

Slovak Republic: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Slovak Republic

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Slovak Republic, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 7, 2003**, with the officials of the Slovak Republic on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 8, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 23, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Slovak Republic.

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

Statistical Appendix
Report on the Observance of Standards and Codes—Fiscal Transparency
Module—Update

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SLOVAK REPUBLIC

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the
2003 Consultation with the Slovak Republic

Approved by Carlo Cottarelli and Anthony R. Boote

July 8, 2003

- Consultation discussions were held in Bratislava during April 22–May 7. The mission met with Deputy Prime Minister and Finance Minister Mikloš, central bank Governor Jusko, other senior officials, and members of parliament, private enterprises, trade unions, and financial institutions. The staff team comprised Mr. Fernández-Ansola (Head), Ms. Choueiri, and Mr. Moore (all EU1), Mr. Adachi (PDR), and Mr. Christou, Resident Representative. Mr. Sipko, assistant to Mr. Kiekens (Executive Director), attended the meetings. The authorities released the mission's concluding statement and have agreed to the publication of the staff report.
- Slovakia has accepted the obligations of Article VIII. In a May 2003 referendum, voters supported EU membership; accession is scheduled for May 2004.
- In concluding last year's consultation, Directors agreed that the short-term outlook remained positive, but expressed concerns about the widening external deficit, rooted in part in excessive fiscal expansion. Directors urged the authorities to take measures to meet their fiscal deficit target for 2002, and welcomed plans for medium-term fiscal consolidation primarily through retrenchment of government spending. They commended the authorities for their skillful monetary policy, but cautioned that an extensive reform agenda remains.
- Over the past few years, policies have remained in line with Fund advice in several respects, but key policies still await implementation. The government of Prime Minister Dzurinda won a second term in the September 2002 elections. In its first term, the government restructured and privatized state enterprises and banks; curtailed quasi-fiscal activities; improved fiscal transparency and control; and put inflation on a downward path. The growth payoff has been evident. Nonetheless, the government's second-term policy statement acknowledges the need for accelerating fiscal consolidation and structural reforms, and envisages reforms in taxation, labor market, benefits, pensions, and the judiciary, and targets meeting the requirements for euro adoption by 2006.

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Executive Summary

Background and Outlook: Economic growth was brisk (4 percent) in 2001–02 and is projected to remain strong in 2003, despite necessary increases in administered prices and indirect taxes. These measures also contributed to a jump in headline inflation in early 2003, but underlying inflation has remained low given moderate wage settlements, strong productivity gains, and an appreciating koruna. Competitiveness remains strong, and external deficits, while still large (over 8 percent of GDP) in 2001–02, are narrowing. The fiscal deficit remained sizable in 2001–02, exceeding 7 percent of GDP, and sustained progress towards the Maastricht deficit criterion (3 percent of GDP) is required in the period ahead. Beyond 2003, prospects remain positive for growth, with downside risks from weak external demand, and for core inflation.

Policy Issues and Discussions: Authorities and staff broadly agreed on both the issues and the requisite policies, albeit with nuances. Namely:

1. *Sustainability of the external current account.* General agreement that the external current account is gradually returning towards sustainable levels. The authorities were more optimistic on the speed; they assume stronger exports and lower imports, and project a deficit below 5 percent of GDP in 2003, while staff projects it at 6–6½ percent of GDP. Staff is recommending that the authorities aim for a current account deficit under 5 percent of GDP—narrower than the sustainable level—to offset remaining risks. The authorities do not have a specific objective, but agree that the external deficit should be narrower than its current level (6–7 percent of GDP).
2. *Speed of fiscal adjustment, and mix of expenditure and tax policies.* Agreement on the need for fiscal consolidation and on the fiscal targets for 2003–04, given the objective to reach a deficit under 3 percent of GDP (Maastricht criterion) by 2006. But—in light of past fiscal slippages—staff questioned policy implementation. Expenditure policies, in particular, should be articulated more clearly. Moreover, the authorities should be prepared to bring forward expenditure reform to offset any revenue slippages from the implementation in 2004 of a tax reform featuring a 19 percent rate for the unified VAT, flat personal, and corporate income taxes. While welcoming the ambitiousness of the tax reform, staff also noted that social expenditure reform may prove even more important than the tax reform for improving incentives to work. The authorities see tax reform as central to their overall strategy, particularly for fostering investment; but seem prepared if revenue shortfalls eventuate to take appropriate expenditure measures to achieve fiscal targets. They would envisage later achievement of these targets if the government introduces a second pension pillar, on which a decision is pending.
3. *Monetary policy in the face of strong capital inflows.* Agreement that, if surges in inflows recur, there remained room to cut interest rates in response to resulting appreciation pressures. Staff believes that the 150 bp interest rate cut in November 2002 was right, as a strong appreciation would have involved excessive risks given the still-large external deficit. The central bank agreed that a gradual nominal appreciation, in line with productivity increases, should not be opposed, but seems recently to have prioritized exchange-rate stability over inflation objectives. In this context, staff emphasized that the National Bank of Slovakia should continue to underscore the importance of medium-term inflation objectives, focusing the public on core inflation. The central bank agreed, but will most likely not pursue disinflation at a pace that threatens competitiveness. Staff believes that this approach is reasonable to the extent that it does not entail opposing equilibrium exchange rate appreciation.
4. *Euro adoption.* Staff agreed that the government's plan to meet the relevant requirements by 2006 was feasible, but emphasized that “how” is as important as “when” the euro will be adopted. Strong policies are needed to limit vulnerabilities and enhance economic flexibility. Two policy areas were singled out: labor market flexibility and financial sector strengthening. While the authorities agreed that these are essential, and are pursuing them, the central bank felt more strongly about the timing of euro adoption, because a concrete target date would provide welcome momentum to fiscal consolidation and structural reforms.

I. BACKGROUND

1. **Slovakia is now one of the fastest growing EU accession countries.** Economic growth averaged nearly 4 percent through 2001–02, against 2½ percent for other Visegrad countries (text table). Strong performance has been supported by the coming on stream of past foreign direct investments (FDI), successful macroeconomic management, and lower trade barriers.¹

	Real GDP growth (%)	CPI inflation (%)	Public debt (% of GDP)	Fiscal balance (% of GDP)	Current account balance (% of GDP)	Unemployment rate (%)	Productivity growth (%)	FDI (% of GDP)
Slovakia	3.8	5.3	47.1	-7.3	-8.4	18.0	3.5	11.1
Other Visegrad 1/	2.4	4.8	39.7	-6.5	-4.3	10.4	3.0	5.3
Other AC-8 2/	4.1	4.3	45.4	-3.6	-5.0	10.5	3.6	4.8

1/ The Visegrad countries are the Czech Republic, Hungary, Poland, and Slovakia.
2/ The AC-8 countries are the Visegrad countries plus Estonia, Latvia, Lithuania, and Slovenia.

2. **Despite the upswing, the Slovak economy remains hampered by structural weaknesses and related macroeconomic imbalances.** The unemployment rate is high, including by regional standards, as is the fiscal deficit—over 7 percent of GDP in 2002.² Since mid-2001 large external imbalances have re-emerged.

3. **The economic expansion recently gained momentum, with the external current account deficit and unemployment easing from their peaks, and core inflation remaining low** (Tables 1–2; Figures 1–2):

- Real GDP grew by 4.4 percent in 2002, led by household consumption. Fixed investment was flat at a high level after surging in 2001. Reflecting the implementation of an austerity package in January, growth eased slightly to 4.1 percent in the first quarter of 2003, notwithstanding increasingly strong net exports.
- Despite the European slowdown, real exports—notably automobiles and electronic equipment—grew by almost 12 percent in 2002 and accelerated further in early 2003.

¹ Slovakia’s trade regime—which remained unchanged over the last 12 months—is ranked “1” on the Fund’s trade index, denoting the most open regime.

² Measured on an ESA 95 basis.

Imports grew by 9 percent, down from 20 percent in 2001. Consequently, the external current account deficit narrowed slightly to 8.2 percent of GDP last year and further to 6.9 percent of GDP in the first quarter of 2003. FDI was a record 17 percent of GDP in 2002, owing largely to the sale of the state gas monopoly.

- The stubbornly high unemployment rate reflects skills mismatches, regional disparities, high social contribution rates, and a benefit system that creates disincentives to work. The (registered) unemployment rate fell by 2½ percentage points in the first five months of 2003, to less than 15 percent, possibly reflecting a tightening of unemployment benefit eligibility requirements, but also buoyant economic activity.
- The 12-month core inflation rate was 1.9 percent at end-2002, well below the lower bound of the National Bank of Slovakia (NBS) indicative band, and remained low through May 2003. However, following administered prices and indirect taxes increases in January 2003, headline inflation reached 7.6 percent in May.

4. **Meeting fiscal targets has proved difficult.** The original 2002 target was missed, repeating fiscal slippages in 2001 (Box 1). Despite better-than-budgeted revenues, the fiscal deficit widened by about ½ percentage point of GDP reflecting nontax revenue shortfalls, benefit spending overruns, and higher pre-election capital spending. Besides—owing to the issuance of state guarantees and bank restructuring costs—a comprehensive measure (ESA 95) of the fiscal deficit showed a *much higher imbalance than the cash-based measure then targeted by the authorities* (Box 1, Table 3).

5. **Monetary policy has continued to face the usual dilemma of other countries in the region:** inflation objectives—and the corresponding monetary policy stance—can conflict with external objectives. Faced with pressures from capital inflows, the Slovak authorities have responded by lowering interest rates in late 2002 (Figure 3).

6. **Competitiveness remains strong (Tables 4 and 5).** Real appreciation has been modest since 2000: despite the January 2003 spike caused by the surge in headline inflation, the CPI-based REER remains close to the 2001–02 average, and the ULC-based REER has also been broadly flat in the two years to March 2003 (Figure 2). Previous staff analysis³ concluded that external imbalances were unrelated to competitiveness issues, a conclusion reinforced by the strength of exports, increasing market share in Europe, and recent announcements of major FDI projects.

³ See SM/02/239 (7/26/02); and SM/02/240 (7/26/02). This analysis concluded that external imbalances reflected a number of factors, including import-intensive investment, a secular increase in households' propensity to consume imports, and an expansionary fiscal stance.

Box 1. Fiscal Targets and Deficit Size

Fiscal slippages in 2001–02 were significant. The government targeted fiscal deficits of 3.9 percent of GDP in 2001 and 3.5 percent of GDP in 2002. These targets were subsequently revised: slightly downward in 2001, and substantially upward in 2002. Both the original and revised targets were missed in 2001, and only the revised target—which accommodated a substantial slippage—was met in 2002.

Moreover, actual fiscal deficits were much larger than under the cash-based measure targeted by the authorities. This measure excluded expenditures on bank restructuring, called state guarantees, and other one-off items including debt-reducing expenditures of the National Property Fund. Under ESA 95 methodology, state guarantees certain to be called add to the fiscal deficit at the time of issue and other excluded items should be taken into account when measuring the deficit. The authorities calculated that roughly two-thirds of state guarantees issued in 2001–02 will be called. Adding them back, together with bank restructuring costs and other items, **augmented the fiscal deficits in 2001–02 to over 7 percent of GDP.** A new law on state guarantees should prevent their extensive use in the future.

Slovak Republic: General Government Balances, 2001–02
(In percent of GDP)

	2001	2002
Target	-3.9	-3.5
Revised target	-3.7 ^{1/}	-4.5 ^{2/}
Outcome	-4.1	-4.5
Outcome, ESA 95 basis	-7.3	-7.2
<i>Of which: from issued state guarantees</i>	-2.3	-1.1

1/ Revised November 2001 reflecting external imbalance concerns.

2/ Target adopted in May 2002, largely to accommodate nontax revenue shortfalls.

II. REPORT ON THE DISCUSSIONS

7. **Against this background, Slovakia faces four main challenges:**
 - ***Reducing the external current account deficit: Does the recent narrowing of the external current account deficit indicate a return towards sustainable levels?***
 - ***Achieving fiscal consolidation:*** The government’s objective of meeting the Maastricht deficit criterion by 2006 requires, starting in 2003, an annual reduction in the fiscal deficit of about 1 percentage point of GDP. Sustained consolidation is also needed to reduce pressures on the external accounts and ensure fiscal solvency. ***Is the government’s envisaged speed of fiscal adjustment appropriate, and is the mix of expenditure and tax policies right?***

- *Maintaining the course of disinflation:* Significant second-round effects from recent administered price increases, while unlikely, cannot be excluded, and headline inflation remains well above euro-area levels. Moreover, further planned increases in administered prices and indirect taxes could complicate the reduction of inflation to Maastricht levels by 2006. ***How can monetary policy restore low inflation, without threatening competitiveness or the economic expansion?***
 - *Lowering unemployment and strengthening the economy's supply response.* Addressing these challenges is vital for real convergence with the euro area. ***What are the authorities' intentions regarding structural policies in the run-up to EMU entry?***
8. ***In the context of strategic decisions on the timing of euro adoption, discussions focused on these challenges,*** on the economic outlook and risks, financial sector policies, and transparency.

A. Economic Outlook and Risks

9. **Short-term growth prospects remain positive.** Staff projects a slight slowdown in real GDP growth to 4 percent in 2003–04—broadly in line with the authorities—owing to a warranted moderation in consumption that reflects higher indirect taxes and flat or declining real wages. A recovery in fixed investment is expected to support growth, with help from net exports. But risks are skewed to the downside: while a stronger-than-projected rebound in investment following the pickup in FDI and industrial production is possible, external demand conditions remain highly uncertain.

10. **Inflation is under control, despite indirect tax and administered price increases.** Recently announced increases in excises should push inflation to 9 percent by year-end. However, core inflation, which was just below 2 percent at end-May, is projected to rise only to 2.8 percent, as modest seasonal food price increases and second-round effects emerge. Such effects have been minimal so far, and should remain small with an appropriate monetary policy by the central bank (including communication aspects; see below) and assuming continued modest contractual private sector wage increases—which have so far ranged between 5 and 8 percent, less than headline inflation.

11. **The external current account deficit should narrow further—and fairly rapidly according to NBS projections.** The NBS envisages a deficit below 5 percent of GDP in 2003, following robust export growth in the first quarter. This may be too optimistic: staff projects a deficit of 6–6½ percent of GDP in 2003, around 5 percent of GDP in 2004, and declining thereafter. The increasing share of Slovak products in the EU market reflects Slovakia's integration into global production networks given its favorable wage-skills combination, and efficiency gains from recent FDI, and suggests that exports should be resilient to a short-lived downturn in Europe. But the recent recovery in 12-month export growth also reflects a disappointing performance in the first half of 2002; moreover, a

sustained slump in Europe could dampen exports. Also, the envisaged pickup in investment, which has been import-intensive, could lead to more capital goods imports.

12. **Over the medium term, staff believes that Slovakia should aim for an external current account deficit under 5 percent of GDP.** A somewhat larger external deficit would be sustainable (text table).⁴ However, staff projections are predicated on the sustained

dynamism of exports, which are currently concentrated on a few large exporters, and thus subject to firm-specific risks, including possible changes in worldwide production allocation and marketing strategies. Staff thus argued that a smaller deficit would be more prudent, and that policies should be geared to achieve this objective and to diversify exports away from a few large firms. To this end—and to

The Sustainable External Current Account Deficit			
	3-year average 2003-05	6-year average 2003-08	
Greenfield FDI (% of GDP)	2.7	2.4	(a)
US\$ GDP growth rate (%)	13.9	10.9	(b)
Real growth rate (%)	4.0	4.2	
Change in exchange rate (%)	-4.7	-2.7	
Koruna GDP deflator (%)	4.6	3.7	
Sustainable current account deficit (% of GDP)	6.8	5.7	(a+(b/(1+b))*c)
Net external debt, end-2001 (% of GDP)	33.5	33.5	(c)

maintain Slovakia's attractiveness—it is essential to pursue fiscal consolidation (see below), maintain wage restraint, and implement structural reforms as scheduled. A smaller deficit would also guard against other vulnerabilities, including possible adverse debt dynamics following a sharp real exchange rate depreciation (Appendix I). The authorities do not have a specific objective, but agree that the external deficit should be narrower than its current level (6–7 percent of GDP).

B. Fiscal Policy

13. **All agreed on the need for fiscal consolidation, but staff questioned recent—and prospective—policy implementation.** Lowering the deficit below the 3 percent of GDP Maastricht limit by 2006 is realistic, and would maintain public debt below the 60 percent of GDP Maastricht limit, even under plausible shocks (Appendix I). However, this requires major expenditure reforms. The authorities do plan to cut spending but they also intend to implement a major tax reform in 2004, featuring a shift from direct to indirect taxation. Staff noted risks to revenues from this reform. Moreover, so far, expenditure reform proposals have been less clearly articulated than tax reform proposals, although work is progressing in several areas.

14. **The authorities are targeting a general government deficit of 5 percent of GDP in 2003 (ESA 95 definition)—a fiscal stance supported by staff.** This stance is consistent

⁴ Staff's updated estimate of the sustainable current account deficit (a 6–7 percent of GDP range) is consistent with earlier estimates.

with reducing the general government deficit to 3 percent of GDP by 2006 and should contribute to higher national saving and easing the pressures on the external accounts. Indeed, given the openness of the economy, the impact of the fiscal withdrawal should be transmitted largely to the external accounts rather than to economic growth. The budgeted correction in the overall deficit—2 percentage points of GDP—relies as heavily on revenue measures as on expenditure cuts. On the revenue side, measures to align more closely the two VAT rates and increases in excises are budgeted to raise around 1 percentage point of GDP. On the expenditure side, reforms to contain public health expenditure are expected to generate savings of ¼–½ percent of GDP, and measures to curtail untargeted spending on state benefits and social assistance should save around ½ percent of GDP. Motorway construction, which had expanded substantially in 2002, will also be contained.

15. **However, all agreed that additional measures will be needed to reach the deficit target.** The projected slippage—confirmed by revenue underperformance in early 2003—reflects primarily lower-than-budgeted VAT and corporate income tax revenues, partially offset by higher collections of social security contributions and lower net interest payments, which reflect lower-than-assumed interest rates. Without measures, staff projected—consistent with the authorities’ estimates—a deficit of 5¼–5½ percent of GDP. Following the mission, the government advanced excise tax increases to August 2003, which should help achieve a deficit very close to target. However, the correction in the primary balance would now be only about ½ percentage point of GDP, compared to about 1 percent of GDP implied by the budget, reflecting increased reliance on interest savings. The mission stressed that there remains risks for excise tax collections and the municipal budgets, for which little information is yet available for 2003. Staff also underscored the need to keep reducing the primary deficit, to guard against a reversal of the decline in interest rates observed in the past few years.

16. **At the time of the mission, the authorities had released a budget outline targeting a 1½ percentage points of GDP deficit reduction to under 3½ percent of GDP in 2004.** This outline did not assume any tax reform. After the lack of progress toward fiscal objectives in the past two years, all saw this ambitious goal as necessary. Moreover, the political cycle—with national elections scheduled in 2006—argued for most of the fiscal consolidation to be done during the first two years of the current administration.

17. **The authorities have since moderated the planned pace of fiscal consolidation (text table).** Post-mission, the authorities had to relax the deficit target—to about 4 percent of GDP—in order to reach political consensus on tax reform. The revised 2004 fiscal objectives would still be achieved through a combination of expenditure and tax measures. Given the objective of achieving a

	2003	2004
Total revenue, cash basis 1/	34.3	33.1
Total expenditure, cash basis 2/	40.1	37.4
Overall balance, ESA 95 basis 3/	-5.1	-3.9
Adjusted primary balance 4/	-2.1	-1.4

Sources: Ministry of Finance; and Fund staff estimates (Table 3).
 1/ Adjusted for Sk 10 billion in one-off refunds in 2003.
 2/ Includes net lending (excluding privatization receipts) and assumes expenditure measures of Sk 4.9 billion in 2004.
 3/ Includes adjustments to record transactions on an accrual basis.
 4/ Excludes bank restructuring costs and other net lending, and called guarantees.

3 percent of GDP deficit by 2006, the new fiscal target remains adequate; however, in the staff's view, achieving it may require additional measures of about 0.3 percent of GDP if the revenue gains projected by the authorities (Box 2) do not materialize. There would be limited scope to achieve the target with further excise tax increases, because of their impact on smuggling and on demand; bringing forward permanent expenditure reduction would be preferable.

Box 2. The Government's Tax Reform

The government's tax reform features a 19 percent rate for the unified VAT, personal (PIT), and corporate income taxes (CIT). Excises will be increased substantially. *The authorities project the reform to provide a revenue gain of 0.3 percent of GDP, while staff projects no change.* The difference is mainly PIT revenues—for which projections are sensitive to the different underlying wage distribution assumptions. Given that data from tax returns, which would give the actual wage distribution, are not yet available, staff used fairly conservative assumptions.

The reform represents a further shift in the tax burden from direct to indirect taxes (table). Income tax rates have been cut significantly in recent years: PIT top and bottom rates were cut in 2002, from 42 to 38 percent and from 12 to 10 percent respectively; and CIT was gradually reduced from 40 percent in 1999 to 25 percent in 2002. The existing two VAT rates were brought closer together in 2003, with the standard rate reduced from 23 to 20 percent and the lower rate raised from 10 to 14 percent.

The distributional consequences of the reform are not fully clear, although the burden will almost certainly be skewed towards those with lower incomes.

Social security contribution rates are high, at 50.8 percent of gross wages, and the authorities have discussed reducing them, but this step is separate from the current tax reform.

Tax Reform: Estimated Impact ^{1/}			
In billions of koruny			
	Ministry of Finance Baseline	Ministry of Finance Impact	DMF staff Impact
Taxes on income	83.3	-19.9	-23.0
Taxes on employment income	38.0	-12.1	-15.4
Self-employment tax	6.4	-2.8	-2.6
Corporate income tax	29.4	-7.1	-7.1
Withholding income tax ^{2/}	9.5	2.1	2.1
Taxes on goods and services	136.2	24.4	23.7
Value-added tax	100.5	17.9	17.2
Excise duties ^{3/}	35.7	6.5	6.5
Taxes on property	5.8	-0.3	-0.3
To state budget	1.9	-1.9	-1.9
To municipal budgets	3.9	1.6	1.6
Road tax	2.5	-0.5	-0.5
Customs duties	1.6	0.0	0.0
Total	229.4	3.7	-0.1
<i>Impact, in percent of GDP</i>	...	0.3	0.0

^{1/} Effective January 2004, unless otherwise stated. A negative sign denotes a revenue loss.
^{2/} Revenue impact from abolition of dividend taxation occurs in 2005.
^{3/} Increase in excises to be brought forward to August 2003.

18. **The tax reform appropriately aims to make the economy more market-oriented, partly by providing better incentives to work and save.** The reform features a more transparent and simpler tax law, a shift in the tax burden from direct to indirect taxes, and a flat income tax rate. The measures sought are likely to improve economic performance. Removal of exemptions, deductions, and exclusions should lead to fewer distortions in income and consumption taxation, and help finance lower rates of direct taxation. The uniform rate of VAT should improve administration and compliance, while leading to a more

neutral taxation of goods and services. Lower direct taxation will encourage the legalization of firms operating in the grey economy, and encourage foreign and domestic investment.

19. **But haste in implementation could endanger fiscal consolidation.** Forecasting the revenue impact of the reform involves major uncertainties—including the scale of taxpayer responses—which partly reflect serious gaps in the statistics presently available for estimating this impact. Staff argued that it would be prudent to introduce the tax reform gradually, by first adjusting indirect taxes and then phasing in the reduced income taxes. The authorities resisted this idea, arguing that the reform sequence was right because direct tax reductions would not go ahead without prior approval of less popular indirect tax increases.

20. **Besides, the overall government strategy to improve incentives needs to take into account two other considerations:**

- **The majority of taxpayers may not see the desired reduction in marginal tax rates that would improve incentives to work.** A simulation of the “composite marginal tax rate”—which takes account of the impact of income taxes, payroll taxes, and consumption taxes (VAT and excises)—at different wage levels shows that the highest tax rates will remain virtually unchanged for most working taxpayers. This reflects two facts: (i) the largest part of this composite rate reflects payroll taxes and VAT, because most taxpayers are concentrated on the lower end of the wage distribution; and (ii) there is a maximum assessment base for payroll taxes, after which the composite marginal tax rate falls sharply. No doubt some taxpayers, especially those in the higher income brackets, will benefit from the introduction of the flat income tax. But a significant reduction in the composite marginal rate for most taxpayers—which is needed to change work incentives—will not be achieved by shifts between income tax and VAT rates in a broadly revenue-neutral manner, but by a reduction in the payroll tax. This would also reduce distortions in the labor market, and rebalance the taxation of labor and capital.
- **Social expenditure reform may prove even more important than tax reform for improving incentives to work.** The social welfare system is serving multiple objectives, resulting in mistargeting of benefits, and the level of benefits is high in relation to the economy-wide average wage. This could be corrected by lowering benefits to eliminate the imbalance between the latter and the average wage. Further gains could result by delaying the retirement of those who retire early today. A comprehensive reform of the benefits system would also provide the most sustainable way to reduce payroll taxes, which are very high.

21. **The authorities’ strategy remains to achieve medium-term fiscal consolidation through expenditure reduction, but they acknowledged that a more explicit expenditure policy was needed.** They intended to take required steps with the assistance of Fund advice.

- Recent steps in health sector reform appear promising. Parliament has confirmed controversial measures—overturning a presidential veto—to control wasteful spending, including the introduction in June 2003 of modest co-payments for

pharmaceuticals, hospital accommodation, doctor visits, and nonemergency transportation. A reduction of the scope of the universal health benefit package is needed, and care should be taken to ensure that exemptions from the new co-payment system are not excessive.

- Measures were also implemented to control state and social assistance benefits, through better enforcement of eligibility rules and other measures to control abuse. Moreover, a fundamental rethinking of the benefits system is now underway to improve incentives to work and contain social spending through rationalizing the existing multiple welfare schemes and improving targeting.
- The excessive size of government employment requires attention. Although the public wage bill is not excessive as a share of GDP, partly reflecting a compressed wage scale, general government employment accounts for nearly 9 percent of the total population—high relative to other countries. The authorities would have to reduce the size of employment through a selective and partial hiring freeze, including in health and education sectors, and by eliminating duplication and overlap of activities among budgetary units.
- Although the requirements of the Common Agricultural Policy limit the scope to cut agricultural subsidies, the planned elimination of tax concessions for the sector would provide savings.
- Despite recent progress in restructuring the railways, the sector continues to incur losses. Savings are possible from better targeting of subsidies, and lower transfers to impose hard budget constraints.
- Monitoring and controlling spending at the subnational level has proved difficult. Staff recommended to track this spending better, especially through accelerated budget reporting requirements.

22. **The authorities are planning a reform of public pension system, which is not sustainable in the longer term.** This (first pillar) system faces looming demographic pressures common elsewhere in Europe. It also suffers from structural problems including low retirement ages, especially for women, and a disconnect between benefits and contributions. Government plans to improve the financial health of the system include raising the retirement age by nine months a year, until retirement age is unified for men and women at 62,⁵ and changing the benefit formula to better reflect contributions. The government is also considering the introduction of a mandatory, funded, privately managed system (second pillar), with a 10 percent contribution rate, implying a projected diversion of contributions to

⁵ Current retirement age for men is 60, and for women 53 to 57, depending on the number of children.

the second pillar of 1–1½ percent of GDP annually. The revenue loss to the first pillar would be financed for several years by earmarked privatization receipts from 2002 (about 6½ percent of 2002 GDP), plus receipts from future privatizations. However, the large-scale diversion of contributions from the first to the second pillar would almost certainly jeopardize meeting the Maastricht deficit criterion by 2006.

23. **EU accession will have significant medium-term budgetary implications, which need to be assessed carefully.** Slovakia should be a net beneficiary of EU accession: the authorities project a net inflow of about 1 percent of GDP annually in 2004–06. However, transfers from the EU will require cofinancing from the budget. Therefore, assuming full use of structural fund entitlements, EU accession could add around ¾ percent of GDP to the deficit in 2004, and up to 1½ percent of GDP annually in 2005–06 (Box 3), if the government does not prioritize expenditures to make room for the use of EU funds. The authorities need to promptly design a multi-year spending plan that makes room for EU-related spending, while remaining within the overall expenditure consolidation envelope.

C. Monetary Policy

24. **Monetary policy has been challenged by appreciation pressures.** The clear outcome of the September 2002 elections and subsequent invitations to join NATO and the EU, plus sovereign rating upgrades, reduced the perceived risks on Slovak assets and spurred capital inflows. Despite NBS intervention, the koruna appreciated by about 5 percent vis-à-vis the euro between mid-September and mid-November, when capital inflows peaked. After intervening by more than € 500 million over three days, the NBS reduced its policy interest rate by 150 basis points effective November 18—stabilizing markets. The currency has since been broadly stable against the euro, albeit with occasional limited NBS intervention.

25. **In this context, monetary policy discussions focused on how the NBS should respond to renewed inflows and to the continued rise in credit to households, and on potential improvements to the monetary policy framework.**

26. **The staff and the NBS agreed that the current monetary stance appropriately reflected the balance of risks.** The main policy interest rate—at 6½ percent—remains among the highest in the region, contributing to tightening monetary conditions (text chart). The strength of economic activity—especially if compounded by fiscal slippages—and potential effects of planned administered price and indirect tax increases justify this tightening bias, notwithstanding low core inflation. Also, credit to households has been rising rapidly, albeit from a low base (text chart), and the NBS is increasingly constrained by the medium-term goal of reducing inflation to Maastricht levels by 2006 (text chart). However, at their current level, asset returns in Slovakia are substantially higher than in neighboring countries (Box 4), creating the conditions for short-term inflows, and exerting strong upward pressure on the koruna.

Box 3. Financial Implications of EU Accession, 2004-06

In millions of koruny

a) Slovak Republic vis-à-vis the EC				b) Budgetary Impact			
	2004	2005	2006		2004	2005	2006
Cash revenues from EC	23,564	31,515	34,258	Cash revenues from EC 1/	14,235	23,393	27,269
Pre-accession aid	7,471	4,077	2,309	Guarantee section of EAGGF	5,815	11,318	12,713
Guarantee section of EAGGF	5,815	11,318	12,713	Structural operations	5,480	11,542	14,023
Structural operations	5,480	11,542	14,023	Special compensation	2,940	533	533
Internal policies	1,858	4,045	4,680	Claim on direct payments committed by EC	3,394	856	806
Other (special compensation)	2,940	533	533	Total EU-related revenues	17,629	24,249	28,075
Claim on direct payments committed by EC (accrual item)	3,394	856	806	Contributions to EC budget	10,458	15,911	16,458
Total revenues from EC	26,958	32,371	35,064	Use of earmarked revenues from EC	5,480	11,542	14,023
Contributions to EC budget	10,458	15,911	16,458	Additional EAGGF-related agricultural spending 2/	3,858	9,361	10,756
Own sources	10,458	15,911	16,331	Co-financing from Slovak public sources	8,253	9,035	9,396
Other	0	0	127	Total EU-related expenditures	28,049	45,849	50,633
Net position of Slovak Republic				Net budgetary impact			
Cash	13,106	15,604	17,800	Excluding co-financing	-2,167	-12,565	-13,162
<i>In percent of GDP</i>	<i>1.0</i>	<i>1.1</i>	<i>1.2</i>	<i>In percent of GDP</i>	<i>-0.2</i>	<i>-0.9</i>	<i>-0.9</i>
Accrued	16,500	16,460	18,606	Including co-financing	-10,420	-21,600	-22,558
<i>In percent of GDP</i>	<i>1.3</i>	<i>1.2</i>	<i>1.3</i>	<i>In percent of GDP</i>	<i>-0.8</i>	<i>-1.6</i>	<i>-1.5</i>

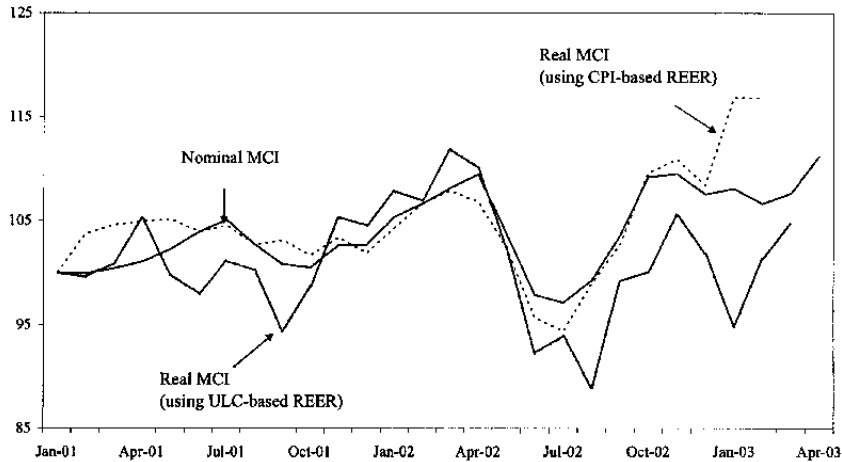
Source: Ministry of Finance.

Sources: Ministry of Finance; and Fund staff estimates.

1/ Appropriations for internal EC policies and pre-accession assistance are not included in the state budget.

2/ Draft budget outline for 2004 indicates replacement by EU appropriations of Sk 1,957 million in state budget spending on agriculture. Assumed equal to EC transfers, less Sk 1,957 million, in 2005 and 2006.

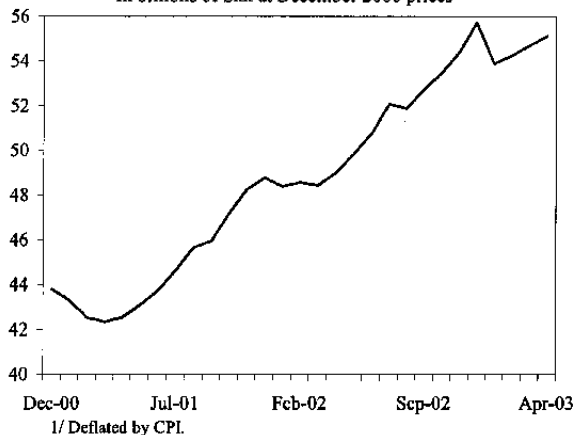
Monetary Conditions Indices (January 2001=100) 1/



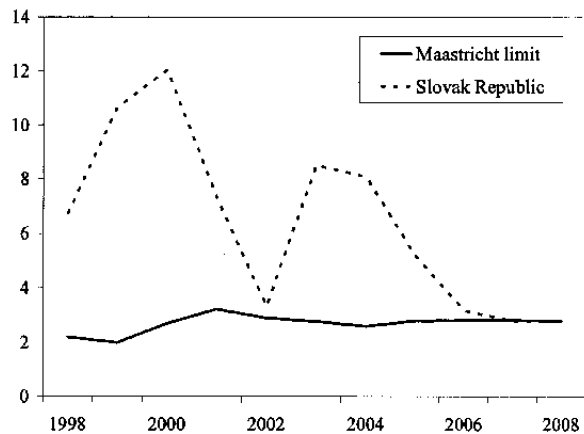
1/ $MCI(t) = (R(t) - R(0)) + 2(E(t) - E(0)) + 100$. R is the one-month interbank rate (deflated by the CPI when calculating the real MCI). E is the nominal exchange rate in euros per Sk (or REER when calculating the real MCI). 0 refers to the base period, January 2001.

Real Credit to Households 1/

In billions of Skk at December 2000 prices



Annual Average CPI Inflation

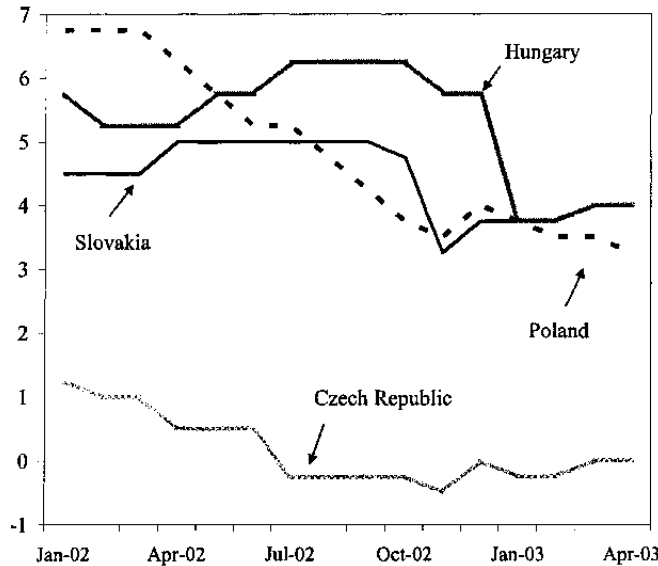


27. **The NBS is prepared to respond aggressively—including through further interest rate cuts—to strong capital inflows, a stance supported by staff.** Markets were given notice in early May: the NBS intervened by over € 400 million to halt the koruna's appreciation, and imposed a temporary cap on the size of its weekly repo tender—the most common NBS instrument to absorb liquidity—which forced banks to post funds at an overnight facility with a substantially lower interest rate. The NBS noted that while it is seeking to delay interest rate cuts for as long as possible due to inflation concerns, it will not hesitate to implement such cuts in the face of strong appreciation pressures. Staff believes that this would be appropriate. While the central bank should not oppose an equilibrium appreciation of the koruna justified by productivity gains (Balassa-Samuelson effect), it should avoid sharp oscillations of the exchange rate that reflect speculation and could undermine competitiveness. Although this approach could slow the pace of disinflation, it would be warranted to safeguard external objectives in the context of a still large external

Box 4. Attractiveness of Slovak Assets Relative to Neighboring Countries

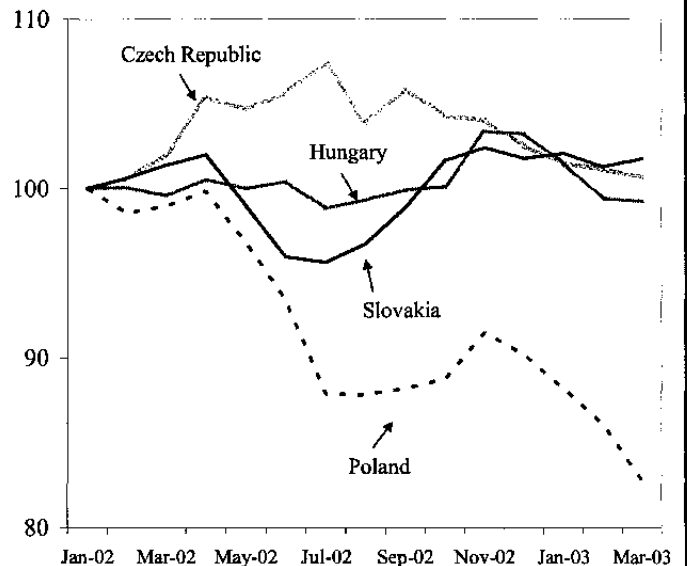
A combination of high interest rates and currency appreciation (Charts 1 and 2) pushed yields on Slovak assets above those on comparable assets in neighboring countries in the fall of 2002 (Chart 3), while Slovakia's relative sovereign debt ratings improved. Slovakia's assets have remained the most profitable in the region in 2003.

Chart 1. Policy Rate Spreads vis-à-vis the Euro Area 1/ in percent



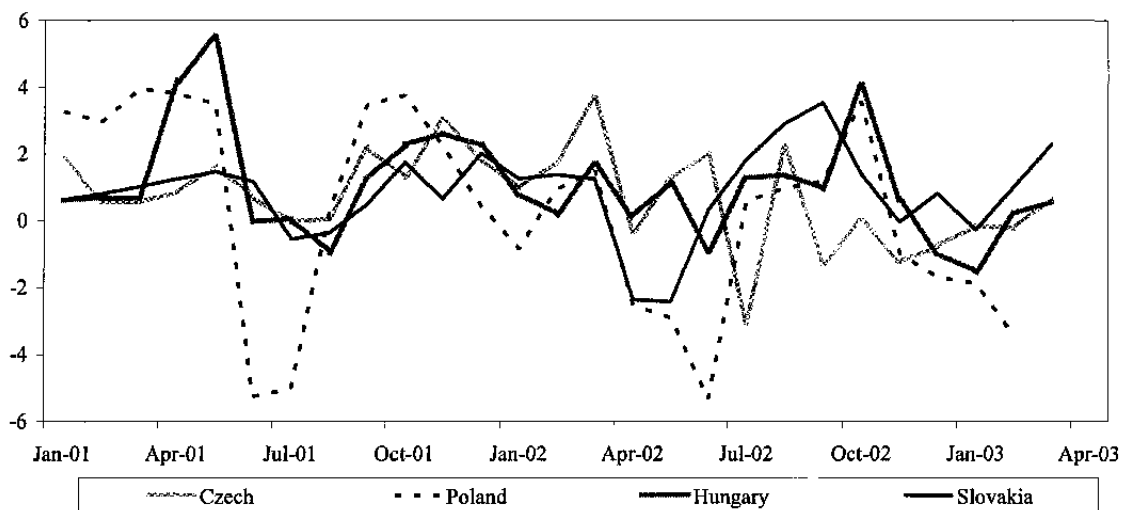
1/ Calculated as the difference between each country's main policy interest rate and the ECB's main refinancing rate.

Chart 2. Nominal Exchange Rate Indices 1/ January 2002 = 100



1/ An increase indicates nominal exchange rate appreciation vis-à-vis the euro.

Chart 3. Average Rates of Return on One-month Interbank Deposits 1/ valued in euros, in percent



1/ Rates of return are calculated as $E(t)/E(t+1) * (1+I(t)) * 100 - 100$, where $E(t)$ is the month t average nominal exchange rate and $I(t)$ is the month t average interest rate on one-month interbank deposits.

deficit. In discussing possible additional measures, most bank board members were highly skeptical about capital controls. Staff shares this skepticism, in particular given the negative signals that imposing capital controls could send.

28. **The authorities' flexible monetary policy framework has been working well, although some improvements in communications would assist disinflation.** While it does not target inflation formally, and has intervened in the foreign exchange market at times to avoid sharp currency fluctuations, the NBS aims mainly to achieve low inflation, announcing benchmark ranges for headline and core inflation. In the past, these benchmarks have been relatively effective in guiding expectations. However, over the past 18 months, benchmarks have proven to be on the high side, which may have given an upward bias to wage negotiations and budget preparation. Staff suggested that the NBS try to strengthen its guidance of inflation expectations by improving inflation forecasts. The authorities agreed on the need to improve such forecasts, and noted efforts now underway to enhance the bank's inflation modeling capabilities, which should also support a more forward-looking monetary policy. Closer NBS-government coordination on public communications would also help guide market expectations.

Box 5. Inflation Inertia in Slovakia

Inflation inertia seems low. First, although NBS staff indicated that the public tends to be backward-looking in forming inflation expectations, there is no widespread formal inflation indexation in private sector wage agreements. Second, unions in Slovakia seem weak and private sector employers able to resist wage demands. Third, wage agreements are influenced by announced public sector wage decisions and by minimum wage adjustments, both of which are based on budget inflation assumptions.

But it cannot be ruled out. Several univariate autoregressive inflation models were estimated for various measures of monthly inflation. All series exhibited unit root characteristics. In addition, the sum of the coefficients attached to lags of inflation in the AR(q) models,¹ always exceeded 0.7, indicating that more than 70 percent of historical inflation seems to be carried forward. However, the role of inertia in this effect is unclear, pending further investigation by staff.

¹ The number of lags, q, varied depending on the inflation measure used.

29. **Continued disinflation to meet the Maastricht criterion by 2006 will require skillful central bank guidance.** The envisaged tax increases and administered price adjustments could lead to high single-digit inflation in 2004. Despite evidence to the contrary, inflation persistence cannot be ruled out (Box 5), and indeed will depend on the policies followed. Disinflation has been helped by the recent exchange rate appreciation, and by structural changes that led to a fall in food prices, but looking ahead, and absent these effects, the NBS will need to break—or preempt—inflationary persistence, by guiding inflationary expectations more proactively. In particular, the NBS should give more emphasis to its forward-looking inflation benchmarks rather than past inflation in its public communications, and stress that it is gearing monetary policy to achieve these benchmarks. Moreover, the accent should be on the core inflation benchmarks with policies focused on limiting the second-round effects of the increases in administered prices and indirect taxes

that are dominating the headline rates. Market participants noted that the NBS seems recently to have prioritized exchange rate stability over inflation objectives. In this context, the central bank should make clear that it is not targeting the exchange rate per se, and that its policy is not to lean against exchange rate appreciation that reflects productivity gains and helps disinflation. Rather, its policy aims at controlling threats to competitiveness stemming from sudden surges in capital inflows, along a path of disinflation.

D. Financial Sector Policies

30. The banking sector has gained more in strength than in profitability.

Capitalization, liquidity, and profitability ratios have significantly improved, but profitability remains low (text table).⁶ With declining interest margins, banks' profits are derived mainly from government securities and NBS bills, while credit to the private sector remains a smaller (albeit increasing) share of their balance sheets.

	December		
	2000	2001	2002
Capital adequacy ratio	13.1	19.7	21.1
Nonperforming loans / gross loans	15.3	15.4	11.0
Net income / total assets	1.4	1.0	1.2
Net income / total equity	25.2	22.7	31.1
Liquid assets / total assets	18.1	21.7	28.3

Source: National Bank of Slovakia.

31. Staff noted risks posed by the ongoing household credit boom. Real credit to households increased by 14 percent in 2002, with mortgages and credit from building societies accounting for 80 percent of the increase. The authorities are continuing to monitor these developments, largely explained by greater competition among banks following restructuring and by declining interest rates. While they were less concerned than staff, rapidly rising credit growth was one of the reasons justifying the authorities' hesitation to reduce interest rates. Nonetheless, they saw no cause for further policy action at this stage: household credit is below 6 percent of GDP and less than 10 percent of M2 (Table 6); increases in real estate prices—which remain below prices in neighboring countries—represent an equilibrium convergence phenomenon; and banks are well capitalized and follow prudent lending practices.

32. The March 2003 reorganization of the NBS's Banking Supervision Department (BSD) has improved its efficiency and management. Progress was already noted on both operations and regulations: bank examinations are proceeding at an adequate pace and using newly introduced procedures, and a review of the legislative framework is underway. Transparency of supervision has also improved through web-based information and enhanced communication with banks on regulations and methodological guidelines preparation. Staff

⁶ Although banks have not yet adopted IAS, accounting standards have improved substantially; therefore, the healthier soundness indicators correspond to the underlying strengthening of banks' balance sheets.

encouraged the authorities to implement fully the Supervisory Development Plan, including improvements to on-site and off-site supervision, as well as to develop appropriate consolidated supervision policies, and procedures for resolution policies and troubled banks.

33. **The Financial Markets Authority (FMA) has improved cooperation with other regulators, but should make further progress in institutional development.** A December 2002 memorandum of understanding with the BSD should enhance consolidated financial sector supervision. And better collaboration with the Ministry of Finance should do likewise with nonbank supervision. Institutional capacity at FMA, though, needs to be improved to keep up with rapid financial sector development.

E. Policies for Euro Adoption and Structural Reform

34. **The authorities have announced a strategy for euro adoption.** The strategy leaves open the timing of euro adoption itself, suggesting a likely range of 2008-2010; but envisages meeting the Maastricht criteria by 2006, a prerequisite for earliest possible euro adoption in 2008. Staff concurred that plans to meet the Maastricht criteria by 2006 were feasible, but would hinge on—and also could provide welcome momentum for—full implementation of the planned fiscal consolidation and structural reforms. Indeed, before adopting the euro, Slovakia should make sure that all the Maastricht criteria have been met on a *sustainable basis*—without jeopardizing infrastructural and other investment required for real convergence—and be ready to move to structural fiscal balance in a relatively short period of time, conforming to Stability and Growth Pact requirements.

35. **Critical reforms are needed to ensure this, including:**

- *Policies to enhance competition and productivity, and promote investment.* The government is putting more emphasis on developing entrepreneurship, particularly through strengthening the judicial system, enhancing creditor rights, and improving accounting standards.⁷ It is also liberalizing the energy sector to increase competition. Staff encouraged the authorities to strike the right balance between fiscal consolidation and infrastructural development needs, as improving basic infrastructure is needed for sustained and balanced growth.
- *Labor market and benefits reform to support both real convergence and sustainable fiscal consolidation.* Unemployment remains one of Slovakia's most pressing problems, and measures are needed to improve work incentives and promote labor market flexibility. The authorities have already introduced amendments to the labor code that imply less restrictions on part-time employment and overtime, and more

⁷ In compliance with the OECD anti-bribery convention, Slovakia has recently adopted legislation that tightened penalties for bribery offenses and adapted domestic accounting rules and auditing principles to international standards.

flexible separation arrangements. Other measures are needed to redesign the social safety net to both improve incentives to work and reduce the burden on the budget.

- *Financial sector development and financial supervision strengthening to further private sector development and the economy's resilience to shocks, as argued above.*

F. Transparency and International Standards

36. **Economic statistics are improving.** Slovakia conforms to the SDDS standards. However, the authorities are still addressing remaining significant weaknesses in the consistency, quality, and transparency of fiscal and real sector data. The authorities are converting the fiscal accounts to ESA 95, and in parallel also to GFSM 2001.

III. STAFF APPRAISAL

37. **Slovakia's economic performance has continued to improve.** Policies implemented over the past few years have resulted in brisk growth and declining inflation, despite an adverse external setting. The economic recovery now appears well established, unemployment is falling, and the external current account deficit, which had reached a worrisome size, has begun to narrow. The resilience of exports is especially remarkable given the weak economic conditions in Europe. The government's commitment to major structural reforms augurs well for this performance to continue. Indeed, recent announcements of major FDI projects have bolstered this positive outlook.

38. **Within this context, policies need also to support the return of the external deficit to sustainable levels in the medium term.** Overall developments in the external accounts suggest that the current exchange rate is broadly appropriate. The authorities should ensure that policies help reinforce the narrowing trend of the current account deficit over the medium term, so as to provide a cushion against remaining vulnerabilities. In particular, wage growth, a core factor affecting competitiveness, should remain moderate, and fiscal policy should continue to be tightened.

39. **Indeed, fiscal consolidation remains the top priority to anchor macroeconomic policies.** Meeting the Maastricht deficit criterion will require steadfast policy implementation and avoiding a repeat of past fiscal slippages. Staff regrets that the tax reform has gone ahead without having first secured permanent expenditure reductions, and is concerned about the recent move to slow the pace of fiscal consolidation in 2004. The main fiscal challenges remain to implement planned streamlining of health sector and social welfare spending, and to continue to seek savings in other areas. In particular, the government should consider ways to trim the substantial subsidy bill and reduce the size of government employment.

40. **More detailed medium-term expenditure plans are needed to underpin the credibility of announced fiscal targets.** The authorities' current medium-term framework sets the goals of expenditure policy, but is less clear on how to achieve these goals. The

preparation of a detailed multiyear expenditure plan, with concrete measures and a timetable, is needed not only to provide the link between the 2004 budget now being drafted and the announced fiscal targets for 2005–06, but also to accommodate co-financing of EU-funded projects. In this context, carefully prioritized expenditure reduction should make room for infrastructure development needed for real convergence.

41. While the goals of tax reform are worthy, the authorities should be ready to address potential fiscal slippages. Forecasting the revenue impact of such a major reform involves large uncertainties, and revenue losses are a risk that could jeopardize the government's deficit-reduction objectives. The authorities should adhere to these objectives by bringing forward permanent expenditure reductions and accelerated expenditure reform, as these appear the most sustainable way to reconcile the tax reform with continued fiscal consolidation. Expenditure reform would also exploit synergies in some areas to improve economic efficiency; for example, social insurance reform should save budget resources, create incentives for retiring later, and provide incentives to work to those living off benefits today.

42. Indeed, the government's re-evaluation of incentives to work seeks to exploit these synergies, and lies at the core of labor market and benefit reforms. The staff welcomes steps taken in both areas. The removal of labor market rigidities would add to the attractiveness of Slovakia as a destination for FDI, and increase the economy's resilience to shocks. The parallel benefits reform will open the door for further reductions in payroll contributions, higher employment, and reduced demands on the budget. The reduction in payroll contributions should remain a priority within the overall strategy of fiscal consolidation, as it will be the most effective way to reduce the composite marginal tax for most taxpayers.

43. Pension reform is also needed to achieve the government's longer-term fiscal objectives. The government is pondering how to sequence and time the relevant measures, as introduction of the second pillar could complicate meeting the Maastricht deficit criterion. While the authorities will need to evaluate priorities carefully, they should nonetheless proceed with the reform of the first pillar, including through further increases in retirement ages even beyond current targets, and strengthening the relationship between benefits and contributions.

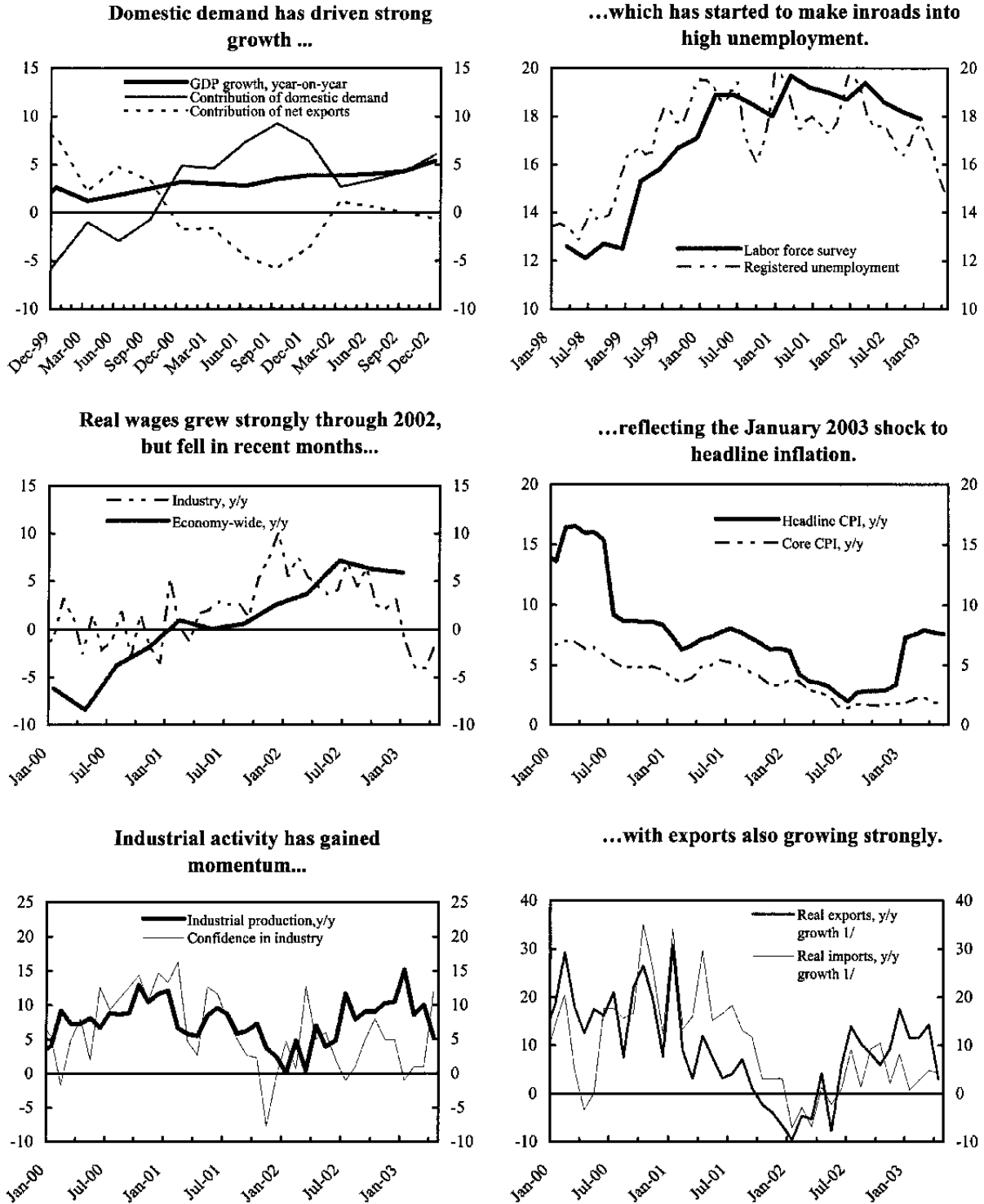
44. Monetary policy has been skillfully managed, but achieving the Maastricht inflation criterion remains challenging. Although core inflation is subdued, the second-round effects of administered price adjustments remain uncertain. The challenge in the period ahead will be to continue with the disinflation process while safeguarding competitiveness in the face of sudden surges in capital inflows. This difficult balancing act underscores the importance of medium-term inflation objectives, and requires the NBS to focus the public on core inflation, and not to lean against equilibrium exchange rate appreciation that will help rapid disinflation. In this context, the present monetary stance is appropriate, but if strong capital inflows return, the central bank may need to cut interest rates to avoid a disruptive appreciation of the koruna vis-à-vis the euro.

45. **Preparing for EMU entry is rightly a government priority, and the government should direct policies to mitigate risks to the economy during the transition to, and after, euro adoption.** Staff supports the authorities' decision not to set, for now, a specific target date for euro adoption, because the issue of "how" is as important as the issue of "when" the euro will be adopted. In particular, prior to euro adoption, strong policies are needed to limit vulnerabilities and enhance economic flexibility. Beyond meeting the Maastricht criteria—and being able to do so on a sustainable basis—successful euro adoption will require special attention to two policy areas. The first is the need to continue improving **labor and product market flexibility**: with the loss of the exchange rate instrument—preceded by reduced flexibility during the ERM-II period—the labor market in particular will need greater flexibility to facilitate the smooth adjustment of the economy to adverse shocks. The second is the need to continue strengthening the **financial sector**, particularly through enhanced supervision, given the credit booms that have generally been associated with euro adoption in other countries, and the tensions to which financial systems can be subjected when capital flows increase.

46. Slovakia's **economic data** are mostly adequate for surveillance, although fiscal data are not as transparent as desirable for economic analysis. The authorities are addressing fiscal data weaknesses, in line with fiscal ROSC recommendations.

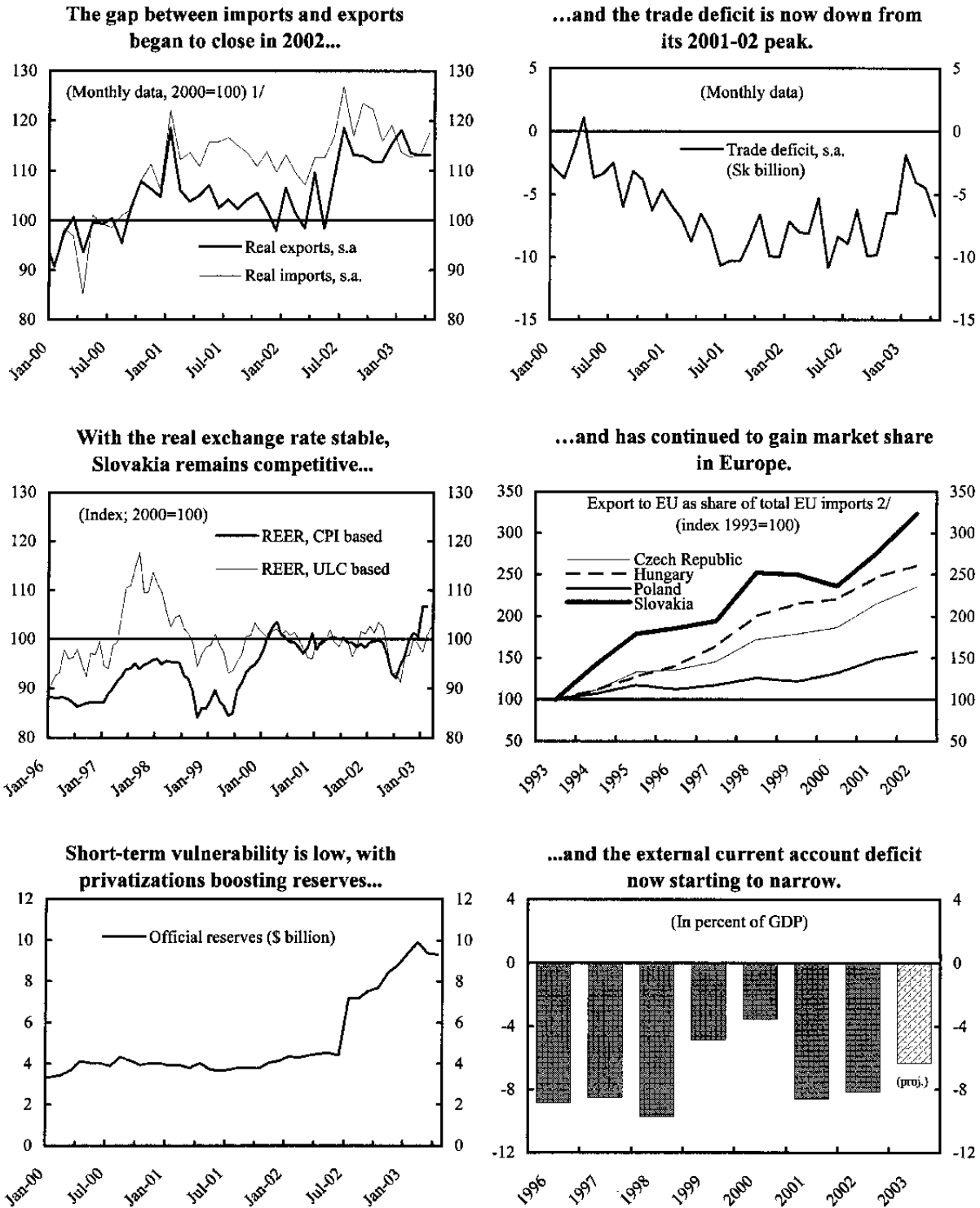
47. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Slovak Republic: Activity and Prices, 1998-2003



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

Figure 2. Slovak Republic: External Indicators, 1993-2003



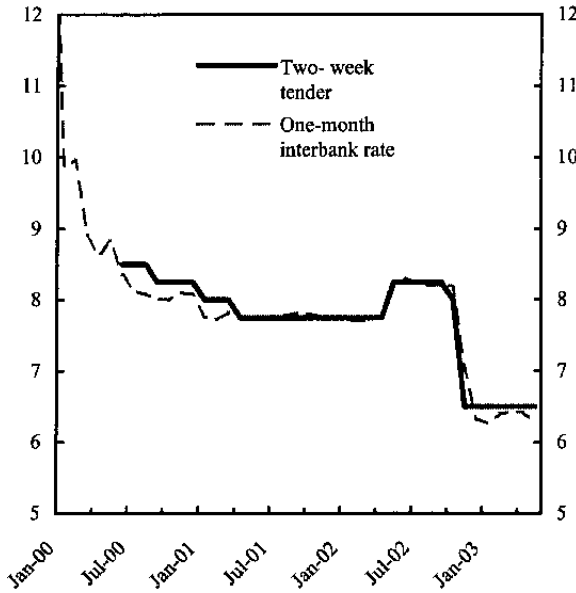
Sources: National Bank of Slovakia; and Fund staff calculations.

1/ Deflated by PPI.

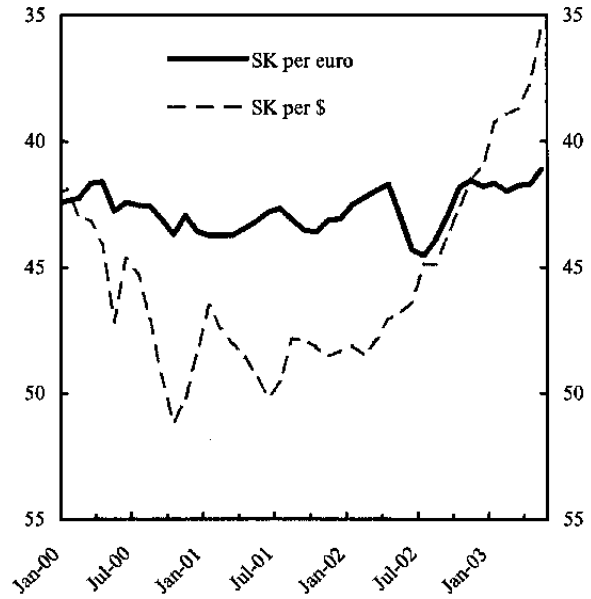
2/ Excluding intra EU trade and oil imports.

Figure 3. Slovak Republic: Financial Market Indicators, 2000-03

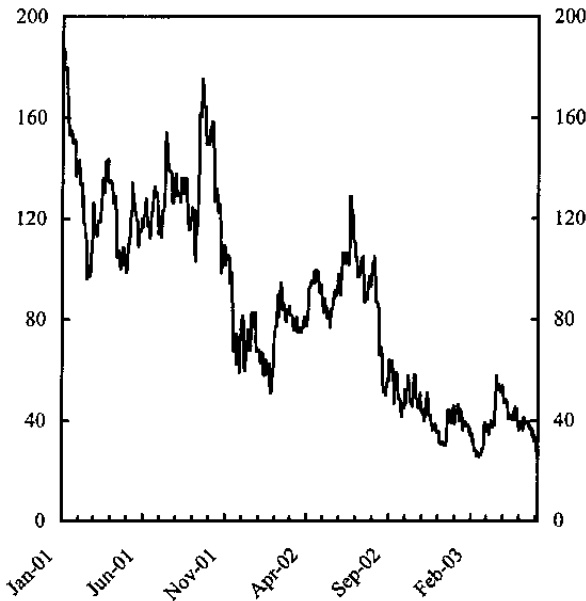
The NBS eased monetary policy aggressively in November 2002...



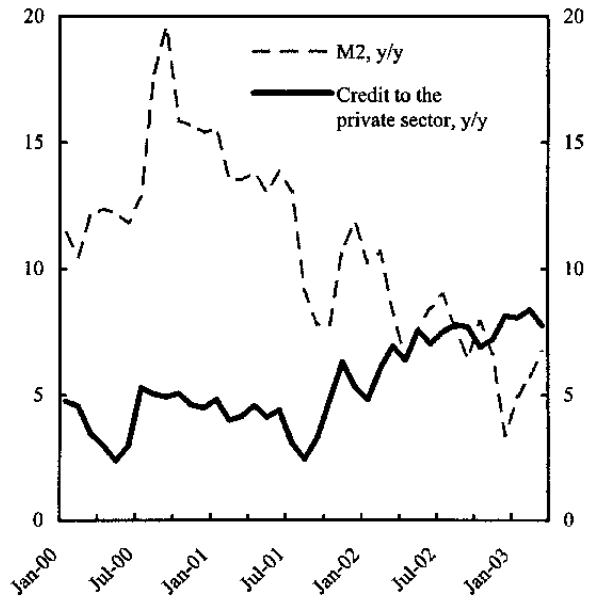
...contributing to the recent stability of the koruna against the euro.



Sovereign spreads have narrowed substantially since mid-2002.



Meanwhile, credit to the private sector has been recovering.



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

Table 1. Slovak Republic: Selected Economic and Financial Indicators, 1999-2003

	1999	2000	2001	Prel. 2002	Proj. 2003
	(Percent change, period average)				
Real sector					
Real GDP	1.3	2.2	3.3	4.4	4.0
Consumer prices					
Period average	10.7	12.0	7.3	3.3	8.5
12 months to end of period	14.2	8.4	6.6	3.4	9.0
Gross industrial output (constant prices)	4.1	8.6	7.0	6.6	...
Real wages in industry					
PPI-based	4.0	0.4	4.1	4.4	...
CPI-based	-2.8	-2.9	2.9	4.0	...
Employment in industry	-3.0	-3.0	1.0	0.2	...
Unemployment rate, period average	17.5	18.2	18.3	17.8	15.3
Real effective exchange rate ^{1/}					
CPI-based	-2.5	11.0	0.3	0.2	...
ULC-based	-14.1	1.6	0.3	-2.4	...
	(In percent of GDP)				
General government finances					
Revenue	37.0	37.9	35.7	36.2	33.5
Expenditure ^{2/ 3/}	40.2	41.8	39.8	40.7	38.8
Balance ^{3/}	-3.3	-3.9	-4.1	-4.5	-5.3
Net borrowing, ESA 95 basis	-6.4	-10.7	-7.3	-7.2	-5.1
	(Percent change, end of period, unless otherwise indicated)				
Money and credit					
Net domestic assets ^{4/}	9.5	6.2	16.5	-13.0	18.5
Credit to enterprises and households	4.6	4.5	5.3	12.1	11.0
Broad money	11.4	15.5	11.8	3.4	10.5
Interest rates (in percent, end-of-period)					
Lending rate (short-term)	16.4	10.7	8.8	7.5	...
Deposit rate (one-week)	12.1	6.0	6.0	4.0	...
NBS policy rate (two-week standard tender repo rate)	...	8.00	7.75	6.50	...
Velocity	-3.2	-5.8	-2.6	5.0	0.0
	(US\$ billion, unless otherwise indicated)				
Balance of payments					
Merchandise exports	10.2	11.9	12.6	14.4	18.3
(percent change)	(-4.6)	(16.1)	(6.4)	(13.7)	(27.2)
Merchandise imports	11.3	12.8	14.8	16.5	20.5
(percent change)	(-13.4)	(12.9)	(15.6)	(11.7)	(24.1)
Trade balance	-1.1	-0.9	-2.1	-2.1	-2.2
Current account balance	-1.0	-0.7	-1.8	-1.9	-2.0
(percent of GDP)	(-4.9)	(-3.6)	(-8.6)	(-8.2)	(-6.3)
Official reserves, end-period	3.4	4.1	4.2	9.2	9.6
(in months of imports of GNFS)	(3.1)	(3.4)	(3.0)	(5.9)	(4.9)
(in percent of broad money)	(26.9)	(31.0)	(29.8)	(59.3)	(47.1)
Gross reserves of banking system	4.4	5.6	5.4	10.2	...
Gross external debt, end-period ^{5/}	10.5	10.8	11.0	13.2	14.2
Gross external debt, end-period (in percent of GDP) ^{5/}	52.2	54.9	54.0	55.7	45.6
Short-term debt (end of period) ^{6/ 7/}	4.4	4.0	4.2	6.5	7.0
Short-term debt (end of period) ^{6/ 8/}	2.7	2.4	3.1	4.2	5.4
Official reserves to short-term debt (in percent) ^{6/ 7/}	78.0	102.0	100.5	140.6	136.6
Memorandum items:					
GDP, current prices (Sk billions)	835.7	908.8	989.3	1,073.6	1,186.5
Exchange rate (Sk/U.S. dollar)					
Period average	41.4	46.2	48.4	45.3	...
End of period	42.3	47.4	48.5	40.0	...
Public debt (in percent of GDP)	40.1	44.1	49.8	44.3	45.2

Sources: Statistical Office of the Slovak Republic; Ministry of Finance; National Bank of Slovakia; and Fund staff calculations.

^{1/} Calculated for trade partners of Austria, Czech Republic, France, Germany, Hungary, Italy, and Poland.

^{2/} Includes net lending, excluding privatization proceeds.

^{3/} Excluding privatization proceeds, bank restructuring costs, and called guarantees.

^{4/} Includes deposits of Sk 61.4 billion in privatization receipts at the pension fund account at the NBS in 2002.

^{5/} Excludes domestic currency denominated debt.

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

^{7/} Short-term debt is defined including medium- and long-term debt due in the subsequent year.

^{8/} Short-term debt is defined excluding medium- and long-term debt due in the subsequent year.

Table 2. Slovak Republic: Medium-Term Macroeconomic Framework, 1998-2007

	1998	1999	2000	2001	Prel.		Projection			2007
					2002	2003	2004	2005	2006	
Real GDP growth	4.0	1.3	2.2	3.3	4.4	4.0	4.0	4.1	4.2	4.3
Inflation (CPI)	6.7	10.7	12.0	7.3	3.3	8.5	8.1	4.8	3.2	2.8
Inflation (CPI, end of period)	5.6	14.2	8.4	6.6	3.4	9.0	8.3	3.6	2.8	2.8
Core inflation (end of period)	5.2	7.0	4.6	3.2	1.9	2.8	4.8	2.0	2.0	2.0
Inflation (GDP deflator)	5.2	6.4	6.4	5.4	4.0	6.3	5.9	3.8	3.0	2.8
(In billions of koruny, current prices)										
Gross domestic product	775	836	909	989	1,074	1,187	1,307	1,413	1,516	1625
Factor income (net)	-6	-12	-16	-15	-17	-4	-3	-2	0	1
Gross national income	769	823	892	974	1,057	1,182	1,305	1,411	1,516	1627
Current transfers (net)	13	8	5	10	8	4	4	4	3	2
Gross national disposable income	782	831	898	984	1,065	1,186	1,308	1,415	1,519	1629
Net exports of GNFS	-82	-36	-22	-84	-79	-75	-66	-59	-45	-46
Domestic demand	857	872	931	1,073	1,152	1,261	1,374	1,472	1,561	1671
(In percent of GDP)										
Gross national income	99.2	98.5	98.2	98.5	98.4	99.6	99.8	99.9	100.0	100.1
Gross national disposable income	100.9	99.5	98.8	99.5	99.2	100.0	100.1	100.2	100.2	100.2
Net exports of GNFS	-10.6	-4.3	-2.4	-8.5	-7.3	-6.3	-5.1	-4.2	-2.9	-2.8
Consumption	75.9	76.1	76.0	76.6	76.4	75.0	73.2	72.2	71.7	71.9
Nongovernment	57.2	58.9	58.5	58.7	58.0	56.7	55.6	54.6	54.0	52.4
Government	21.8	19.8	19.8	20.0	20.2	20.0	19.1	18.9	18.8	18.7
Gross national savings	25.0	23.4	22.8	22.9	22.8	25.0	26.9	27.9	28.4	28.3
Nongovernment	25.8	26.6	24.4	27.0	26.5	27.0	27.5	28.0	27.9	27.5
Government	-0.8	-3.3	-1.6	-4.1	-3.7	-2.0	-0.6	-0.1	0.5	0.9
Gross capital formation	34.7	28.2	26.4	31.9	30.9	31.3	31.8	31.9	31.2	30.9
Nongovernment	30.8	25.1	23.2	28.7	27.4	28.2	28.6	28.5	27.4	27.2
Government	3.9	3.2	3.2	3.2	3.6	3.1	3.2	3.4	3.5	3.6
Savings-investment gap (current account) 1/	-9.7	-4.9	-3.6	-9.0	-8.2	-6.3	-5.0	-4.0	-2.8	-2.6
Nongovernment net savings	-5.0	1.6	1.2	-1.6	-0.9	-1.2	-1.1	-0.5	0.2	0.1
Government net savings	-4.7	-6.4	-4.8 2/	-7.3	-7.2	-5.1	-3.9	-3.5	-3.0	-2.7
(Annual percentage change, constant prices, unless otherwise indicated)										
GDP	4.0	1.3	2.2	3.3	4.4	4.0	4.0	4.1	4.2	4.3
Domestic demand	6.9	-6.2	0.0	7.2	4.0	2.9	3.1	3.1	2.6	4.2
Consumption	7.8	0.1	-1.0	4.2	4.9	1.7	1.6	3.4	3.3	4.5
Nongovernment	5.8	2.9	-1.8	4.0	5.4	1.8	2.2	3.5	3.2	4.8
Government	11.5	-7.7	1.3	5.1	4.0	1.4	0.0	3.1	3.6	3.7
Gross capital formation	5.1	-20.2	2.8	15.2	1.7	6.1	6.8	2.4	0.8	3.3
Nongovernment 3/	10.1	-20.0	2.3	16.8	0.0	8.1	6.6	1.5	0.0	3.1
Government	-22.8	-21.8	6.1	2.5	16.6	-9.3	8.7	9.9	7.5	5.3
Exports of GNFS	13.2	5.2	13.8	6.5	5.9	15.1	10.5	8.3	10.7	6.7
Imports of GNFS	16.9	-6.3	10.2	11.7	5.3	13.4	9.2	7.1	9.0	6.6
Households' disposable income	5.4	5.7	-1.5	2.0	6.1	2.4	4.8	4.2	4.1	4.6
Gross saving as percent of disposable income	8.6	10.6	11.1	9.2	9.7	10.1	12.1	12.6	13.3	13.0
Employment	-0.4	-2.2	-1.4	1.1	-0.3	1.0	1.0	1.1	1.2	1.3
Nominal wages	9.0	6.7	6.4	8.3	9.3	8.8	8.9	5.6	5.2	4.3
Productivity	4.4	3.5	3.6	2.2	4.7	3.0	3.0	3.0	3.0	3.0
Unemployment rate (in percent)	13.8	17.5	18.2	18.3	17.8	15.3	15.0	14.5	13.7	12.7

Sources: Statistical Office of the Slovak Republic; and Fund staff estimates and projections.

1/ The saving-investment gap for 2001 implied by national accounts data differs from the current account deficit reported in BOP statistics.

The discrepancy is 0.4 percent of GDP.

2/ Excludes net borrowing for SKA in 2000, amounting to Sk 53.34 billion.

3/ Includes changes in inventories and the statistical discrepancy.

Table 3. Slovak Republic: Fiscal Operations of the Consolidated General Government, 2001-07 1/

(In millions of koruny)

	2001	2002	2003		2004			2005	2006	2007	
			Budget	Proj.	Apr 03 draft outline 12/	Auth. rev. baseline	Auth. (proj)				Staff (proj.)	Projection
Total revenue	353,357	388,586	412,344	397,218	452,503	438,879	436,213	432,474	473,364	506,548	538,877
Tax revenue	304,962	345,225	377,526	362,401	403,514	389,889	387,223	383,485	413,394	441,147	470,580
Personal income tax	44,158	46,457	51,900	51,268	56,900	53,900	41,100	37,997	40,566	43,202	45,641
Corporate profit tax	21,728	29,759	30,900	24,247	32,600	29,400	22,253	22,344	24,143	25,920	27,789
Social security contributions	124,619	139,490	146,022	147,718	159,214	160,489	154,170 9/	154,170 9/	164,591	175,287	185,184
VAT	73,567	82,241	99,400	87,087 7/	107,900	100,500	118,400	117,673	128,155	136,662	147,237
Excises	28,402	32,001	36,200	38,977	36,700	35,700	42,200	42,200	44,883	47,862	51,566
Import duties, property tax and other	12,488	15,277	13,104	13,104	10,200	9,900	9,100	9,100	11,056	12,214	13,163
Nontax revenue 2/	48,395	43,361	34,817	34,817	34,755	34,755	34,755	34,755	36,577	38,133	39,665
Grants (from European Union)	...	...	...	...	14,235	14,235	14,235	14,235	23,393	27,269	28,632
Total expenditure, excluding bank restructuring costs and called guarantees	390,071	435,000	459,014	459,414	487,283	...	481,979	481,979	522,966	560,139	601,076
Current expenditure 3/	353,400	388,539	414,450	414,850 8/	435,974	...	430,670	430,670	464,473	495,403	530,989
Of which: wages	58,908	65,993	72,959	72,959	74,783	...	74,783	74,783	80,805	86,752	93,008
interest 3/	24,127	25,275	29,237	27,237	26,712	...	26,712	26,712	28,006	26,799	28,596
Capital spending 4/	36,671	46,461	44,565	44,565	51,309	...	51,309	51,309	58,493	64,737	70,087
Net lending 5/	3,484	1,777	1,035	1,035	1,035	...	1,035	1,035	1,347	1,380	1,406
Unidentified measures	...	...	...	...	...	...	-1,111	-4,850	-10,827	-17,516	-26,150
Overall balance, excluding bank restructuring costs and called guarantees	-40,198	-48,191	-47,705	-63,230	-35,815	...	-45,689	-45,689	-40,122	-37,455	-37,454
Bank restructuring costs	8,048	14,565	10,700	10,700	7,672	...	7,672	7,672	7,672	6,256	4,840
Of which: interest	...	12,289	7,800	7,800	7,672	...	7,672	7,672	7,672	6,256	4,840
Called guarantees	7,983	4,599	7,000	5,000	3,000	...	3,000	3,000	3,000	3,000	3,000
Overall balance	-56,229	-67,355	-65,405	-78,930	-46,487	...	-56,361	-56,361	-50,794	-46,711	-45,294
Adjusted primary balance 6/	-16,587	-28,139	-17,434	-24,959	-8,068	...	-17,943	-17,943	-10,769	-9,275	-7,452
Adjustment items, from cash to ESA 95	-16,174	-10,450	7,937	18,370	2,927	...	5,927	5,927	1,347	1,380	1,406
Net lending/borrowing (+/-), ESA 95 basis	-72,403	-77,805	-57,468	-60,560	-43,560	...	-50,435	-50,435	-49,447	-45,331	-43,888
Public debt, ESA 95 basis	493,081	475,670	533,138	536,230	...	...	...	586,665	636,112	681,442	725,331
Memorandum item: nominal GDP	989,297	1,073,613	1,155,400	1,186,507	1,281,200	1,293,200	1,293,200	1,307,489	1,412,766	1,516,078	1,625,491

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

1/ Unless otherwise noted, on GFS 1986 basis, excluding privatization receipts and specified one-off items. Excludes Slovak Consolidation Agency in 2001 and 2002.

2/ In 2002, excludes Sk 3 billion from the sale of mobile phone licenses.

3/ In 2001, excludes interest on redemption of NPF bonds (Sk 7.5 billion); in 2002-07, excludes interest on bank restructuring bonds. Adjusted for increases in new indebtedness of health insurance companies (in 2001, Sk 1.5 billion; in 2002, Sk 0.8 billion).

4/ Excludes one-off debt-reducing expenditures of the NPF in 2001 and 2002, as defined under the 2001-02 Staff-Monitored Program.

5/ Excludes repayments from Slovak Consolidation Agency. In 2002, excludes extraordinary repayment of Russian debt (Sk 13.5 billion), and repayment from CSOB (Sk 6 billion).

6/ Excludes bank restructuring costs and other net lending, called guarantees, and in 2001-02 debt-reducing expenditures of the NPF. Adjusted downwards by Sk 4 billion in 2001 and 2002 to include the off-budget railway subsidy, shifted on-budget in 2003. Also adjusts for cash shortfall in 2003 from one-off tax refunds (Sk 3 billion CIT from 2002, Sk 7 billion VAT from earlier years).

7/ On a cash basis, that is, net of estimated Sk 7 billion refund for accrued VAT prior to 2003.

8/ Assumes Sk 2 billion in overruns on education spending by municipalities, and additional pension spending of Sk 0.4 billion. Also assumes Sk 2 billion saving on interest bill.

9/ Staff estimate, assuming 2 percentage point reduction in sickness contributions. The authorities are also discussing a 1.75 percentage point reduction in unemployment insurance contributions.

Table 3. Slovak Republic: Fiscal Operations of the Consolidated General Government, 2001-07 (concluded) 1/

(In percent of GDP)

	2001	2002	2003		2004				2005	2006	2007
			Budget	Proj.	Apr 03 draft outline 12/	Auth. rev. baseline	Auth. (proj)	Staff (proj.)				Projection
Total revenue	35.7	36.2	35.7	33.5	35.3	33.9	33.7	33.1	33.5	33.4	33.2
Tax revenue	30.8	32.2	32.7	30.5	31.5	30.1	29.9	29.3	29.3	29.1	29.0
Personal income tax	4.5	4.3	4.5	4.3	4.4	4.2	3.2	2.9	2.9	2.8	2.8
Corporate profit tax	2.2	2.8	2.7	2.0	2.5	2.3	1.7	1.7	1.7	1.7	1.7
Social security contributions	12.6	13.0	12.6	12.4	12.4	12.4	11.9 9/	11.8 9/	11.7	11.6	11.4
VAT	7.4	7.7	8.6	7.3 7/	8.4	7.8	9.2	9.0	9.1	9.0	9.1
Excises	2.9	3.0	3.1	3.3	2.9	2.8	3.3	3.2	3.2	3.2	3.2
Import duties, property tax and other	1.3	1.4	1.1	1.1	0.8	0.8	0.7	0.7	0.8	0.8	0.8
Nontax revenue 2/	4.9	4.0	3.0	2.9	2.7	2.7	2.7	2.7	2.6	2.5	2.4
Grants (from European Union)	...	...	...	...	1.1	1.1	1.1	1.1	1.7	1.8	1.8
Total expenditure, excluding bank restructuring costs and called guarantees	39.4	40.5	39.7	38.7	38.0	...	37.3	36.9	37.0	36.9	37.0
Current expenditure 3/	35.7	36.2	35.9	35.0 8/	34.0	...	33.3	32.9	32.9	32.7	32.7
Of which: wages	6.0	6.1	6.3	6.1	5.8	...	5.8	5.7	5.7	5.7	5.7
interest 3/	2.4	2.4	2.5	2.3	2.1	...	2.1	2.0	2.0	1.8	1.8
Capital spending 4/	3.7	4.3	3.9	3.8	4.0	...	4.0	3.9	4.1	4.3	4.3
Net lending 5/	0.4	0.2	0.1	0.1	0.1	...	0.1	0.1	0.1	0.1	0.1
Unidentified measures	...	...	...	...	...	...	-0.1	-0.4	-0.8	-1.2	-1.6
Overall balance, excluding bank restructuring costs and called guarantees	-4.1	-4.5	-4.1	-5.3	-2.8	...	-3.5	-3.5	-2.8	-2.5	-2.3
Memorandum items:											
Bank restructuring costs	0.8	1.4	0.9	0.9	0.6	...	0.6	0.6	0.5	0.4	0.3
Of which: interest	...	1.1	0.7	0.7	0.6	...	0.6	0.6	0.5	0.4	0.3
Called guarantees	0.8	0.4	0.6	0.4	0.2	...	0.2	0.2	0.2	0.2	0.2
Adjusted primary balance 6/	-1.7	-2.6	-1.5	-2.1	-0.6	...	-1.4	-1.4	-0.8	-0.6	-0.5
Adjustment items, from cash to ESA 95	-1.6	-1.0	0.7	1.5	0.2	...	0.5	0.5	0.1	0.1	0.1
Net lending/borrowing (+/-), ESA 95 basis	-7.3	-7.2	-5.0	-5.1	-3.4	...	-3.9	-3.9	-3.5	-3.0	-2.7
Public debt, ESA 95 basis	49.8	44.3	46.1	45.2	...	...	...	44.9	45.0	44.9	44.6

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

1/ Unless otherwise noted, on GFS 1986 basis, excluding privatization receipts and specified one-off items. Excludes Slovak Consolidation Agency in 2001 and 2002.

2/ In 2002, excludes Sk 3 billion from the sale of mobile phone licenses.

3/ In 2001, excludes interest on redemption of NPF bonds (Sk 7.5 billion); in 2002-07, excludes interest on bank restructuring bonds. Adjusted for increases in new indebtedness of health insurance companies (in 2001, Sk 1.5 billion; in 2002, Sk 0.8 billion).

4/ Excludes one-off debt-reducing expenditures of the NPF in 2001 and 2002, as defined under the 2001-02 Staff-Monitored Program.

5/ Excludes repayments from Slovak Consolidation Agency. In 2002, excludes extraordinary repayment of Russian debt (Sk 13.5 billion), and repayment from CSOB (Sk 6 billion).

6/ Excludes bank restructuring costs and other net lending, called guarantees, and in 2001-02 debt-reducing expenditures of the NPF. Adjusted downwards by Sk 4 billion in 2001 and 2002 to include the off-budget railway subsidy, shifted on-budget in 2003. Also adjusts for cash shortfall in 2003 from one-off tax refunds (Sk 3 billion CIT from 2002, Sk 7 billion VAT from earlier years).

7/ On a cash basis, that is, net of estimated Sk 7 billion refund for accrued VAT prior to 2003.

8/ Assumes Sk 2 billion in overruns on education spending by municipalities, and additional pension spending of Sk 0.4 billion. Also assumes Sk 2 billion saving on interest bill.

9/ Staff estimate, assuming 2 percentage point reduction in sickness contributions. The authorities are also discussing a 1.75 percentage point reduction in unemployment insurance contributions.

Table 4. Slovak Republic: Balance of Payments, 1998-2007

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

	1998	1999	2000	2001	Prel. 2002	2003	2004	Projection		
								2005	2006	2007
Current account balance	-2,132	-979	-700	-1,756	-1,939	-1,962	-1,707	-1,444	-1,076	-1101
Trade balance	-2,353	-1,092	-904	-2,135	-2,131	-2,195	-1,960	-1,709	-1,295	-1289
Exports, f.o.b.	10,720	10,229	11,872	12,631	14,365	18,272	20,764	22,922	25,917	28037
Imports, f.o.b.	-13,073	-11,321	-12,777	-14,766	-16,497	-20,467	-22,725	-24,631	-27,211	-29326
Services balance	20	218	439	480	456	241	229	210	149	97
Receipts	2,295	2,063	2,247	2,490	2,786	3,278	3,383	3,501	3,580	3741
Payments	-2,275	-1,845	-1,807	-2,010	-2,330	-3,037	-3,153	-3,290	-3,431	-3644
Income balance	-166	-301	-353	-313	-456	-110	-72	-46	-6	28
Receipts	437	300	269	322	343	750	763	843	932	1023
Payments	-603	-601	-622	-634	-800	-860	-835	-889	-938	-995
Of which: interest	-539	-561	-187	-267	-634	-656	-655	-714	-744	-793
Current transfers	367	196	118	212	193	101	96	101	76	63
Official	-1	0	-3	-9	-12	-30	-35	-35	-35	-35
Private	368	196	121	221	205	131	131	136	111	98
Capital and financial account balance	1,957	2,140	1,511	1,719	5,175	2,355	2,376	1,957	2,016	1892
Capital transfers	71	160	92	78	107	152	329	379	431	429
Direct foreign investment	314	756	2,096	1,137	3,963	1,042	1,515	2,343	1,909	1202
Of which: Privatization			1,000	699	3,352	340	686	1,027	998	400
Greenfield investment			1,117	480	613	727	855	1,339	947	844
Portfolio investment	793	623	819	-217	554	381	222	268	250	260
Credit extended (net) - other investment assets	167	16	-159	-14	274	-53	-145	-150	-169	-168
Credits received (net)	585	660	-429	-100	-247	-159	61	-637	-405	-310
Disbursements	1,843	2,031	1,254	1,482	1,082	2,146	1,700	970	825	716
Amortization	-1,258	-1,371	-1,683	-1,582	-1,329	-2,306	-1,639	-1,606	-1,230	-1026
Short-term capital (net)	27	-75	-908	835	524	992	394	-247	0	480
Errors and omissions	-117	-605	-32	180	409	0	0	0	0	0
Overall balance	-292	555	779	143	3,645	393	670	513	941	791
Financing	292	-555	-779	-143	-3,645	-393	-670	-513	-941	-791
Gross reserves (- = increase)	362	-502	-652	-143	-3,645	-393	-670	-513	-941	-791
Use of Fund credit	-70	-53	-127	0	0	0	0	0	0	0
Memorandum items:										
Current account balance (in percent of GDP)	-9.7	-4.9	-3.6	-8.6	-8.2	-6.3	-5.0	-4.0	-2.8	-2.6
Export growth (US\$ value)	11.2	-4.6	16.1	6.4	13.7	27.2	13.6	10.4	13.1	8.2
Export growth (volume)	15.8	-4.3	18.7	11.2	11.7	15.4	12.0	9.3	12.1	7.1
Import growth (US\$ value)	11.9	-13.4	12.9	15.6	11.7	24.1	11.0	8.4	10.5	7.8
Import growth (volume)	16.5	-13.3	15.2	20.1	9.2	12.0	10.2	7.6	9.7	6.8
Gross official reserves (US\$ million)	2,923.3	3,425.2	4,076.8	4,188.6	9,195.5	9,588.2	10,257.9	10,770.8	11,711.4	12,502.5
In months of imports of goods and services	2.3	3.1	3.4	3.0	5.9	4.9	4.8	4.6	4.6	4.6
Total external debt (US\$ millions) 1/	11,902.0	10,517.9	10,804.2	11,042.4	13,188.2	14,165.8	14,728.3	13,956.9	13,799.9	14,255.5
(in percent of GDP)	54.1	52.2	54.9	54.0	55.7	45.6	43.1	38.8	35.4	33.8
Short-term external debt (US\$ million) 2/	4,604.6	2,706.0	2,415.0	3,073.1	4,236.7	5,378.6	5,830.9	5,665.6	5,750.0	6,314.1
Short-term external debt adjusted (US\$ million) 2/ 3/	5,976.0	4,389.0	3,996.7	4,169.4	6,542.3	7,017.9	7,436.9	6,895.2	6,775.5	7,312.6
Reserves/short-term debt (in percent) 3/	48.9	78.0	102.0	100.5	140.6	136.6	137.9	156.2	172.8	171.0
Reserves/broad money (in percent)	21.8	27.0	31.0	29.8	59.3	47.1	45.8	45.8	45.9	45.2
MLT External debt service/Exports of GNFS	14.3	16.2	14.1	12.2	11.4	13.7	9.5	8.8	6.7	5.7
GDP (US\$ millions)	21,995.1	20,163.0	19,670.2	20,459.4	23,686.1	31,063.1	34,204.3	35,938.0	38,965.3	42,183.0

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

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

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

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

Table 5. Slovak Republic: Vulnerability Indicators, 1998-2003
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	Prel. 2002	Proj. 2003
Financial indicators						
Public sector debt 1/	28.8	40.1	44.1	49.8	44.3	45.2
Broad money (percent change, 12-month basis)	4.2	11.4	15.5	11.8	3.4	10.5
Private sector credit (percent change, 12-month basis)	5.8	4.6	4.5	5.3	12.1	11.0
Domestic credit to GDP 2/	70.3	68.9	67.2	69.9	56.2	58.7
Bond yield at issue (one-five years, annual average)	23.2	17.0	9.0	7.8	7.4	...
Bond yield at issue, real (one-five years, annual average) 3/	16.5	17.0	9.0	7.8	7.4	...
External indicators						
Merchandise exports (percent change, 12-month basis in US\$)	11.2	-4.6	16.1	6.4	13.7	27.2
Merchandise imports (percent change, 12-month basis in US\$)	11.9	-13.4	12.9	15.6	11.7	24.1
Terms of trade (percent change, 12-month basis)	2.4	-2.1	-0.2	-2.2	-0.5	-0.5
Current account balance	-9.7	-4.9	-3.6	-8.6	-8.2	-6.3
Capital and financial account balance	8.9	10.6	7.7	8.4	21.7	7.6
Capital transfers	0.3	0.8	0.5	0.4	0.5	0.5
Portfolio investment, net	3.6	3.1	4.2	-1.1	2.3	1.2
Medium- and long-term credits + short-term credits	3.5	3.0	-7.6	3.5	2.1	2.5
Direct investment, net	1.4	3.7	10.7	5.6	16.7	3.4
Net foreign assets (NFA) of commercial banks (in US\$ billions)	0.7	0.5	1.0	1.0	0.3	...
Gross official reserves (in US\$ billions)	2.9	3.4	4.1	4.2	9.2	9.6
Net international reserves (NIR) (in US\$ billions)	3.7	4.0	5.3	4.8	8.8	...
Central bank short-term foreign liabilities (in US\$ billions) 4/	0.0	0.0	0.0	0.0	0.0	...
Central bank foreign currency exposure (in US\$ billions)	0.4	0.7	1.2	1.4	6.1	...
Short-term foreign assets of commercial banks (in US\$ billions) 5/	3.1	1.0	1.5	1.2	1.0	...
Short-term foreign liabilities of commercial banks (in US\$ billions) 5/	2.1	0.2	0.3	0.6	1.0	...
Foreign currency exposure of commercial banks (in US\$ billions)	0.7	0.5	1.0	1.0	0.3	...
Official reserves in months of imports of goods and services	2.3	3.1	3.4	3.0	5.9	4.9
Reserve money to (gross official) reserves (percentage)	84.2	82.7	60.3	56.2	27.7	33.8
Broad money to (gross official) reserves (percentage)	438.0	371.8	322.8	335.7	168.6	212.1
Total short-term external debt to gross official reserves (percentage) 6/	204.4	128.1	98.0	99.5	71.1	73.2
Total external debt	54.1	52.2	54.9	54.0	55.7	45.6
Of which: Public sector debt	11.4	14.0	17.2	16.9	15.8	11.2
Total external debt to exports of goods and services (in percent)	91.4	85.6	76.5	73.0	77.7	65.7
Total external debt service payments to exports of goods and services	14.3	16.2	14.1	12.2	10.1	13.7
Exchange rate (per US\$, period average)	35.2	41.4	46.2	48.4	45.3	38.2
REER depreciation (-) (12-month basis; CPI-based)	-1.4	-2.5	11.0	0.3	0.2	12.3
REER depreciation (-) (12-month basis; ULC-based)	-6.8	-14.1	1.6	0.3	-2.4	3.7
Financial market indicators (end-year)						
Stock market index	94	77	92	121	140	...
Foreign currency debt rating (Moody's)	Ba1	Ba1	Ba1	Baa3	A3	...
Spread of (five-year benchmark) bond (basis points) 7/	...	248	181	56	42	...

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

1/ General government.

2/ Includes deposits of Sk 65 billion in privatization receipts at the pension fund account at the NBS in 2002.

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

4/ Includes short-term liabilities of the government.

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

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

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

Table 6. Slovak Republic: Monetary Survey, 2000-04
(In actual exchange rates, Sk billion)

	2000	2001	2002		2003				2004	
	Dec 1/	Dec	1/1/02 Adjusted 2/	Dec	1/1/03	Mar	Jun Proj.	Sep Proj.	Dec Proj.	Dec Proj.
Net foreign assets, NIR definition	104.1	119.3	130.2	253.5	249.5	249.5	229.1	234.2	232.2	294.3
Position of banks vis-à-vis nonresidents in Sk	17.8	2.2	2.2	-23.8	-19.4	-15.9	-15.9	-15.9	-15.9	-15.9
Bonds held by nonresidents	-11.0	-20.6	-20.6	-21.0	-21.0	-19.2	-21.1	-23.1	-25.0	-33.0
Net foreign assets	110.9	101.0	111.8	208.6	209.1	214.4	192.0	195.2	191.2	245.5
Net domestic assets (M2)	497.1	578.9	568.1	494.3	499.4	494.1	538.6	558.2	585.6	613.0
Domestic credit	622.0	691.6	691.6	603.4	605.0	613.5	643.0	663.1	696.6	782.4
Net credit to government 3/	305.1	345.4	347.4	265.6 4/ 5/	266.6	275.9	292.4	300.1	321.8	367.9
From banking system	159.3	190.2	190.2	113.7	114.8	128.2	149.7	150.2	168.0	197.1
Foreign financing	133.4	136.7	138.6	128.6	128.6	123.1	117.5	124.3	127.7	142.7
In foreign currency	122.4	116.0	117.9	107.6	107.6	103.9	96.4	101.2	102.6	109.7
In Sk denominated bonds	11.0	20.7	20.7	21.0	21.0	19.2	21.1	23.1	25.0	33.0
Nonbank domestic financing	12.4	18.3	18.3	23.2	23.2	24.6	25.1	25.6	26.1	28.1
Net credit to National Property Fund 3/	0.1	10.4	8.4	-3.1	-3.6	-11.1	-7.7	-5.3	-3.7	-3.7
Credit to enterprises and households	316.8	335.8	335.8	340.9 6/	342.0	348.7	358.3	368.2	378.4	418.2
Other items, net (M2)	-124.9	-112.7	-123.5	-109.1	-105.6	-119.4	-104.5	-104.9	-111.0	-169.3
Broad money (M2)	608.0	679.9	679.9	702.9	708.5	708.5	730.6	753.3	776.8	858.5
Koruna broad money	513.7	574.8	574.8	596.2	601.7	609.3	628.3	647.2	667.2	738.6
Currency	67.0	81.0	81.0	84.2	84.2	86.8	89.7	88.2	89.7	106.8
Deposits	541.0	598.9	598.9	618.7	624.3	621.7	640.8	665.1	687.1	751.7
Of which: in foreign currency	94.4	105.1	105.1	106.7	106.8	99.2	102.3	106.1	109.6	119.9
Memorandum items (year-on-year percentage change, unless otherwise indicated)										
Nominal GDP growth	8.9	9.2	9.2	8.5	...	8.9	10.0	10.1	10.5	10.5
M2	15.5	11.8	11.8	3.4	...	6.7	7.8	10.3	10.5	10.5
Change in M2 velocity, in percent, year-on-year	-5.8	-2.6	-2.6	6.3	...	2.7	3.9	-1.5	0.0	0.0
Koruna M2	14.0	11.9	11.9	3.7	...	8.2	11.2	13.4	11.9	10.7
M2-base money multiplier	5.4	5.98	6.0	6.1	...	6.2	6.0	6.3	6.3	6.3
Currency-deposits ratio	0.124	0.135	0.135	0.136	...	0.140	0.140	0.133	0.131	0.142
Net lending/borrowing (ESA 95 basis), cumulative from Jan 1	...	...	...	...	...	17.8	28.9	37.8	60.6	50.4
Increase in pension account at NBS (cumulative)	...	...	...	63.7	...	1.1	2.2	3.2	4.3	4.4
Credit to enterprises and households 7/	2.6	6.0	6.0	12.1	...	11.4	11.1	11.6	11.0	10.5

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

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

2/ Revaluation of NFA amounting to Sk 10.9 billion.

3/ Includes accumulated interest payments on restructuring bonds.

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

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

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

7/ Adjusted for the removal of credits from SKA (Sk 31.5 billion) and Devin Bank (Sk 4 billion) from the statistics in February 2002.

External and Fiscal Sustainability

Tables A1 and A2 show the results of the sustainability analysis of Slovakia's external debt. Under the baseline scenario, Slovakia's external debt stock (private and public) is projected to decline from 56 percent of GDP in 2002 to 34 percent of GDP in 2007,¹ reflecting the steady decline of the external current account deficit and the continuation of strong nondebt creating capital inflows (Table A1). Gross external financing need, defined as the sum of the noninterest current account deficit, short-term debt, and medium- and long-term debt service, also appears manageable (Table A2).

To assess the robustness of these conclusions, staff conducted various stress tests, assuming higher external interest rates, lower GDP growth, and a depreciation of the koruna vis-à-vis the U.S. dollar. The results indicate that while Slovakia's debt dynamics are generally manageable in case of adverse shocks, the country is vulnerable to a sharp real exchange rate depreciation due to the high foreign-currency share of the overall external debt (estimated at about 90 percent). For example, when the baseline change in the dollar-based GDP deflator, a proxy for the real exchange rate, is lowered by two standard deviations in 2003–04, the external debt-to-GDP ratio rises to 81 percent of GDP, before declining to 70 percent in 2007.

Turning to fiscal sustainability (Table A3), under the baseline scenario—which assumes the Maastricht fiscal deficit criterion is met by 2006—the public debt stock is projected to stabilize around its current level of 45 percent of GDP. Significant slippages in progress towards meeting the Maastricht deficit criterion would risk compromising fiscal sustainability (stress test 1); but under other adverse shock scenarios, public debt should be sustainable in the medium term, remaining below the Maastricht ceiling of 60 percent of GDP.

¹ The external debt stock is projected to decline by 10 percentage points of GDP already in 2003, owing mainly to currency movements.

Table A1. Slovak Republic: External Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual						Projections				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 External debt	46.3	54.1	52.2	54.9	54.0	55.7	45.6	43.1	38.8	35.4	33.8
2 Change in external debt	8.9	7.8	-1.9	2.8	-1.0	1.7	-10.1	-2.5	-4.2	-3.4	-1.6
3 Identified external debt-creating flows (4+8+11)	7.7	5.5	5.1	-6.5	-1.0	-16.6	-9.4	-3.7	-4.7	-5.1	-2.9
4 Current account deficit, excluding interest payments	8.0	7.2	2.1	0.8	5.8	5.6	4.2	3.1	2.0	0.9	0.7
5 Deficit in balance of goods and services	9.5	10.6	4.3	2.4	8.1	7.3	6.3	5.1	4.2	2.9	2.8
6 Exports	56.0	59.2	61.0	71.8	73.9	71.7	69.4	70.5	73.5	75.7	75.3
7 Imports	65.6	69.8	65.3	74.1	82.0	79.0	75.7	75.6	77.6	78.6	78.1
8 Net nondebt creating capital inflows (negative)	-0.2	-2.1	-3.7	-10.8	-7.2	-17.8	-3.4	-4.4	-6.5	-4.9	-2.8
9 Net foreign direct investment, equity	0.2	2.1	3.7	10.8	7.2	17.8	3.4	4.4	6.5	4.9	2.8
# Net portfolio investment, equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
# Automatic debt dynamics 1/	-0.1	0.3	6.8	3.5	0.4	-4.5	-10.3	-2.3	-0.2	-1.1	-0.8
# Contribution from nominal interest rate	1.3	2.5	2.8	2.8	2.8	2.5	2.1	1.9	2.0	1.9	1.9
# Contribution from real GDP growth	-2.1	-1.8	-0.8	-1.2	-1.7	-2.0	-1.7	-1.7	-1.7	-1.5	-1.4
# Contribution from price and exchange rate changes 2/	0.7	-0.4	4.8	1.9	-0.6	-5.0	-10.7	-2.5	-0.5	-1.5	-1.3
# Residual, incl. change in gross foreign assets (2-3)	1.2	2.3	-7.0	9.2	0.0	18.3	-0.6	1.1	0.5	1.7	1.3
External debt-to-exports ratio (in percent)	82.7	91.4	85.6	76.5	73.0	77.7	65.7	61.0	52.9	46.8	44.9
Gross external financing need (in billions of U.S. dollars) 3/	6.1	8.3	7.0	5.3	5.8	6.6	11.4	11.9	12.3	11.7	11.8
in percent of GDP	29.2	37.8	34.8	27.2	28.4	27.7	36.7	34.8	34.2	29.9	28.0
Key macroeconomic and external assumptions											
Real GDP growth (in percent)	5.6	4.0	1.3	2.2	3.3	4.4	4.0	4.0	4.1	4.2	4.3
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-8.8	-4.6	-15.0	-10.3	-4.5	6.7	18.7	0.0	-2.8	1.0	1.0
GDP deflator in U.S. dollars (change in percent)	-2.7	0.4	-9.5	-4.5	0.7	10.9	26.2	5.9	0.9	4.0	3.8
Nominal external interest rate (in percent)	3.5	5.5	4.7	5.3	5.3	5.4	5.0	4.6	4.8	5.3	5.7
Growth of exports (U.S. dollar terms, in percent)	8.3	10.2	-5.6	14.9	7.1	12.3	26.9	12.0	9.4	11.6	7.7
Growth of imports (U.S. dollar terms, in percent)	5.0	11.1	-14.2	10.8	15.0	11.6	25.6	10.1	7.9	9.7	7.6
II. Stress Tests for External Debt Ratio											
0. Baseline							45.6	43.1	38.8	35.4	33.8
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07							55.2	55.5	55.0	55.9	56.4
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							46.5	45.0	40.8	37.3	35.7
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							47.2	46.1	41.9	38.4	36.7
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							68.1	80.9	76.5	72.1	69.6
5. Noninterest current account is at historical average minus two standard deviations in 2003 and 2004							55.4	63.3	59.0	55.0	53.0
6. Combination of 2-5 using one standard deviation shocks							67.7	80.6	76.2	71.8	69.4
7. One time 30 percent nominal depreciation in 2003							73.5	69.5	65.2	61.1	58.9
Historical statistics for key variables (past 10 years)											
			Historical Average		Standard Deviation				Average 2003-07		
Current account deficit, excluding interest payments			3.0		5.5				2.2		
Net nondebt creating capital inflows			3.3		3.8				4.4		
Nominal external interest rate (in percent)			5.1		1.0				5.1		
Real GDP growth (in percent)			4.2		1.9				4.1		
GDP deflator in U.S. dollars (change in percent)			1.6		8.6				8.2		

1/ Derived as $[r - g - \rho(1+g) + \epsilon\alpha(1+r)]/(1+g+\rho+g\alpha)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, ϵ = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

Table A2. Slovak Republic: External Sustainability Framework- Gross External Financing Need, 1997-2007

	Actual						Projection				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/ in percent of GDP	6.1	8.3	7.0	5.3	5.8	6.6	11.4	11.9	12.3	11.7	11.8
	29.2	37.8	34.8	27.2	28.4	27.7	36.7	34.8	34.2	29.9	28.0
II. Stress Tests											
Gross external financing need in billions of U.S. dollars 2/											
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07							10.8	11.6	13.0	13.9	14.9
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							11.8	12.6	12.9	12.2	12.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							11.4	11.8	12.3	11.7	11.9
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							11.0	11.4	12.2	12.2	12.7
5. Noninterest current account is at historical average minus two standard deviations in 2003 and 2004							15.6	19.2	18.0	17.7	18.2
6. Combination of 2-5 using one standard deviation shocks							12.6	14.2	14.4	14.4	14.9
7. One time 30 percent nominal depreciation in 2003							10.6	11.0	11.7	11.5	11.9
Gross external financing need in percent of GDP 2/											
1. Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2003-07							42.9	43.6	46.2	46.6	47.3
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							38.0	36.9	35.8	31.4	29.5
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							37.9	37.0	36.6	32.2	30.3
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							52.8	62.6	63.9	58.9	56.5
5. Noninterest current account is at historical average minus two standard deviations in 2003 and 2004							50.2	56.2	50.1	45.4	43.2
6. Combination of 2-5 using one standard deviation shocks							55.8	66.2	63.7	58.7	56.3
7. One time 30 percent nominal depreciation in 2003							58.0	54.3	55.0	50.2	47.9

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

2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

Table A3. Slovak Republic: Public Sector Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual						Projection				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 Public sector debt 1/	28.8	28.8	40.1	44.1	49.8	44.3	45.2	44.9	45.0	44.9	44.6
Of which: foreign-currency denominated	5.8	4.6	12.5	13.0	16.4	13.9	12.6	10.3	9.8	8.0	6.9
2 Change in public sector debt	2.3	0.0	11.3	4.1	5.7	-5.5	0.9	-0.3	0.2	-0.1	-0.3
3 Identified debt-creating flows (4+7+12)	0.9	2.1	6.2	6.3	15.3	-12.8	-2.0	-4.0	-2.9	-6.3	-0.9
4 Primary deficit	1.8	1.9	3.3	7.8	4.1	3.7	2.2	1.2	1.0	0.8	0.7
5 Revenue and grants	40.1	37.8	37.0	37.9	35.7	35.9	34.3	33.1	33.5	33.4	33.2
6 Primary (noninterest) expenditure	41.9	39.7	40.2	45.7	39.8	39.6	36.5	34.3	34.5	34.3	33.8
7 Automatic debt dynamics 2/	-0.6	0.6	2.7	1.2	-0.5	-2.6	-3.1	-1.5	-0.6	-1.0	-1.1
8 Contribution from interest rate/growth differential 3/	-1.1	0.4	1.1	-0.3	-0.4	-0.4	-1.3	-1.5	-0.8	-0.9	-1.0
9 Of which: contribution from real interest rate	0.3	1.4	1.4	0.5	0.9	1.6	0.3	0.1	0.9	0.8	0.8
10 Of which: contribution from real GDP growth	-1.3	-1.0	-0.4	-0.8	-1.3	-2.0	-1.6	-1.7	-1.7	-1.8	-1.8
11 Contribution from exchange rate depreciation 4/	0.5	0.2	1.7	1.6	-0.1	-2.2	-1.9	0.0	0.3	-0.1	-0.1
12 Other identified debt-creating flows	-0.3	-0.4	0.2	-2.7	11.7	-13.9	-1.0	-3.6	-3.3	-6.1	-0.5
13 Privatization receipts (negative)	-0.6	-0.7	-0.3	-4.4	-3.7	-15.0	-1.0	-3.6	-3.3	-6.1	-0.5
14 Recognition of implicit or contingent liabilities	0.3	0.3	0.5	1.7	2.3	1.1	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	13.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	1.4	-2.0	5.1	-2.2	-9.6	7.3	2.9	3.6	3.1	6.2	0.6
Public sector debt-to-revenue ratio 1/	71.7	76.2	108.4	116.5	139.5	122.4	135.0	135.7	134.4	134.5	134.6
Gross financing need 5/ in billions of U.S. dollars	11.4	13.3	15.1	16.3	10.8	13.8	16.3	12.5	12.3	11.9	11.6
	2.4	2.9	3.0	3.2	2.2	3.3	5.1	4.3	4.4	4.6	4.9
Key macroeconomic and fiscal assumptions											
Real GDP growth (in percent)	5.6	4.0	1.3	2.2	3.3	4.4	4.0	4.0	4.1	4.2	4.3
Average nominal interest rate on public debt (in percent) 6/	8.2	10.7	11.8	7.8	7.9	7.7	7.4	6.5	6.1	5.1	4.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.5	5.5	5.4	1.4	2.5	3.8	1.1	0.5	2.3	2.1	2.0
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-8.5	-4.5	-15.7	-11.8	0.8	17.2	18.7	0.0	-2.8	1.0	1.0
Inflation rate (GDP deflator, in percent)	6.7	5.2	6.4	6.4	5.4	4.0	6.3	5.9	3.8	3.0	2.8
Growth of real primary spending (deflated by GDP deflator, in percent)	2.1	-1.7	2.7	16.2	-10.0	4.5	-7.2	0.1	4.8	3.5	3.0
II. Stress Tests for Public Debt Ratio											
0. Baseline							45.2	44.9	45.0	44.9	44.6
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07							45.7	47.1	48.6	50.1	51.5
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004							47.6	50.1	50.2	50.0	49.5
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							46.5	47.5	47.4	46.9	46.6
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004							51.6	58.4	58.4	58.0	57.3
5. Combination of 2-4 using one standard deviation shocks							50.5	56.8	55.7	54.3	52.7
6. One time 30 percent real depreciation in 2003 7/							53.9	53.3	53.3	53.0	52.5
7. 10 percent of GDP increase in other debt-creating flows in 2003							55.2	54.5	54.6	54.3	53.7
Historical statistics for key variables (1994-2002)											
		Historical Average		Standard Deviation				Average 2003-07			
Primary deficit		2.0		3.3				1.2			
Real GDP growth (in percent)		4.3		1.7				4.1			
Nominal interest rate (in percent) 6/		10.1		2.6				6.0			
Real interest rate (in percent)		3.2		2.0				1.6			
Inflation rate (GDP deflator, in percent)		6.9		3.1				4.4			
Revenue to GDP ratio		39.4		3.2				33.3			

1/ Consolidated general government gross debt, ESA 95 basis.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha(1+r)$.

5/ Defined as public sector deficit, plus (short-term and MLT) debt with a maturity of less than one year, at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Slovak Republic: Fund Relations

(As of April 30, 2003)

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

II. General Resources Account:	<u>SDR Million</u>	<u>%Quota</u>
Quota	357.50	100.0
Fund Holdings of Currency	357.50	100.0

III. SDR Department:	<u>SDR Million</u>	<u>%Allocation</u>
Holdings	0.85	N/A

IV. **Outstanding Purchases and Loans:** NoneV. **Financial Arrangements:**

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
Stand-by	07/22/1994	03/21/1996	115.80	32.15

VI. **Projected Obligations to Fund:** NoneVII. **Exchange Rate Arrangement:**

The Slovak Republic's exchange rate regime is a managed float with no preannounced path of the exchange rate. The currency of the Slovak Republic is the Slovak koruna, created on February 8, 1993 upon dissolution of the currency union with the Czech Republic. A single exchange rate applies to all transactions within the convertible currency area. The currency was floated on October 1, 1998. The exchange rate stood at Sk 36.509 per U.S. dollar and Sk 41.737 per euro on June 30, 2003.

VIII. **Article IV Consultation:**

Last consultation with the Slovak Republic concluded on August 9, 2002 (SM/02/239, July 26, 2002).

IX. **Technical Assistance:** See the attached table.X. **Resident Representative Post:** Mr. Costas Christou assumed the post in Bratislava upon its reopening in January 2002.

Slovak Republic: Technical Assistance, 1991–2003¹

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

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

Department	Timing	Purpose
	October 1997	Mission on monetary statistics compilation procedures, and classification of bank accounts in monetary statistics
	February 2000	Mission on pros and cons, and modalities of moving to an inflation targeting framework, operational issues (money markets and policy instruments), and dealing with potential problems posed by capital inflows for monetary operations
	December 2001	Long-term resident expert on banking supervision (still ongoing)
	February–March 2002	Financial Sector Assessment Program (FSAP)
	May 2003	Two missions on inflation modeling
FAD	February and July 1991	Advice on the design of new corporate and personal income taxes
	May and September 1991	Advice on policy and administrative aspects of the introduction of VAT
	Since December 1991	Regular visits by FAD consultant on VAT administration
	March 1992	Advice on administration (particularly VAT)
	April 1992	Examination of public financial management
	April 1993	Follow-up mission on public financial management
	May 1993	Mission on tax policy and administration
	June 1994	VAT administration, visit by expert
	March/April 1998	Tax and customs administration, and administration of social security contributions
	September/October 1999	Review macro fiscal management and system for monitoring and consolidating fiscal operations; review legislative and institutional setting for public expenditure management; and assess progress in establishing state treasury
	April 2000	Tax administration
	February 2001	Tax administration follow-up
	April 2001	Public finance management follow-up
	August 2001	Tax administration: installation of resident expert to advise on establishment of Large Taxpayer Unit (LTU)
	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

Department	Timing	Purpose
LEG	April and July 1991	Assistance with the drafting of new corporate and personal income tax laws
	October 1991	Assistance with the drafting of income tax and VAT laws
	January 1992	Assistance with the drafting of the tax administration law
	March 1992	Follow-up visit by consultant focusing on the income tax and tax administration laws
	May 1993	Assistance with revision of tax reform legislation
	September 1993	Assistance with income tax legislation
	May 1995	Assistance with drafting of the foreign exchange act, and acceptance of Article VIII obligations
STA	June 1991	Mission on government finance statistics
	September 1991	Mission on balance of payments statistics
	May 1993	Mission on monetary statistics
	December 1993	Mission on balance of payments statistics
	January 1994	Mission on government finance statistics
	February 1994	Mission on money and banking statistics
	November 1994	Mission on money and banking statistics
	November 1995	Mission on national accounts statistics
	November/December 1995	Mission on balance of payments statistics
	October 1997	Mission on money and banking statistics
	September/October 1998	Mission on Dissemination Standards Bulletin Board
	February 1999	Mission on money and banking statistics
	February 2000	Mission on national accounts and price statistics
	March 2001	Multisector mission
July 2003	Mission on government finance statistics	

SLOVAK REPUBLIC: STATISTICAL ISSUES

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

2. With regard to timeliness and public access, the authorities in general follow a free and open data publication policy. Data are promptly released to news services, and are also published regularly in various monthly and quarterly statistical publications, and on the Internet¹ according to a pre-announced schedule. Changes in definitions and coverage, however, often diminish the usefulness of published data. Data on core surveillance variables are provided regularly to the Fund, and with minimal lags: a week or less for exchange rates and foreign exchange reserves; three weeks or less for general government financing and detailed state budget implementation data; 10 days to a month for consumer prices, reserve money, broad money, and interest rates; two months for foreign trade data; and about three months for other fiscal, balance of payments, and national accounts data.

Real sector and prices

3. Significant progress has been made in the elaboration of the Slovak national accounts statistics. However, output estimates for the last few years may yet have to be revised in the future. The quarterly national accounts data on expenditures exhibit weaknesses and there was a significant statistical discrepancy between the supply side and the demand side (representing almost 1% of GDP in 2000).² An important outstanding issue is the construction of reliable price deflators for imports and exports that would enable better decomposition into volume and price changes. The unit value trade price indices—on which the national accounts trade price deflators are based—are published with long delays and are currently not appropriately adjusted for quality changes. The problem is recognized by the statistical authorities; however, improvement is still pending.

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

²In line with a staff recommendation, the Slovak Statistics Office has started publishing data on this discrepancy, which is no longer included in inventories. For 2002, the discrepancy is less than 0.3 percent of GDP.

4. In the area of consumer price indices, it is important that historical data are produced on the basis of the new basket for core inflation and total CPI.

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

6. In the enterprise sector, it would be very useful if the line ministries produced systematic accounts of the financial positions of the public enterprises under their purview. It would also be helpful if the authorities provided more detailed data on privatization transactions.

Fiscal sector

7. General government statistics are compiled annually in accordance with the methodology of the *1986 Manual on Government Finance Statistics (GFSM)* for internal use, publication in the *GFS Yearbook*, and dissemination on the MoF website in compliance with the SDDS. In accordance with the EU *acquis communautaire*, the authorities report semi-annually on general government net lending/borrowing. The March 2001 multi-sector STA mission recommended that the authorities implement the classifications and reporting concepts of the revised *2001 GFS Manual* in the new treasury system. In November 2002, the MoF requested technical assistance for the introduction of the *GFSM 2001* methodology. In response to the request, a GFS mission will visit Bratislava during July 2003 to undertake this task, and also to assist with the adoption of *ESA 95* statistical standards that are required for the presentation of the 2004 budget.

External sector

8. The Slovak Republic provides balance of payments statistics in a timely manner. The balance of payment statements are presented in two formats, an analytical presentation and the standard presentation, and are reported on a quarterly basis. Banks are now reporting their arbitrage transactions accurately. Improvements have also been made in reporting nonresidents' claims and liabilities in Slovak koruny. Information on external debt, including short-term debt, is reported on a timely basis. Weekly information on Gross International Reserves is reported timely via the reserves template. Moreover, the NBS has revised with effect from January 1, 2002 its methodology of reporting foreign exchange reserves. These changes are in line with IMF guidelines and STA technical recommendations and include the valuation of gold at market price and a change in the reporting of repo operations and gold swaps. Also, the reporting of foreign exchange reserves by commercial banks has been revised to include selected long-term assets in the item "foreign exchange reserves." Some problem areas remain, including: (i) the measurement of inward portfolio investment; (ii) the need for more detailed and timely information on publicly guaranteed external debt; and

(iii) the need to improve data compilation on the composition of exports. A March 2001 STA mission recommended the adoption of a conduct survey for obtaining data on transportation, travel, and direct investment, and provided model survey forms for this purpose.

Monetary sector

9. Monetary statistics are of good quality, and are reported on a timely basis to the Fund. A STA mission that went to Bratislava in March 2001 noted that data sources for monetary statistics are being progressively adapted to meet the European Central Bank requirements, including for the valuation of financial instruments based on fair values. In 2002, the NBS had implemented the mission's recommendations concerning the treatment of repurchase agreements, holdings of the NBS bills by commercial banks, and classification of SKA. It also reviewed the accuracy of data on the government's positions with the banking system. In addition to implementing the methodological recommendations for the current data, revisions of the historical data are also being carried out as far back as the available detailed information permits.

Slovak Republic: Core Statistical Indicators
(As of June 20, 2003)

	Exchange Rates	Gross International Reserves	Central Bank Balance Sheet 1/	Reserve/ Base Money	Broad Money	Interest Rates 2/	Consumer Price Index	Exports/ Imports	Current Account Balance	Government Balance	GDP/GNP	External Debt
Date of Latest Observation	6/20/03	6/18/03	5/30/03	4/30/03	4/30/03	6/20/03	5/03	4/03	03/03	5/03	Q1/03	02/03
Date Received	6/20/03	6/20/03	6/20/03	5/20/03	5/21/03	6/20/03	6/5/03	5/29/03	6/2/03	6/02/03	6/12/03	5/29/03
Frequency of Data 3/	D	W	M	M	M	D	M	M	M	M	Q	M
Frequency of Reporting 3/	D	W	M	M	M	D	M	M	M	M	Q	M
Source of Data 4/	N	A	A	A	A	N	N	N	N	A	N	N
Mode of Reporting 5/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 6/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 3/	D	W	M	M	M	D	M	M	M	M	Q	M

1/ In addition to the complete balance sheet published monthly, three times per month a 10-day return is published.

2/ Interbank rates. Deposit and lending rates are reported on a monthly basis. T-bill and government bond rates are reported at issue.

3/ D=daily; W=weekly; M=monthly; Q=quarterly; O=other.

4/ A = Central bank, ministry of finance, or other official agency; N=official publication or press release.

5/ E = Electronic data transfer.

6/ C = Unrestricted use.

Slovak Republic: Relations with the World Bank

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

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

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

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

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

Administration Reform Project. The project (€ 26.2 million) was approved in February 2002. Also, a Public Finance Reform Project and a Judicial Reform Project are underway, and a Health Sector Modernization Project (US\$60 million) is being appraised.

The Bank is also involved in analytical work to prepare Slovakia for joining the EU. In this regard, the Bank is carrying out several studies on accession impact, including a study on strategy and policy issues in agriculture. In parallel, in 2002 the Bank prepared a Development Policy Review (DPR), which articulated an integrated development agenda including policy priorities, and sequencing of key reforms taking into account linkages across sectors and policy areas. The document provided an integrated overview of medium-term policy issues to the government as Slovakia approaches the EU.

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

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



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 03/94
FOR IMMEDIATE RELEASE
August 5, 2003

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

IMF Concludes 2003 Article IV Consultation with the Slovak Republic

On July 23, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Slovak Republic.¹

Background

Slovakia has emerged as one of the fastest growing European Union accession countries over the past two years against the backdrop of successful macroeconomic management and structural reforms since the late 1990s, including the curtailment of quasi-fiscal activities and restructuring and privatization of public sector enterprises; improvements in fiscal transparency and control; and inflation reduction. Lower trade barriers, substantial foreign direct investment, and financial sector reform added further impetus to growth. Recent reforms have culminated in an invitation to join the EU in May 2004, which was then ratified by a national referendum held in May 2003.

Despite significant progress, the Slovak economy continues to be hampered by structural weaknesses and related macroeconomic imbalances. The unemployment rate remains very high, both absolutely and by regional standards; large fiscal deficits have persisted; and substantial external imbalances have re-emerged since mid-2001.

Having won a second term in the September 2002 elections, the government of Prime Minister Dzurinda declared its intention to address these weaknesses through accelerated fiscal consolidation and structural reforms covering the tax system, the benefits system, pensions, labor markets, and the judiciary. The government and the National Bank of Slovakia (NBS) have also announced their intention to meet the requirements for euro adoption by 2006.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The economic expansion gained momentum in 2002 in the context of low core inflation and improving external accounts, but a widening fiscal deficit. Real GDP grew by a robust 4.4 percent, led by strong household consumption. Core inflation was only 1.9 percent at year-end, well below the indicative benchmark of the NBS. A combination of strong real export growth and declining import growth rate helped a slight narrowing of the current account deficit to 8.2 percent of GDP, while the general government deficit exceeded 7 percent of GDP (ESA95 basis). Foreign direct investment was a record 17 percent of GDP in 2002, owing largely to the sale of the state gas monopoly.

Buoyant—although slowing—economic activity so far in 2003 reflects a shift away from consumption, towards investment and exports. Indeed, despite the slowdown in Europe, exports continued to accelerate, led by strong expansion in the automotive sector. Price deregulation and indirect tax hikes have curtailed household consumption and fueled a rise in headline inflation to 8½ percent at end-June—but core inflation remained low, at 3 percent. Also, fiscal retrenchment was initiated in the context of a 2003 budget that targets a 2 percentage point reduction in the general government deficit from 2002.

Unemployment remained stubbornly high through end-2002, reflecting mainly structural factors including skills mismatches, regional disparities, high social contribution rates, and a benefit system that creates disincentives to work. But the registered unemployment rate fell by 3 percentage points in the first six months of the year, to less than 15 percent, reflecting a tightening of eligibility requirements and buoyant economic activity.

Since the fall of 2002, monetary policy has been challenged by the increasing conflict between reducing inflation and containing speculative capital inflows. The NBS has resorted to foreign exchange market intervention—most recently in May 2003—and cut interest rates by 150 basis points in November 2002. It has indicated its readiness to reduce interest rates further if warranted by market developments.

Executive Board Assessment

Executive Directors commended the Slovak authorities for their successful implementation over the past few years of policies that have resulted in brisk economic growth, falling unemployment, and notably resilient exports despite weak growth in Slovakia's major trading partners. The government's skillful economic management and commitment to reform have contributed to a major improvement in the perception of the Slovak economy abroad, and the recent announcements of major Foreign Direct Investment (FDI) projects have further bolstered the outlook for continued productivity gains, strong growth, and progress toward EU convergence.

Directors nevertheless agreed that, to sustain this favorable outlook, the authorities will need to take further decisive action to address the still-high unemployment, achieve a sustainable fiscal deficit reduction, and promote a further narrowing of the external current account deficit. They welcomed the government's wide-ranging reform agenda to address these challenges, and noted that full implementation of this ambitious agenda will also be key to prepare Slovakia's entry into the EU. They encouraged the authorities to build on the outcome of the recent

referendum on Slovakia's EU membership and on its prospective accession in 2004 to press ahead with their reform plans.

Directors emphasized that fiscal consolidation to increase national savings, improve the policy mix and reduce external imbalances should remain the top priority in the period ahead. They supported the authorities' plan to meet the Maastricht deficit criterion of 3 percent of GDP by 2006 as well as their intermediate objective to reduce the general government deficit to 5 percent of GDP in 2003. They urged the authorities to pursue steadfast policy implementation to avoid future fiscal slippages, and to carefully design and sequence the expenditure and revenue measures needed to help achieve the fiscal objectives.

Directors agreed that fiscal consolidation will hinge on expenditure reduction. They supported the authorities' plans to streamline health sector and welfare spending, and urged them to continue to seek savings in other areas. Directors stressed the importance of reducing public employment and of a prudent wage policy, including to help ensure economy-wide wage discipline and continued competitiveness. Carefully prioritized expenditure reductions will also be essential to create room for the infrastructure development needed to support real convergence to EU living standards. Directors encouraged the authorities to carry on with their plans to develop a comprehensive medium-term expenditure framework to support progress towards their fiscal objectives and ensure spending discipline at all levels of government.

Directors agreed that the forthcoming tax reform will support economic performance, reduce distortions and improve tax administration and compliance through enhanced transparency and simplicity. Given the uncertainties surrounding the revenue impact of the reform, Directors urged the authorities to stand ready to take all necessary measures to achieve their fiscal targets should downside risks to revenue materialize. They were encouraged that the authorities already demonstrated their commitment in this regard. Some Directors suggested close monitoring of the distributional impact of tax reform proposals.

Directors highlighted the importance of pension reform for underpinning a sustainable fiscal position in the longer term. They recognized that the authorities face a difficult decision on whether to introduce a mandatory, funded pillar to the pension system given the potential implications for the timely observance of the Maastricht deficit criterion. Directors encouraged the authorities to press ahead in any event with the reform of the existing public pension system. The priority should be to achieve a sufficiently ambitious increase in retirement ages and to strengthen the relationship between benefits and contributions.

Directors commended the NBS for its skillful management of monetary policy, with core inflation remaining low notwithstanding increases in administered prices and indirect taxes. They noted that monetary policy will continue to face a delicate balancing act between further progress on disinflation and the need to safeguard competitiveness in the face of surges in capital inflows, without leaning against exchange rate appreciation that would be in line with economic fundamentals. Given the still relatively high level of headline inflation, some Directors suggested that priority should be given to further disinflation efforts. Directors welcomed the NBS's efforts to improve inflation forecasts, which would support a more forward-looking monetary policy with greater emphasis on core inflation benchmarks. They also stressed that closer coordination

between the government and the NBS on public communications would help guide market expectations.

Directors welcomed the authorities' strategy for euro adoption, and saw their plans to meet the Maastricht criteria by 2006 as feasible. They stressed, however, that this will require the full implementation of the planned fiscal consolidation and structural reforms to ensure that the Maastricht criteria are met in a sustainable manner prior to the adoption of the euro. Directors therefore encouraged the authorities to continue to make strong progress on their structural reform agenda. In particular, they saw a need for further efforts to enhance product and labor market flexibility and improve the benefits system, to address the still-high unemployment, reduce regional disparities, and facilitate the adjustment of the economy to adverse shocks.

Directors also stressed the importance of continued efforts to strengthen the resilience of the financial sector against the possibility of increased capital flows. They welcomed the recent strengthening of banking supervision—including the reorganization of the NBS's banking supervision department—and the increased cooperation among financial market regulators, and encouraged the authorities to implement fully the Supervisory Development Plan to improve on-site and off-site banking supervision.

Directors commended the authorities' focus on developing entrepreneurship, including recent efforts to comply with the Organization for Economic Cooperation and Development anti-bribery convention. They welcomed the progress made on improving the quality of economic statistics, increasing transparency, and complying with international standards, including in the areas of fiscal transparency and management. They looked forward to further improvements in line with the original Reports on the Observance of Standards and Codes recommendations.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with the Slovak Republic is also available.

Slovak Republic: Selected Economic Indicators

	1999	2000	2001	Prel. 2002
	(Percent change, period average)			
Real sector				
Real GDP	1.3	2.2	3.3	4.4
Consumer prices				
Period average	10.7	12.0	7.3	3.3
12 months to end of period	14.2	8.4	6.6	3.4
Gross industrial output (constant prices)	4.1	8.6	7.0	6.6
Real wages in industry				
PPI-based	4.0	0.4	4.1	4.4
CPI-based	-2.8	-2.9	2.9	4.0
Employment in industry	-3.0	-3.0	1.0	0.2
Unemployment rate, period average	17.5	18.2	18.3	17.8
Real effective exchange rate 1/				
CPI-based	-2.5	11.0	0.3	0.2
ULC-based	-14.1	1.6	0.3	-2.4
	(In percent of GDP)			
General government finances				
Revenue	37.0	37.9	35.7	36.2
Expenditure 2/ 3/	40.2	41.8	39.8	40.7
Balance 3/	-3.3	-3.9	-4.1	-4.5
Net borrowing, ESA 95 basis	-6.4	-10.7	-7.3	-7.2
	(Percent change, end of period, unless otherwise indicated)			
Money and credit				
Net domestic assets 4/	9.5	6.2	16.5	-13.0
Credit to enterprises and households	4.6	4.5	5.3	12.1
Broad money	11.4	15.5	11.8	3.4
Interest rates (in percent, end-of-period)				
Lending rate (short-term)	16.4	10.7	8.8	7.5
Deposit rate (one-week)	12.1	6.0	6.0	4.0
Velocity	-3.2	-5.8	-2.6	5.0
	(US\$ billion, unless otherwise indicated)			
Balance of payments				
Merchandise exports	10.2	11.9	12.6	14.4
(percent change)	(-4.6)	(16.1)	(6.4)	(13.7)
Merchandise imports	11.3	12.8	14.8	16.5
(percent change)	(-13.4)	(12.9)	(15.6)	(11.7)
Trade balance	-1.1	-0.9	-2.1	-2.1
Current account balance	-1.0	-0.7	-1.8	-1.9
(percent of GDP)	(-4.9)	(-3.6)	(-8.6)	(-8.2)
Official reserves, end-period	3.4	4.1	4.2	9.2
(in months of imports of GNFS)	(3.1)	(3.4)	(3.0)	(5.9)
(in percent of broad money)	(26.9)	(31.0)	(29.8)	(59.3)
Gross reserves of banking system	4.4	5.6	5.4	10.2
Gross external debt, end-period 5/	10.5	10.8	11.0	13.2
Gross external debt, end-period (in percent of GDP) 5/	52.2	54.9	54.0	55.7
Short-term debt (end of period) 6/ 7/	4.4	4.0	4.2	6.5
Short-term debt (end of period) 6/ 8/	2.7	2.4	3.1	4.2
Official reserves to short-term debt (in percent) 6/ 7/	78.0	102.0	100.5	140.6
Memorandum items:				
GDP, current prices (Sk billions)	835.7	908.8	989.3	1,073.6
Exchange rate (Sk/U.S. dollar)				
Period average	41.4	46.2	48.4	45.3
End of period	42.3	47.4	48.5	40.0
Public debt (in percent of GDP)	40.1	44.1	49.8	44.3

Sources: Statistical Office of the Slovak Republic; Ministry of Finance; National Bank of Slovakia; and IMF staff calculations.

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

2/ Includes net lending, excluding privatization proceeds.

3/ Excluding privatization proceeds, bank restructuring costs, and called guarantees.

4/ Includes deposits of Sk 61.4 billion in privatization receipts at the pension fund account at the NBS in 2002.

5/ Excludes domestic currency denominated debt.

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

7/ Short-term debt is defined including medium- and long-term debt due in the subsequent year.

8/ Short-term debt is defined excluding medium- and long-term debt due in the subsequent year.

**Statement by Willy Kiekens, Executive Director for Slovak Republic,
and Juraj Sipko, Assistant to Executive Director
July 23, 2003**

Introduction

The Slovak authorities thank the staff for their well-balanced assessment. They value highly the staff's insights and advice, and the exchange of views with the visiting consultation mission. In addition, the Fund's resident representative in Bratislava has been a source of invaluable advice, assistance, and support for the government's efforts, and has been particularly effective in helping shape the ongoing reform agenda. The Slovak authorities agree with most of the staff's views, including its assessment of Slovakia's present situation.

In September 2002 the newly elected reform-minded government announced that it would pursue fiscal consolidation and launched a vigorous and comprehensive program of structural reforms. The change in governments gave rise to changes in how the Slovak economy is perceived abroad, resulting in strong inflows of capital, an appreciation of the currency, and invitations for Slovakia to join the EU and NATO.

Slovakia's macroeconomic policy continues to concentrate on improving the fiscal position and keeping money tight. To stabilize the public finances and increase the efficiency and transparency of the government, the government has prepared—and is enacting—comprehensive reforms in all areas of public expenditure, including health, pensions, social benefits, education, energy, and transportation. These reforms will be complemented by an ambitious tax reform that should come into force on January 1, 2004.

With an eye to EU accession, the Ministry of Finance and the National Bank of Slovakia (NBS) have prepared, and the government has approved, a joint strategy for joining ERM-2 and adopting the euro as Slovakia's currency.

Real Sector Developments

Economic growth in 2002 was driven by booming private and government consumption, and by industrial exports, especially automobiles and electronics. Despite the continuing general weakness of external demand, exports to the EU (Slovakia's main trading partner) have increased in recent months, reflecting ongoing restructurings by foreign companies. Slovakia's present 4 percent GDP growth makes it the fastest growing of the advanced accession economies.

External Sector

The strong growth of Slovak exports, and the slowdown of consumption-driven imports (partly due to the sharp increase in administered prices in early 2003, which reduced households' disposable income), are helping reduce Slovakia's current account deficit to more sustainable level. The authorities expect that the current account deficit will continue to narrow faster than projected by the staff. Continued significant inflows of capital, exports of

foreign-controlled firms, and large numbers of greenfield projects coming on stream, will promote further export growth and continue to reduce the current account deficit.

Monetary Policy

Monetary policy has been tight ever since Slovakia's last Article IV consultation. Headline inflation fell in 2002, as the prices of food and imported energy declined and adjustment of regulated prices to cost-recovery levels was postponed. However, price deregulation efforts in preparation for EU accession caused headline CPI inflation to jump from 3.4 percent in 2002 to 8.4 percent year-on-year in June 2003. If these administrative price effects and tax changes are excluded, core inflation has remained low at 3.1 percent year-on-year in June, indicating that underlying inflationary pressures remain subdued.

As already noted, the koruna began to appreciate strongly after last September's elections. The NBS intervened in the foreign exchange markets and cut interest rates by 150 basis points last November, to discourage speculative capital from entering Slovakia, finally succeeding in stabilizing the currency. But the koruna again began to appreciate after the approval of EU accession by last May's referendum. The NBS as made public its intention to take any appropriate action, including reducing interest rates further, to resist the appreciation of the koruna that is not justified by economic fundamentals.

Fiscal Policy

The authorities agree with the staff on the need for fiscal consolidation. To this end, the Ministry of Finance has adopted a medium-term consolidation strategy that is consistent with the Pre-Accession Economic Program (approved recently by the Government and due to be submitted to the EU very soon). The authorities are planning to reduce the general government deficit to below 3 percent of GDP by 2006, which will satisfy the Maastricht convergence criterion for the fiscal deficit. To accomplish this, they are embarking on ambitious expenditure reforms. Advice from a recent mission from the Fund's Fiscal Affairs Department has been very helpful in this regard. Moreover, this advice is being usefully complemented by ongoing World Bank assistance on improving expenditure management—which should strengthen Slovakia's ability to use public resources more efficiently—in the context of the Public Finance Management Project.

The authorities have also prepared an ambitious tax reform, which, as described by the staff, is based on unified flat tax rate of 19 percent for corporate and personal income taxes, which virtually no exemptions. This will be simple, effective, and fair, and by creating a more attractive environment for both domestic and foreign investors, will promote economic growth. On July 10, the parliament approved a unified VAT rate of 19 percent, and expected to approve the remainder of the proposed tax legislation soon.

The authorities expressed their commitment to adopt additional measures as needed to reach the fiscal target if revenue is lower than expected. And indeed, the revenue shortfalls during the first half of this year prompted parliament to approve, on July 10, not only the 19 percent VAT, but also significant increases in excise taxes on tobacco and cigarettes, gasoline,

and beer, in order to close this gap; all these increases in excises are becoming effective on August 1. The Slovak authorities feel confident that they will be able to meet this year's deficit target of 5 percent of GDP.

Restructuring and Privatization

The private sector's share in the economy is around 90 percent. After the very successful completion of the privatization of the majority of the banking sector, and sales of controlling stakes in the gas company and electricity distribution companies, the authorities are now finalizing the privatization of Slovakia's electricity producer.

To help the restructuring of the enterprise sector and to increase the flexibility of bankruptcy procedures, the authorities intend to establish a new legal framework instead of trying to modify the existing bankruptcy laws.

The Banking Sector and its Supervision

Supported by the Enterprise and Financial Sector Adjustment Loan (EFSAL) and in accordance with the recommendations of the World Bank, the NBS has made major changes in its supervision of the banking sector. The Supervision department was reorganized and the implementation of the Supervisory Development Plan is underway.

The process of privatizing the banking sector is in its final stages. In May 2003, 60 percent of the equity of the Bank of Slovakia was sold to Meindl Bank AG Vienna, and the last publicly owned bank, Postova Banka, will be privatized soon. After that the banking sector will be fully privatized, with almost all banks in the hands of foreign companies.

Pension Reform

The authorities consider pension reform to be among the most urgent issues on their present agenda. In April this year the government approved a Strategy for Pension Reform, with three pillars. The reform of the first pillar, the pay-as-you-go system, is now under discussion at Parliament, and it includes an increase in the retirement age to 62 years for both men and women, and a change in the pension adjustment formula. The government is also working on the introduction of a second, fully-funded pillar, and it expects to approve relevant legislation later this year; it is now envisaged that the second pillar be in place in January 2005. At the same time, there exists a third pillar, which consists of employee's savings.

Health Care Reform

Amendments of the Health Care Act have been introduced recently that have started to reform the health care system. The authorities' intention is to complete the new system by January 1, 2004. The main goals of this reform, which include the introduction of co-payments for medical services and pharmaceuticals, are to contain the further accumulation of arrears by health providers, increase the effectiveness of health insurance, and improve the quality and efficiency of health care providers. The authorities are pursuing this strategy with the close

cooperation of the World Bank, which will provide a Health Sector Modernization Support Sectoral Adjustment Loan.

Unemployment

Although the unemployment rate has fallen from 17.8 percent in 2002 to 14.8 percent in June 2003, unemployment remains a major concern. In April 2003, the government approved a Strategy for Promoting Employment which introduced changes in the social system and the labor market. The authorities are preparing a legal framework to make these changes effective on January 1, 2004. This strategy is linked to other newly adopted reform measures in taxes, pensions, and public services, as well as social allowances, and increased flexibility in the labor market. Regarding the latter, parliament approved major amendments of the labor code that greatly facilitates job creation, reduces rigidities in the labor market, and improves reallocation of labor in response to structural changes in the enterprise sector.

Conclusion

The authorities are confident that the positive trends in the Slovak economy will continue. The latest data clearly show that the real economy is growing and moving toward a sustainable path. The authorities recognize that many challenges lie ahead; one of the most important ones is the achievement of fiscal sustainability required by the Maastricht convergence criterion. Intensive work is currently underway to reform the public finances (both the revenue and the expenditure sides) to ensure that fiscal consolidation is sustainable. At the same time, the monetary authorities are going to ensure the continuation of disinflation. Overall, the authorities are determined to prepare the Slovak economy very well so that it can maintain its competitiveness in the world's largest market—that of the EU countries.