7	11.9	11.5	10.8	10.7	10.5
Asset quality								
Nonperforming loans to gross loans	5.6	5.2	5.1	5.3	4.9	4.4	3.7	3.1
Nonperforming loans net of provisions to capital	15.5	13.3	13.1	15.8	13.9	11.8	9.1	6.9
Earnings and Profitability								
Return on assets (after tax)	0.7	1.0	1.3	1.2	1.3	1.4	1.1	1.1
Return on equity (after tax)	6.9	9.1	10.7	10.4	11.2	13.0	10.1	10.1
Interest margin to gross income	70.5	93.6	78.4	85.6	90.9	67.2	74.4	72.8
Noninterest expenses to gross income	49.9	76.9	63.7	66.5	70.8	54.4	60.7	59.6
Liquidity								
Customer deposits to total (noninterbank) loans	109.4	114.2	113.0	110.3	111.0	105.7	101.6	99.7
Liquid assets to total assets	37.4	38.3	36.2	34.1	34.2	31.7	29.7	27.0
Liquid assets to short-term liabilities	52.9	55.9	49.1	46.0	45.9	42.1	39.5	35.4
Sectoral distribution of loans to total loans								
Residents	93.6	92.4	91.6	91.0	93.6	94.0	94.1	93.4
Deposit-takers	0.0	0.0	0.0	0.0	0.1	0.2	0.1	0.0
Central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial corporations	2.8	2.3	2.3	1.9	1.9	1.9	2.1	1.5
General government	2.9	2.6	2.3	2.3	2.2	1.7	1.5	1.6
Nonfinancial corporations	41.6	38.9	36.2	33.4	33.7	32.4	31.4	30.2
Other domestic sectors	46.2	48.6	50.7	53.5	55.7	57.8	59.0	60.1
Nonresidents	6.4	7.6	8.4	9.0	6.4	6.0	5.9	6.6
Other indicators								
Nonfinancial corporation debt (in percent of GDP)	83.9	80.4	85.7	89.5	89.9	91.3	93.2	89.5
Households debt (in percent of GDP)	29.2	31.3	33.4	35.7	37.7	40.7	42.7	44.4
Households debt (in percent of disposable income)	47.4	52.9	57.2	61.8	65.0	69.9	73.9	77.6
Gross asset position in financial derivatives to capital	8.0	5.5	3.7	5.4	4.3	3.4	2.7	3.0
Gross liability position in financial derivatives to capital	9.1	6.7	4.8	6.6	5.5	4.4	3.4	3.4
Trading income to total income	-15.2	2.9	3.5	5.3	5.5	7.3	5.8	2.7
Personnel expenses to noninterest expenses	41.2	40.0	38.6	39.3	44.3	42.7	43.5	44.7
Spread between reference lending and deposit rates (basis points)	376.5	359.0	379.3	369.4	343.4	294.7	287.0	272.0
Foreign currency-denominated loans to total loans	1.6	1.5	1.1	1.9	1.8	1.7	1.6	1.4
Foreign currency-denominated liabilities to total liabilities	4.1	3.6	3.9	4.2	3.8	3.3	3.5	3.2
Net open position in equities to capital	9.1	8.3	14.4	12.6	12.6	11.9	11.3	11.1
Net open position in foreign exchange to capital	-1.7	0.1	2.2	3.7	2.5	0.9	1.0	0.8

Sources: Haver; National Bank of Slovakia; IMF FSI Database; and IMF staff estimates.

Annex I. Slovak Republic's Global Value Chain Participation: Stylized Facts

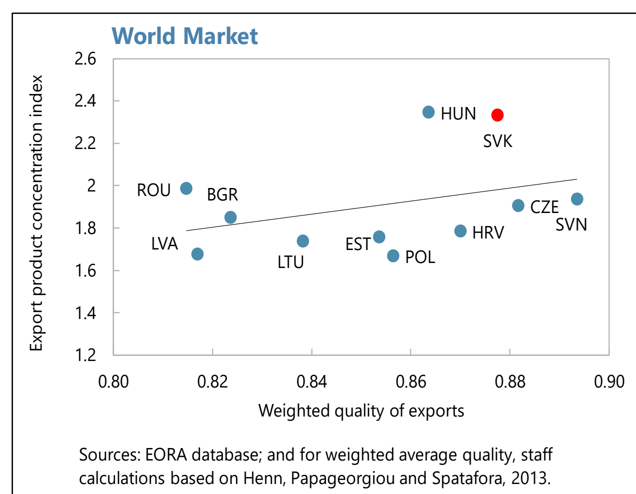
Slovakia has seen tangible benefits from integration in global value chain in terms of productivity growth and spillovers to the domestic economy. At the same time, increased concentration of exports has made the economy more exposed to external shocks. The concentrated export structure also creates strong spillover for the domestic economy given large sectoral interconnectedness.

1. **Slovakia's highly open economy and rapid integration with global value chains (GVCs) has created significant benefits.** Gross exports relative to GDP more than doubled since 2000. Rising exports were largely driven by increased links with GVCs which accounted for close to 90 percent of all exports making Slovakia one of the highest GVC-integrated economies in the world. Labor productivity has benefited from integration through technology transfer and automation and has more than doubled since 1995.



Sources: EORA database, WEO, and IMF staff calculations

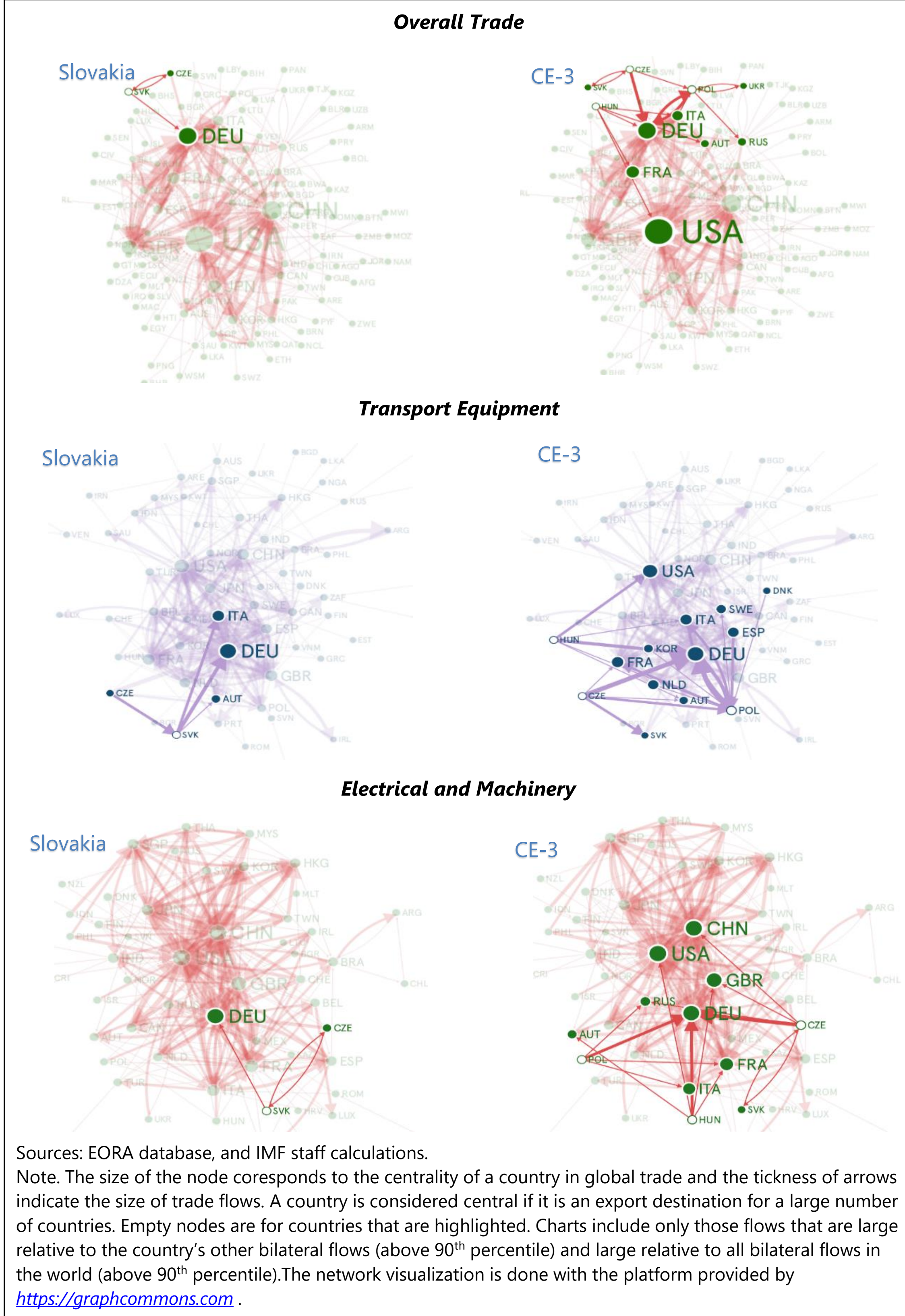
2. **With integration, however, the export structure has become more concentrated.** Top four export products accounted for more than 80 percent of total export in 2017. This has been the outcome of Slovakia trying to specialize in fewer products capitalizing on strong investor interest (Rahman and others, 2015). The rising concentration has been accompanied by higher quality of products. In terms of export destinations, Slovakia's critical trade connections are also limited to mostly Germany and Czech Republic, while other CEE countries, for example Hungary and Poland, have more diversified critical connections, including with countries outside the EU (Figure 1).[1] The situation is similar whether we look at overall trade or sectoral trade, with the transport sector holding a larger number of critical connections, although still with fewer connections than CEE peers.



Sources: EORA database; and for weighted average quality, staff calculations based on Henn, Papageorgiou and Spatafora, 2013.

[1] A country's bilateral trade is considered critical, if it is large relative to the country's other bilateral trade flows (above the 90th percentile of the distribution) and large relative to all bilateral trade flows in the world (above the 90th percentile of the worldwide distribution).

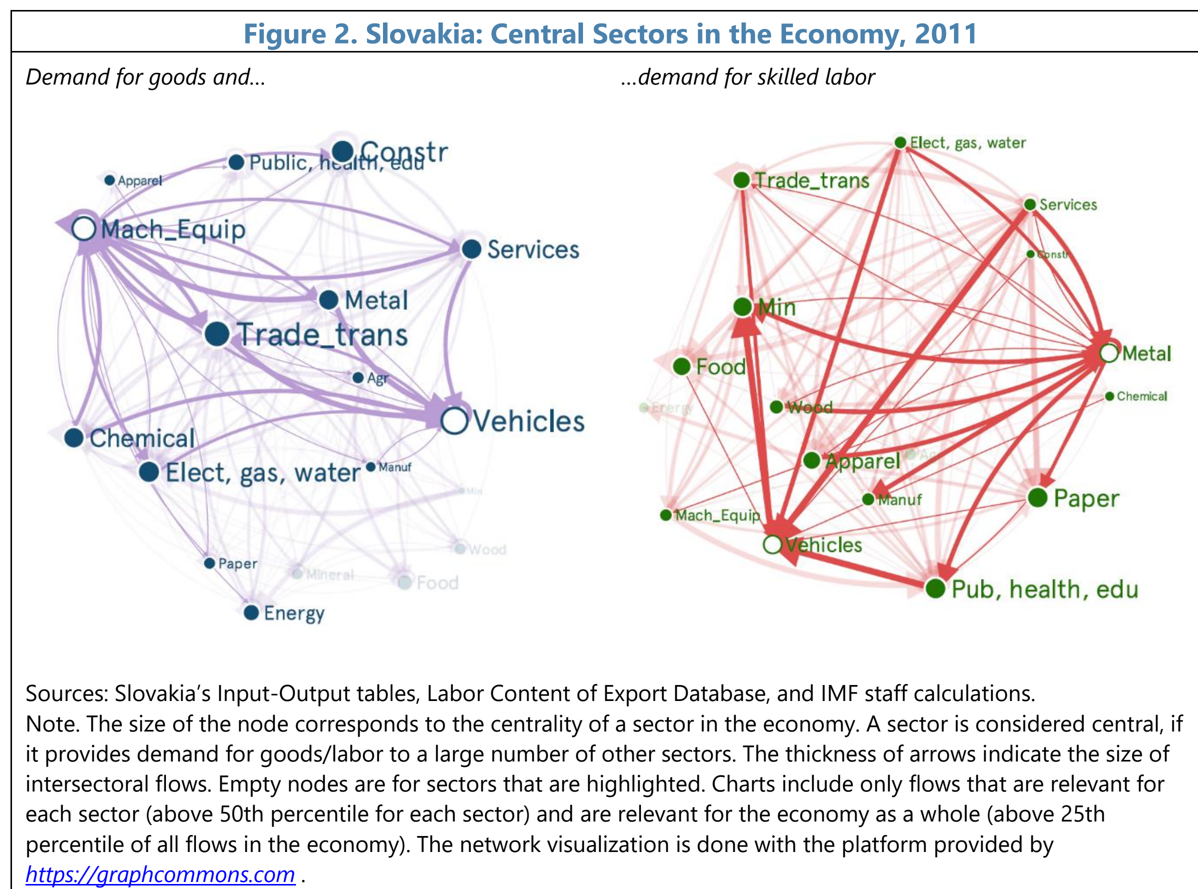
Figure 1. CEE Critical Trade Connections



Sources: EORA database, and IMF staff calculations.
Note. The size of the node coresponds to the centrality of a country in global trade and the tickness of arrows indicate the size of trade flows. A country is considered central if it is an export destination for a large number of countries. Empty nodes are for countries that are highlighted. Charts include only those flows that are large relative to the country's other bilateral flows (above 90th percentile) and large relative to all bilateral flows in the world (above 90th percentile).The network visualization is done with the platform provided by https://graphcommons.com .

3. Slovakia's key exports play a critical role in the domestic economy as well. About 40 percent of Slovakia's output is generated by the four main export products (transport equipment, machinery, metal, and chemicals) along with a third of labor demand through direct and indirect employment. Transport and equipment and electrical and machinery sectors are among the most central sectors in terms of connectivity with other sectors in the economy (Figure 2).[2] Chemical and metal products, though still important, play a less central role in the domestic economy. Metal products and transport equipment sectors play a critical role for generating labor demand. In contrast, chemical and machinery sectors play a more peripheral role for labor demand (Figure 2).

Figure 2. Slovakia: Central Sectors in the Economy, 2011



Sources: Slovakia's Input-Output tables, Labor Content of Export Database, and IMF staff calculations.
Note. The size of the node corresponds to the centrality of a sector in the economy. A sector is considered central, if it provides demand for goods/labor to a large number of other sectors. The thickness of arrows indicate the size of intersectoral flows. Empty nodes are for sectors that are highlighted. Charts include only flows that are relevant for each sector (above 50th percentile for each sector) and are relevant for the economy as a whole (above 25th percentile of all flows in the economy). The network visualization is done with the platform provided by https://graphcommons.com .

[2] A sector is considered central, if it provides demand for goods/labor to a large number of other sectors. We considered only those intersectoral flows that are relevant for each sector (above 50th percentile of the distribution for each sector) and are relevant for the economy as a whole (above 25th percentile of the distribution for all intersectoral flows in the economy).

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Annex II. Success Stories of Value Chain Upgrades and Lessons for the Slovak Republic

Successful examples of countries that have managed to climb up the production ladder of global value chains to capture higher value-added activities are not abundant. This analysis, which is based on a survey of literature, covers experiences of the following countries and products: Korea, China, and India in the automotive value chain, Korea in electronics value chain, and China and Central America in apparel value chain. While each value chain has its distinct characteristics, some factors that facilitated the upward movement have been observed in all cases. These factors are discussed below.

Technology transfer

1. Technology transfer is key to any country's ability to capture higher value-added activities. The experience of China, India, and Korea in the automotive sector suggests that local firms, which eventually became global lead firms, initially contracted out much of their design, engineering, and testing works to global engineering companies. However, they acquired technology over time through various ways.

- **Reverse engineering:** Reverse engineering was a common practice in developing countries. It implies accessing the product blueprints by breaking it down into components, which are then used to create templates to manufacture new parts. Initially, Korean firms did not possess the engineering knowledge to design and produce sophisticated automobile parts. Therefore, Hyundai's first car, Pony was reverse engineered from the Ford Marina and was equipped with an engine supplied by the Mitsubishi Motor Company (Green, 1992).

- **Cooperation with foreign lead firms without giving up control:** Local firms undertook joint ventures (JV) with foreign lead first while investing heavily in production capacity. Because local firms did not have to rely on their foreign partners for financing of large-scale investments, they managed to maintain control over JVs without resorting to restrictive laws, inconsistent with the international rules-based system for trade and investment. For example, Kia financed investments for expanding production capacities and Mazda provided training for production managers and designed products. Similarly, Hyundai received technical assistance in the design and manufacture of the engine, the powertrain, and the emission control system from Mitsubishi while financing investment and allowing Mitsubishi Motor Company and Mitsubishi Corporation to acquire a 5 percent share in Hyundai. Having the domestic financing was crucial in retaining control of the company and the eventual acquisition of technology.

- **Buying up financially-distressed foreign firms that possess technologies:** Whittaker et al. (2010) argue that lead firms from China and India acquired distressed auto companies in the West with the motivation to gain deep competencies in vehicle design and engineering. This process was hastened by the global financial crisis, which made some of these assets available for acquisition at 'fire sale' prices. An example would be Indian Tata Company's acquisition of British luxury vehicle brand Jaguar Land Rover from Ford.

Export Market Diversification

2. Shifting from stagnant mature to dynamic emerging markets, where customers have not yet developed durable preferences for established brands, was another strategy that newly-emerging firms used to ensure success. New markets were also easier to enter for smaller/newer exporters and were used as a learning laboratory before moving into more advanced activities. Korea's experience in the automotive industry provides an example where the strategy was to first export cars primarily to Latin America and the Middle East before trying more mature markets. According to Frederick and Gereffi (2011), a key to Asia's competitive success vis-à-vis Mexico and Central America in the apparel sector has been end-market diversification. For the latter group, regional trade agreements created an overreliance on the US market discouraging suppliers from developing linkages to other markets, or branch into higher value-added activities such as textile production, apparel design, and branding.

Offshoring/Outsourcing

3. Lead firms often outsource final product and subassembly activities to enable them to focus on higher value-adding activities (Sturgeon and Kawakami, 2011). While initially Korea's exports of electronics mainly constituted final products, over time Korean lead firms moved final product assembly (i.e. the "production phase") to lower-cost offshore locations in China and Vietnam. Currently, electronics exports from Korea primarily consist of key intermediate inputs, including semiconductors and displays, which are shipped abroad for assembly into final products. A similar pattern is also observed in the automotive industry. The emergence of local suppliers that benefited from technology transfer and JV cooperation with international lead firms shifted away Korea's automotive exports from finished cars to parts and major components that have higher domestic value added. Currently Korea's exports of car parts exceed imports by fivefold. Due to rising production costs in China, lead firms in the apparel sector also moved the production of price-sensitive items to neighboring Vietnam and Bangladesh.

Building a Regional Producer Network

4. The independent survival of a domestic industry requires large enough production volumes to capture economies of scale. Therefore, in a small open economy with limited domestic market size and labor supply, export orientation and regional cooperation are the only viable options. This motivated Korean firms to look out for export destinations and establish well developed regional networks of manufacturers in electronic products, which was supported by large-scale outward FDI to the region. China has also experienced regionally integrated development of apparel producers with East Asian neighbors. This gave East Asian countries a competitive edge over Mexico and Central American countries that have largely emerged as competitors rather than as a cooperating and unified apparel producing network.

Supportive Role of the Government

5. The government's targeted policies focused on supporting required skills in key products, innovation, and the development of overall infrastructure were common in all cases.

- ***Education:*** Skills required for inventing, developing new products, and marketing final goods are different from those needed for production and logistics activities. The advancement on the value ladder was made possible by the availability of a highly educated labor force. In this regard, significant investments by Korean and Chinese governments in workforce development that looked beyond the current needs of the labor market were instrumental for providing the economy with a large supply of workers with sufficient technical and soft skills to cover the full range of key supply chain functions to advance to higher value-added activities.

- ***Innovation:*** The governments' role was crucial for enhancing local producers' capacity in developing advanced frontend equipment. In addition to sectoral support for innovation from line ministries, Korean government established specialized science and research institutes that focused on increasing competitiveness of key export sectors and facilitated joint R&D ventures with foreign firms. A state-led consortium was formed by a major government research institute and a few large domestic electronics producers, notably Samsung and LG, to facilitate Korea's technological learning (Lee et al., 2016). This substantially increased R&D intensity and accelerated the pace of innovation in the country. However, the efficiency of R&D spending in Korea, reflected in the number of patents and publications per unit of spending, is still below that of the US, Japan, and leading European countries (Bartzokas, 2009). As part of the strategy to promote apparel and textile industries, the Chinese government invested in new spinning machinery and shuttleless looms. In addition, since meeting the quality standards set by foreign firms was one of the biggest challenges that second tier suppliers in China and India have faced, the Chinese government invested in quality control technology to decrease defect rates (Sutton, 2004; Frederick and Gereffi, 2011).

- ***Infrastructure:*** The Korean government invested substantially in infrastructure building ports, transportation networks, industrial parks, and power generation facilities. China has also made significant investments in ports and roads as well as logistics technology to facilitate supply chain collaboration and reduce lead times. In contrast, this was not the case in Mexico where the government support was largely absent (Frederick and Gereffi, 2011).

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Annex III. Public Sector Debt Sustainability Analysis (DSA)

Baseline Scenario

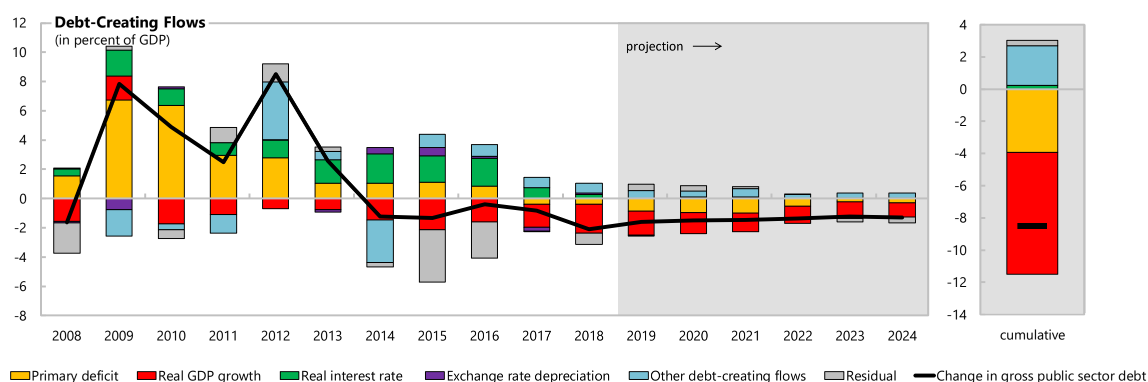
(Percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of May 21, 2019		
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024	Sovereign Spreads		
Nominal gross public debt	46.0	50.9	48.9	47.3	45.8	44.3	42.9	41.7	40.4	EMBIG (bp) 3/		58
Public gross financing needs	10.2	7.2	4.3	2.9	3.9	2.7	2.7	3.1	2.9	5Y CDS (bp)		44
Net public debt	41.4	45.3	42.9	41.1	39.5	37.8	36.5	35.2	33.9			
Real GDP growth (in percent)	2.4	3.2	4.1	3.5	3.1	2.9	2.7	2.7	2.5	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	0.5	1.2	2.1	2.7	2.2	2.4	2.2	2.1	2.1	Moody's	A2	A2
Nominal GDP growth (in percent)	2.9	4.5	6.3	6.3	5.4	5.4	5.0	4.9	4.6	S&Ps	A+	A+
Effective interest rate (in percent) [4/]	3.9	2.8	2.7	2.7	2.5	2.7	2.2	2.2	2.2	Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing
Change in gross public sector debt	2.4	-0.8	-2.1	-1.6	-1.5	-1.5	-1.4	-1.2	-1.3	-8.5	primary
Identified debt-creating flows	3.1	-0.8	-1.3	-2.0	-1.9	-1.6	-1.4	-1.0	-0.9	-8.8	balance [9/]
Primary deficit	2.7	-0.4	-0.4	-0.9	-1.0	-1.0	-0.5	-0.2	-0.3	-3.9	-0.6
Primary (noninterest) revenue and grants	37.3	39.2	39.7	39.4	39.4	39.2	39.1	39.9	38.0	235.0	
Primary (noninterest) expenditure	40.0	38.8	39.3	38.5	38.4	38.2	38.5	39.7	37.7	231.1	
Automatic debt dynamics [5/]	0.4	-1.1	-1.6	-1.7	-1.3	-1.1	-1.2	-1.1	-1.0	-7.3	
Interest rate/growth differential [6/]	0.4	-0.8	-1.7	-1.7	-1.3	-1.1	-1.2	-1.1	-1.0	-7.3	
Of which: real interest rate	1.4	0.8	0.3	-0.1	0.1	0.1	0.0	0.0	0.0	0.2	
Of which: real GDP growth	-1.0	-1.6	-2.0	-1.6	-1.4	-1.3	-1.2	-1.1	-1.0	-7.6	
Exchange rate depreciation [7/]	0.0	-0.3	0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.7	0.7	0.6	0.4	0.6	0.3	0.3	0.3	2.4	
Privatization/Drawdown of Deposits (+ reduces financing need) (negative)	0.0	0.7	0.7	0.6	0.4	0.6	0.3	0.3	0.3	2.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows (specify) (+ increases financing need)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-0.7	0.0	-0.8	0.4	0.4	0.1	0.1	-0.3	-0.4	0.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as $-g$.

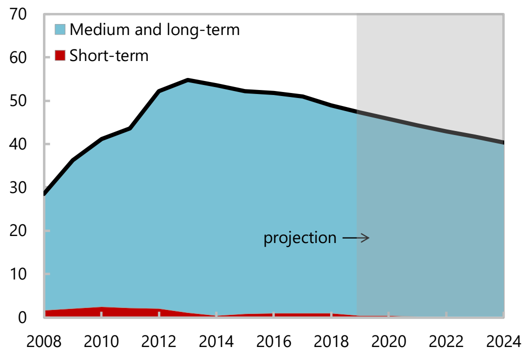
7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

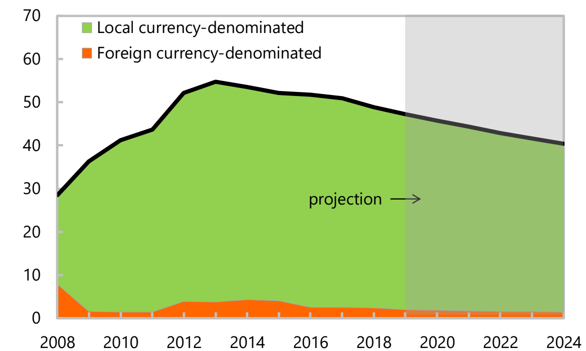
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Composition of Public Debt and Alternative Scenarios

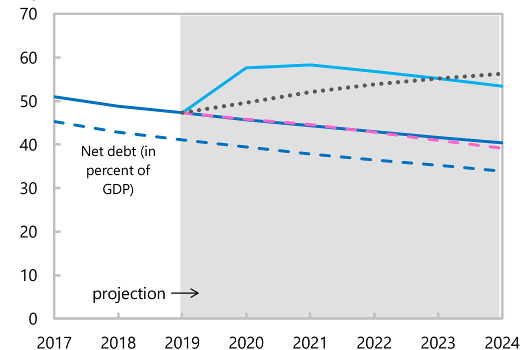
Composition of Public Debt

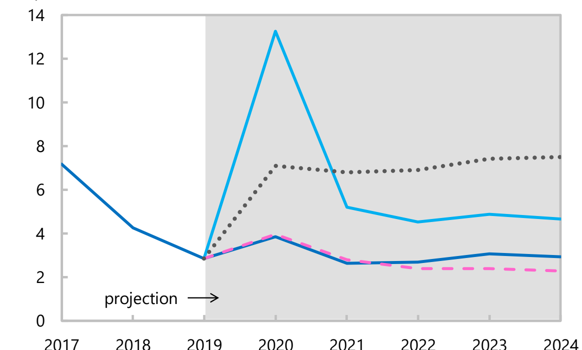




Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance





Underlying Assumptions

(in percent)

Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.5	3.1	2.9	2.7	2.7	2.5
Inflation	2.7	2.2	2.4	2.2	2.1	2.1
Primary Balance	0.9	1.0	1.0	0.5	0.2	0.3
Effective interest rate	2.7	2.5	2.7	2.2	2.2	2.2
Constant Primary Balance Scenario						
Real GDP growth	3.5	3.1	2.9	2.7	2.7	2.5
Inflation	2.7	2.2	2.4	2.2	2.1	2.1
Primary Balance	0.9	0.9	0.9	0.9	0.9	0.9
Effective interest rate	2.7	2.5	2.7	2.2	2.2	2.2

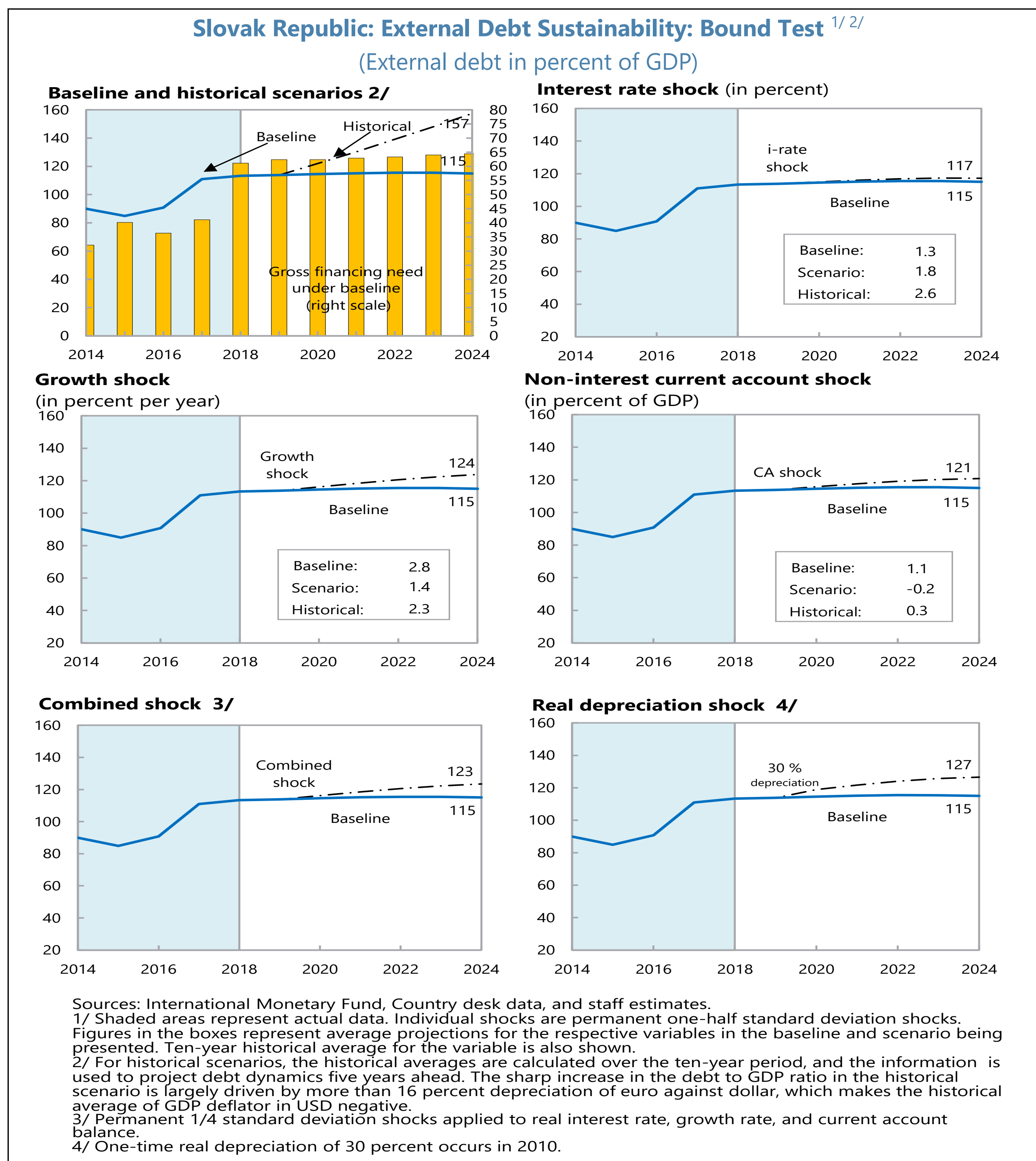
Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.5	2.3	2.3	2.3	2.3	2.3
Inflation	2.7	2.2	2.4	2.2	2.1	2.1
Primary Balance	0.9	-2.2	-2.2	-2.2	-2.2	-2.2
Effective interest rate	2.7	2.5	3.1	2.9	3.0	3.3
Contingent Liability Shock						
Real GDP growth	3.5	0.2	0.0	2.7	2.7	2.5
Inflation	2.7	1.5	1.6	2.2	2.1	2.1
Primary Balance	0.9	-8.1	1.0	0.5	0.2	0.3
Effective interest rate	2.7	2.8	3.0	2.5	2.4	2.4

Source: IMF staff.

Annex IV. External Debt Sustainability Analysis (DSA)

Slovak Republic: External Debt Sustainability: Bound Test 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead. The sharp increase in the debt to GDP ratio in the historical scenario is largely driven by more than 16 percent depreciation of euro against dollar, which makes the historical average of GDP deflator in USD negative.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

Slovak Republic: External Debt Sustainability Framework, 2014–24

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	90.0	84.9	90.8	111.0	113.3			**113.8**	**114.5**	**115.1**	**115.5**	**115.5**	**115.0**	**-5.1**
Change in external debt	7.9	-5.1	5.9	20.2	2.4			0.5	0.7	0.6	0.3	0.0	-0.5	
Identified external debt-creating flows (4+8+9)	-4.3	-2.3	-1.1	-3.3	-5.4			-3.1	-3.3	-3.4	-3.9	-4.2	-4.4	
Current account deficit, excluding interest payments	-3.3	-0.2	0.3	0.3	0.8			0.0	-0.6	-0.9	-1.0	-1.3	-1.7	
Deficit in balance of goods and services	-3.9	-1.6	-2.6	-1.9	-0.9			-1.7	-2.4	-2.9	-3.2	-3.3	-4.0	
Exports	91.3	90.9	93.0	95.1	95.6			98.2	97.2	97.4	97.4	97.6	98.0	
Imports	87.4	89.4	90.4	93.2	94.7			96.5	94.9	94.5	94.2	94.3	94.0	
Net non-debt creating capital inflows (negative)	-1.1	-1.1	-1.1	-1.3	-1.2			-1.1	-1.0	-1.1	-1.2	-1.2	-1.3	
Automatic debt dynamics 1/	0.1	-1.0	-0.3	-2.2	-5.0			-2.0	-1.8	-1.5	-1.7	-1.7	-1.4	
Contribution from nominal interest rate	2.2	1.9	1.9	1.7	1.7			1.7	1.6	1.7	1.3	1.3	1.3	
Contribution from real GDP growth	-2.2	-4.3	-2.6	-2.7	-4.1			-3.7	-3.4	-3.2	-3.0	-3.0	-2.7	
Contribution from price and exchange rate changes 2/	0.1	1.4	0.4	-1.2	-2.6			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	12.2	-2.8	7.0	23.4	7.8			3.6	4.0	4.0	4.2	4.2	4.0	
External debt-to-exports ratio (in percent)	98.6	93.3	97.7	116.7	118.5			116.0	117.8	118.2	118.5	118.3	117.3	
Gross external financing need (in billions of US dollars) 4/	32.4	35.2	32.7	39.4	65.1			68.3	72.8	77.9	82.8	88.1	93.3	
in percent of GDP	32.1	40.1	36.4	41.1	61.1	10-Year	10-Year	62.4	62.4	63.0	63.4	64.0	64.4	
Scenario with key variables at their historical averages 5/								**113.8**	**122.0**	**130.3**	**139.2**	**148.0**	**157.4**	**2.0**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	2.8	4.2	3.1	3.2	4.1	2.3	2.9	3.4	3.1	2.9	2.7	2.7	2.5	
GDP deflator in US dollars (change in percent)	-0.1	-16.6	-0.7	3.3	6.8	-1.0	7.1	-0.6	3.3	2.9	2.8	2.5	2.7	
Nominal external interest rate (in percent)	2.7	1.8	2.3	2.0	1.7	2.6	0.9	1.6	1.5	1.5	1.2	1.2	1.2	
Growth of exports (US dollar terms, in percent)	0.2	-13.5	4.6	9.0	11.8	3.6	13.1	5.5	5.6	6.1	5.7	5.5	5.7	
Growth of imports (US dollar terms, in percent)	0.9	-11.2	3.5	10.0	13.0	3.2	13.1	4.7	4.8	5.5	5.3	5.4	4.9	
Current account balance, excluding interest payments	3.3	0.2	-0.3	-0.3	-0.8	0.3	2.5	0.0	0.6	0.9	1.0	1.3	1.7	
Net non-debt creating capital inflows	1.1	1.1	1.1	1.3	1.2	1.1	0.1	1.1	1.0	1.1	1.2	1.2	1.3	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 13, 2019

Prepared By | European Department

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FUND RELATIONS

(As of April 30, 2019)

Membership Status: Joined January 01,1993; Article VIII

General Resources Account:	SDR Million	Percent of Quota
Quota	1,001.00	100.00
Fund holdings of currency	811.63	81.08
Reserve position	189.37	18.92
Lending to the Fund		

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	340.48	100.00
Holdings	300.27	88.19

Outstanding Purchases and Loans: None

Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	7/22/1994	3/21/1996	115.80	32.15

Projected Payments to Fund:
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2019	2020	2021	2022	2023
Principal					
Charges/Interest	0.34	0.46	0.46	0.46	0.46
Total	0.34	0.46	0.46	0.46	0.46

Exchange Rate Arrangement:

The de jure exchange rate arrangement of the euro area is free floating. The Slovak Republic participates in a currency union (EMU) with 18 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies. The Slovak Republic has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, other than those imposed for security reasons, based on UN Security Council Resolutions and Council of the European Union Regulations, and which have been notified to the Fund under the procedures set forth in Executive Board Decision No. 144-(42/51).

Article IV Consultation:

The Slovak Republic is on a standard 12-month consultation cycle. The previous consultation with the Slovak Republic was concluded on July 23, 2018 (IMF Country Report No. 18/241).

FSAP Participation and ROSCs:

An FSAP was concluded with the completion of the 2002 Article IV consultation on August 7, 2002 (IMF Country Report No. 02/198). An FSAP update mission was held in December 2006 (IMF Country Report 07/243).

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

Technical Assistance: See the attached table.

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

Slovak Republic: Technical Assistance, 2000–2019[1/]		
Department	**Timing**	**Purpose**
MCM	February 2000	Mission on pros and cons, and modalities of moving to an inflation targeting framework, operational issues (money markets and policy instruments), and dealing with potential problems posed by capital inflows for monetary operations
	December 2001	Long-term resident expert on banking supervision
	May 2002	Two missions on inflation modeling
FAD	April 2000	Tax administration
	February 2001	Tax administration (follow-up)
	April 2001	Public Finance Management (follow-up)
	August 2001	Tax administration: Installation of resident expert to advise on establishment of Large Taxpayer Unit (LTU)
	August 2001–August 2002	Regular visits by FAD consultant on establishment of LTU
	December 2001	Tax administration follow-up, tax investigation/fraud issues
	June 2002	Mission to prepare Report on the Observance of Standards and Codes (ROSC), Fiscal Transparency Module
	February 2003	Tax policy
	March 2003	Tax administration
	May 2003	Expenditure policy
	December 2013	VAT gap analysis
	November 2015	Expenditure review workshop
	December 2015	VAT gap follow-up and excise gap analysis
	April 2016	Expenditure review
	November 2016	Tax efficiency
		Expenditure review
	March 2017	Corporate income tax gap
	May 2017	Expenditure review
	November 2017	Cost-benefit analysis of transport investment projects
		Expenditure review (follow-up)
	April 2018	TADAT
	April 2018	International taxation
	May 2018	Expenditure review (preparing baselines)
	November 2018	Expenditure review
	February 2019	Public Investment Management Assessment
STA	February 2000	National accounts and price statistics
	March 2001	Multi sector mission
	July 2003	Government finance statistics
	February–March 2004	Data ROSC mission

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

STATISTICAL ISSUES

1. **Coverage, periodicity, and timeliness of data provided to the Fund are adequate for surveillance purposes.** The Slovak Republic has subscribed to the Special Data Dissemination Standard (SDDS) since 1996 and observes or exceeds all related standards. The Slovak Republic is subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB).

2. **Real Sector.** All data on national accounts follow the ESA 2010.

3. **Fiscal Sector.** The compilation of general government statistics is in line with the ESA 2010. Monthly reconciliation of government operations above and below the line is restricted to state budget transactions on a cash basis quarterly reconciliation of general government operations above and below the line, as well as a financial balance sheet data are available on an accrual basis within 85 days after the end of the quarter. The methodology for reporting some expenditures pertaining to budgetary entities outside central government was changed in 2018 and is currently under review by Eurostat.

4. **External Sector.** External sector statistics are generally of good quality and are reported on a timely basis to the Fund following the standard of the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6). Official BPM6 basis data are available back to 2004. However, net errors and omissions in the balance of payments statistics are large (averaging 2 percent of GDP for the last five years) and reported financial account flows are subject to large volatility. The statistical authorities are aware of these issues and are working to address them.

5. **Monetary Statistics.** The ECB reporting framework is used for monetary statistics and data are reported to the IMF through a "gateway" arrangement with the ECB. The arrangement provides an efficient transmission of monetary statistics to the IMF and for publication in the International Financial Statistics. Monetary statistics for Slovak Republic published in the IFS cover data on central bank and other depository corporations (ODCs) using Euro Area wide and national residency criteria.

6. **Financial Sector Surveillance.** Slovak Republic reports all core and encouraged financial soundness indicators (FSIs) for deposit takers, except for large exposures.

Table 1. Slovak Republic: Table of Common Indicators Required for Surveillance

(As of May 31, 2019)

	Date of Latest Observation	Date Received	Frequency of Data [6/]	Frequency of Reporting [6/]	Frequency of Publication [6/]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities [1/]	March 2019	April 2019	D	W	W
Reserve/Base Money	March 2019	April 2019	M	M	M
Broad Money	March 2019	April 2019	M	M	M
Central Bank Balance Sheet	March 2019	April 2019	M	M	M
Consolidated Balance Sheet of the Banking System	March 2019	April 2019	M	M	M
Interest Rates [2/]	Current	Current	D	D	D
Consumer Price Index	March 2019	April 2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing [3/] — General Government [4/]	2018	April 2019	A	A	A
Revenue, Expenditure, Balance and Composition of Financing [3/] —Central Government	March 2019	April 2019	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt [5/]	2019Q1	April 2019	Q	Q	Q
External Current Account Balance	March 2019	April 2019	M	M	M
Exports and Imports of Goods and Services	March 2019	April 2019	M	M	M
GDP/GNP	2019Q1	May 2019	Q	Q	Q
Gross External Debt	2018Q4	February 2019	Q	Q	Q
International Investment Position [7/]	2018Q4	February 2019	Q	Q	Q

[1/]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2/]Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3/]Foreign, domestic bank, and domestic nonbank financing.

[4/]The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5/]Including currency and maturity composition.

[6/]Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), Not Available (NA).

[7/]Includes external gross financial asset and liability positions vis-à-vis nonresidents.