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Slovak Republic: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for 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 2004 Article IV consultation with the Slovak Republic, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 10, 2004, 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 January 26, 2005. 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 February 11, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Slovak Republic.

The documents listed below have been or will be separately released.

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

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

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

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INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

Staff Report for the 2004 Article IV Consultation

Prepared by Staff Representatives for the
2004 Consultation with the Slovak Republic

Approved by Robert A. Feldman and Anthony Boote

January 26, 2005

The 2004 Article IV consultation discussions were held in Bratislava during October 27–November 10. The team, headed by Mr. Fernández-Ansola, included Mmes. Choueiri and Oomes, and Mr. Moore (all EUR). Mr. Sipko, Advisor to Mr. Kiekens (Executive Director), attended several meetings. The mission met with Deputy Prime Minister and Minister of Finance Mikloš; Governor Jusko and Vice-Governor Kohútiková of the National Bank of Slovakia (NBS); other senior officials; and representatives of parliament, trade unions, financial institutions, and foreign investors.

The Slovak Republic has accepted the obligations of Article VIII, and maintains an exchange rate system free of restrictions (Appendix I).

The Slovak Republic joined the European Union (EU) on May 1, 2004. The center-right coalition government in power since 2002 has a slight minority in parliament. The next general election is due in September 2006. The authorities have announced their intention to adopt the euro in 2009.

In concluding the last Article IV consultation on July 23, 2003, Directors commended the government's skillful economic management and commitment to reform. Directors agreed that to sustain Slovakia's favorable outlook the authorities will need to address still-high unemployment and achieve a sustainable fiscal deficit reduction. They welcomed the government's wide-ranging reform agenda to address these challenges, and noted that its full implementation would be key to prepare Slovakia's entry into the EU.

The mission updated the Report on Standard and Codes (ROSC) fiscal transparency module. The Slovak Republic meets the Special Data Dissemination Standard (SDDS) specifications. Data in this report reflect information received by January 10, 2005.

In compliance with OECD conventions, Slovakia has adopted legislation that tightened penalties for bribery offenses and money laundering, and adapted domestic accounting rules and auditing principles to international standards.

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

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Executive Summary

Background. Fueled by a strong recovery in domestic demand, continued export strength, and productivity growth, real GDP expanded by an estimated 5¼ percent in 2004, a rate above trend. However, employment stagnated, and the unemployment rate remained at 17¾ percent—of which two-thirds is long term. Meanwhile, headline inflation remained high (about 6 percent at end-2004), driven by administered price and indirect tax increases. The external current account deficit widened from 1 percent of GDP in 2003 to an estimated 3 percent in 2004. This is well within sustainable limits and largely reflected dividend repatriation. The fiscal deficit is estimated to have expanded to 3.8 percent of GDP.

Outlook. Growth is expected to remain close to 5 percent in 2005–06, slightly above potential. Although domestic demand remains a key driver of growth in 2005, large investments in export-producing companies provide good prospects for vigorous balanced growth. On present trends, staff expects headline inflation to approach 4 percent in 2005, at the top end of the central bank's target range (3.5 ±0.5 percent). The current account deficit should widen temporarily to about 5 percent of GDP in 2005, owing to strong consumption and investment-related imports. These imports will expand export capacity: accordingly, the current account deficit is projected to be below 2 percent of GDP in 2007–08.

Policy discussions

Monetary policy: Policies are under pressure from large capital inflows despite strong appreciation of the koruna and large cuts in interest rates. Staff recommend a tightening of fiscal policy to contain the risks of overheating, but given the upside risks to inflation and the strong external competitiveness position, argue for a flexible approach to the exchange rate in pursuing disinflation.

Fiscal policy: The fiscal stance, which turned expansionary in 2004, is set to remain so in 2005. While accepting that the 2004 stimulus was timely, with the economy growing above potential in 2005, staff emphasize the desirability of accelerating and deepening fiscal consolidation, particularly in light of the backloading of fiscal adjustment under the authorities' three-year fiscal framework and the upside risks to inflation. The authorities were confident that strict implementation of their policies would be consistent with their fiscal targets and macroeconomic objectives.

Structural policies: The authorities instituted a strong set of structural reforms in 2004. Structural factors still to be addressed include reforming the education system to keep up with evolving labor market demands, promoting labor mobility, developing infrastructure to connect the less developed areas to the rest of the country, and reducing the tax burden on labor.

I. Key Issues

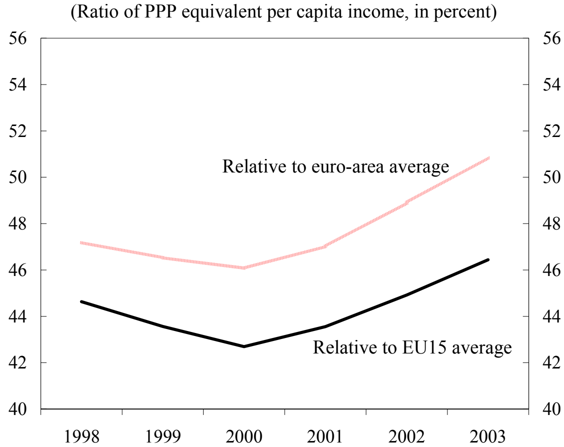
1. **Slovakia's economic performance is benefiting from good policies**. This performance has been favorable compared to regional standards (text table). Output and productivity have expanded strongly. Employment has also grown, and unemployment—though still high—is down from its peak. Although inflation remains high, fiscal and external deficits have narrowed substantially in recent years. These developments reflect sound macroeconomic management, large foreign direct investments, and an improved business climate following important reforms that are supporting convergence to western European income levels (Box 1 and text chart). At end-2003 Slovakia already complied with two Maastricht criteria for euro adoption (text chart). Slovakia's policies are also generally in line with previous Fund advice, notably on fiscal policy (Box 2).

Economic Performance: Selected New EU Member States
Average, 2003-04

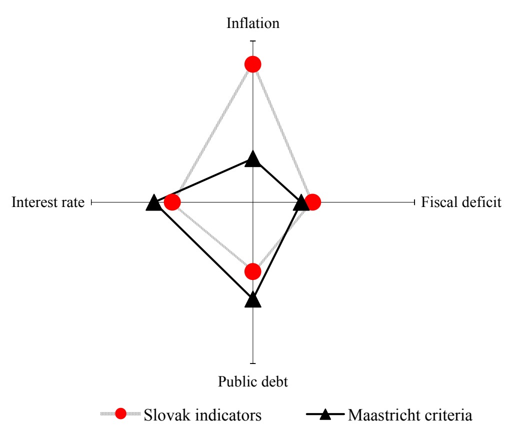
	Real GDP growth (%)	CPI inflation (%)	Employment growth (%)	Productivity growth (%)	FDI (% of GDP)
Slovakia	4.9	8.0	0.9	3.9	2.5
Other Visegrad 1/	3.7	3.2	0.2	3.5	2.3
Of which:					
Czech Republic	3.2	1.7	-0.1	3.4	3.1
Hungary	3.2	5.8	0.0	3.2	1.9
Poland	4.6	2.2	0.8	3.9	2.0

1/ Average of Czech Republic, Hungary, and Poland.

Slovak Republic: Income Convergence to Western Europe
(Ratio of PPP equivalent per capita income, in percent)



Slovak Republic: Position Relative to Maastricht criteria
(end-2003)



Box 1. Slovakia's Reforms

The government that took office in late 2002 has significantly accelerated the reform process. Building on earlier progress in privatization and financial sector restructuring,[1] the government has implemented an ambitious agenda in its first two years:

- *Tax reform:* from 2004, featuring a single rate of 19 percent for VAT, personal and corporate income tax. The reform also widened the tax base by eliminating most exemptions.
- *Welfare reform:* in 2003, measures to reduce abuse of social benefits; and in 2004, a mixture of benefit cuts and increased linkages to job search efforts, to improve incentives to work.
- *Pension reform:* legislation to increase retirement ages (first increases in 2004), tighten link between future benefits and contributions, and introduce a second funded pillar from 2005.
- *Health reform:* co-payments on health services were introduced in 2003; and parliament recently approved legislation comprehensively restructuring the health sector.
- *Labor market reform:* in 2003, an inflexible labor code (introduced under the previous government) was amended to remove many restrictions on overtime and work practices.

[1] Major privatizations included the banks, the gas company, and the regional electricity distribution companies.

Box 2. Policy Implementation and Past IMF Recommendations

Monetary Policy: In 2003, Fund staff advised the NBS to improve communications to support disinflation efforts. *The NBS has improved inflation forecasts, and has recently announced steps to strengthen guidance on inflation expectations by adopting explicit inflation targets*.

Policy mix and fiscal consolidation: Fund staff advised the authorities in late 2002 to reorient the policy mix towards tighter fiscal policy and easier monetary policy given large capital inflows. Recent Article IV consultations also emphasized the need for fiscal adjustment to increase national savings and reduce external imbalances. *The fiscal deficit has declined since 2002, which has supported successive interest rate cuts by the NBS, and national savings have increased significantly. While fiscal policy was expansionary in 2004, the resulting stimulus was in line with the 2004 budget and partly justifiable by cyclical considerations: domestic demand contracted in 2003 and the prospects for its recovery, even in early 2004, appeared dim (but turned out better than expected).*

Medium-term fiscal framework: In the 2003 consultation, the Fund supported the authorities' intentions of developing a comprehensive medium-term expenditure framework to help achieve their fiscal objectives. *The 2005 budget introduces multiyear budgeting; Slovakia's Convergence Programme*[1] *also details medium-term expenditure policy intentions.*

Social spending reform: In 2003, the Fund recommended streamlining health sector and welfare spending, and encouraged reform of the public pension system—though recognizing that introducing a mandatory, funded pillar to the pension system could complicate efforts to meet the Maastricht deficit criterion. *The government has implemented reforms in each of these areas (Box 1).*

Labor and product market reforms: Past Fund advice welcomed the restructuring and privatization of the main banks and utilities, but stressed the need to raise productivity and growth prospects by removing remaining labor market rigidities and improve the business environment. *Box 1 notes the labor market reforms implemented.*

[1] Prepared as a requirement of EU membership.

2. **Slovakia's economic performance has strengthened further since the 2003 Article IV consultation**. Growth has been strong despite cyclical weakness in Europe and increasing oil prices, and core inflation and the external current account deficit have been contained (Figures 1 and 2). Economic activity, which was entirely export-driven in 2003, broadened to the domestic sector in 2004, supported by a modestly expansionary fiscal policy (Tables 1–3). Interest rates were reduced in steps throughout the year by a cumulative 200 basis points, initially to encourage domestic demand but more recently in response to strong appreciation pressures. Yet, as shown by the monetary conditions index in the monetary policy section below, monetary conditions still tightened somewhat, as the koruna appreciated by over 6 percent against the euro in 2004. Despite the strong economic performance, employment gains have been uneven across sectors and small overall, leaving unemployment high.

3. **Looking ahead, Slovakia confronts the challenges of meeting the Maastricht criteria on inflation and the fiscal deficit, while maintaining high growth and increasing employment**. The inflation rate, though falling, is well above the euro-area average and bringing it down to the Maastricht level will require further effort, especially in light of continued rapid wage growth. The fiscal deficit remains substantial and consolidation will become more difficult, given the costs of some reforms, the election cycle, and EU expenditure commitments. Further, income convergence to western European levels calls for maintaining the course of structural reforms.

4. **The discussions thus focused on three policy issues:**

- First, **dealing with the tensions between disinflation and containing real appreciation**. The authorities target inflation at 3.5 percent in 2005, but there may be upside risks. Given these risks, the role of exchange rate flexibility in achieving inflation objectives was explored.

- Second, **ensuring an appropriate speed and path of fiscal adjustment**. The fiscal deficit should decline, both for medium-term considerations and to support monetary policy in bringing down inflation. In particular, the current three-year budget may need to be more ambitious about the 2007 target (3 percent of GDP), which would call for sequencing adjustment in a way that eliminates the current back-loading and strengthening the expenditure framework to enhance fiscal policy credibility.

- Third, **reducing unemployment and sustaining growth**. Ensuring strong job creation and noninflationary growth calls for maintaining structural reform momentum.

II. The Discussions

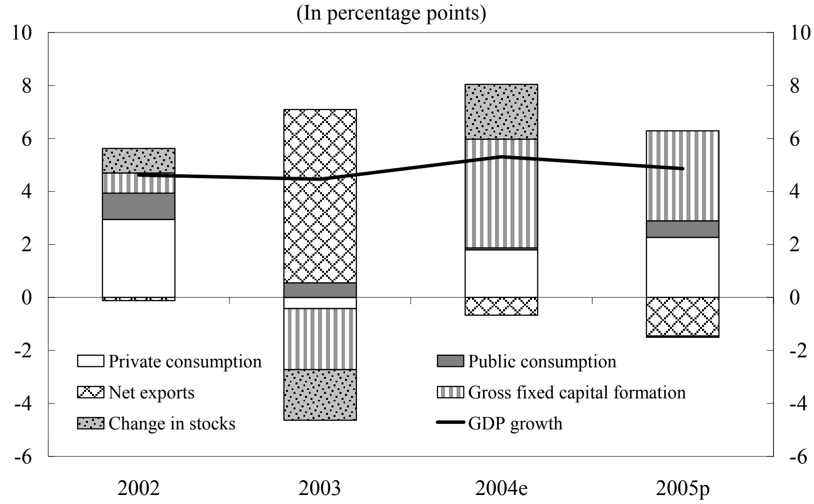
A. Recent Developments and Outlook

5. **After slowing slightly in 2003, the economy grew robustly in 2004** (Tables 1–2). Real GDP expanded by an estimated 5¼ percent, a rate above trend. The upswing reflected a strong domestic demand recovery as well as continued export strength, and was supported by stimulative fiscal policy, strong household credit growth, and record high nonprivatization FDI. The external current account deficit widened to an estimated 3 percent of GDP, compared with 1 percent of GDP in 2003 (Table 4), with the widening largely reflecting dividend repatriation. Nevertheless, the deficit remained well within sustainable bounds; indeed, export volumes grew by 13 percent as Slovakia continued to gain market share in Europe and competitiveness remained strong (see Figure 2). With growth largely driven by productivity gains, employment stagnated, and the unemployment rate therefore remained at 17¾ percent.[1]

6. **Growth is projected to remain close to 5 percent in 2005**. Both authorities and staff agreed that strong growth should continue, with demand shifting from external to domestic sources. In this regard, investment in new plant and equipment is projected to remain the main driver, with consumption—supported by real wage growth—continuing to grow strongly (text chart and Figure 3).

Slovak Republic: Contributions to GDP Growth

(In percentage points)



Calculations based on IMF staff projections.

[1] Based on the internationally comparable Labor Force Survey data. By contrast, the unemployment rate based on registered unemployment declined by 2½ percentage points in 2004, to 13 percent. These measures diverge because of conceptual and sampling differences.

7. **The strength of the economy has prompted an acceleration in wage growth and questions about the degree of slack**. The NBS estimated an output gap of 1½ percent below potential in 2004, against the staff's ½ percent—which was closer to the Ministry of Finance's estimate (Box 3). Although unemployment remains high, as much as two-thirds of it is long term. Private sector representatives noted evidence of specific skill shortages in some regions, and increased supply of these skills would require a pickup in earnings, implying slower disinflation. The NBS did not envisage the output gap closing over the projection period, and believed that on the whole, the pool of unemployed is sufficient to sustain expected growth without significant wage and inflation pressures.

8. **The external current account deficit is expected to increase, but to remain sustainable**. The authorities expected the external current account deficit to widen to about 5 percent of GDP in 2005, owing to strong consumption and investment imports—associated particularly with the construction of Peugeot and Kia car production plants. This widening would be temporary, as the rapid increase in investment imports would support an expansion in export capacity, thereby raising exports and driving the current account deficit below 2 percent of GDP in 2007–08. Moreover, throughout the projection period, the deficit would stay within sustainability boundaries—estimated by staff at 6 percent of GDP. Nonetheless, the authorities were concerned about adverse shocks, as the deficit is projected to come close to sustainable limits in 2005. While staff broadly concurred with the baseline projections, it saw the risks as less skewed than the authorities and more room to maneuver if risks materialize. Slovakia's economy is becoming more flexible, and thus more resilient to shocks. Even if the current account deficit exceeds somewhat projected levels in 2005–06, Slovakia would have no problems financing it. Under the baseline projection, the deficit is already almost fully covered by FDI, and additional financing, if needed, would be readily available.

9. **The near-term growth outlook is subject to balanced risks**. On the upside, a faster-than-anticipated increase in export capacity would raise export-led growth. Domestic demand could also be higher, if the cumulative interest rate cuts over the past 15 months stimulate demand more than projected. Downside risks are primarily external, including from a slower-than-expected recovery in EU demand or sustained high oil prices.

10. **There was broad agreement that medium-term growth prospects remain favorable, based on continued productivity gains**. Slovakia's recent strong economic growth has reflected productivity growth following large capital accumulation during 2001–02. Large investments—particularly in the car industry—have introduced advanced technologies that have greatly increased productivity. Expected

Decomposition of Real GDP Growth, 2000-09

	Actual		Potential	
	2000-04	2005-06	2005-06	2007-09
Real GDP growth	4.0	4.9	4.8	4.5
Contribution to growth:				
Labor	0.2	0.5	0.4	0.5
Capital	0.1	0.4	0.4	0.5
TFP	3.8	4.0	4.0	3.5

Calculations based on IMF staff projections.

Box 3. Slovakia's Output Gap

The output gap is measured as the difference between actual and potential output in percent of potential output, with a negative number indicating a level of output below potential. Estimating the output gap therefore requires an estimate of potential output, an unobserved variable.

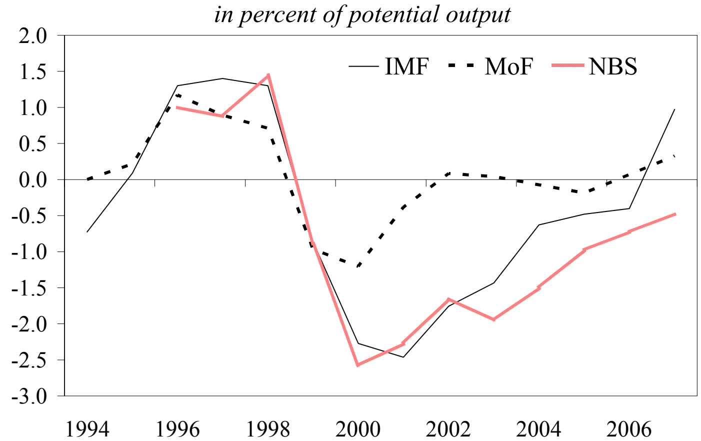
The NBS measures Slovakia's potential output from a multivariate Kalman filtering model with unobserved components that jointly estimates potential output, and equilibrium interest and exchange rates. This approach combines statistical filtering techniques with macromodeling. An adjustment is made to potential output to reflect (i) a permanent shock in 2003 from Volkswagen's new production line of Touareg vehicles and (ii) a temporary shock in 2004Q1 from the leap year effect—the latter estimated at 1 percent year-on-year in the first quarter. Based on this methodology, the NBS finds a negative output gap of 1.5 percent in 2004.[1]

The Ministry of Finance estimates potential output using a production function where inputs are the existing capital stock and potential labor. Employment time series data were filtered using the Hodrick-Prescott filter to derive an estimate for potential labor, while capital stock estimates were obtained from National Accounts data. Assuming a labor-elasticity of output of 47 percent, the results point to a negative output gap of 0.1 percent in 2004.

Like the Ministry of Finance, staff estimates potential output using a production function approach[2], but with somewhat different estimates of potential labor, capital stock and labor-elasticity of output. Therefore, staff finds that the output gap in 2004 is a negative 0.6 percent of potential output.

Slovak Republic: Output Gap Measures

in percent of potential output



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[1] The NBS calculations of the output gap will be published in a paper forthcoming in 2005.

[2] See the background paper on potential growth and the output gap in Slovakia for more details.

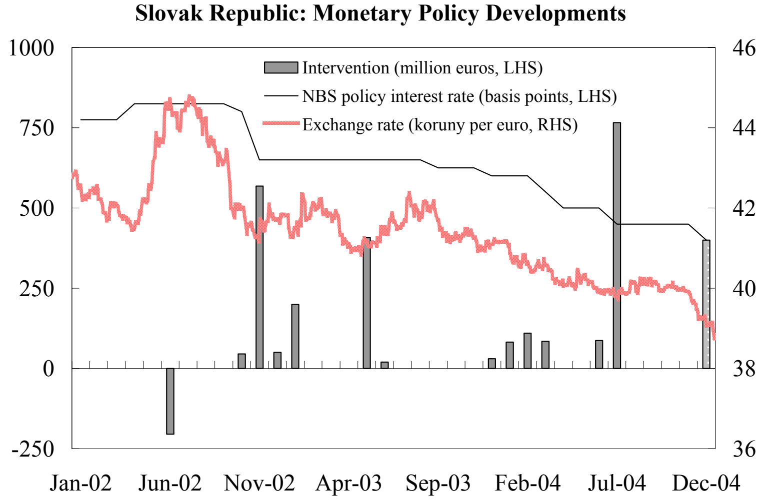
domestic and foreign investment should result in further capital deepening and in technological enhancements that sustain total factor productivity growth (text table). Assuming TFP growth of about 3½ percent in the medium term—a rate similar to that observed in the past four years—Slovakia should be able to grow at around 4½ percent.

11. **In a context of strong growth potential, risks associated with public and external debt accumulation are contained** (Tables 7 and 8). External debt is projected to decline from 45 percent of GDP in 2004 to 28½ percent of GDP in 2009, mainly reflecting strong non-debt creating inflows in 2005–06 and a decline in the current account deficit in 2007–09. Various stress tests—assuming higher external interest rates, lower GDP growth, or xchange-rate depreciation—indicate that Slovakia's external debt dynamics remain manageable, with the debt level generally remaining below 60 percent of GDP under most adverse scenarios. Also, Slovakia's public debt is projected to decline to about 42 percent of GDP by 2009, thereby remaining sustainable in the medium term. Under various adverse scenarios—such as slippages in fiscal adjustment, or adverse growth or interest rate developments—public debt could rise by up to 14 percentage points of GDP but would remain below the Maastricht limit of 60 percent of GDP.

B. Monetary Policy

12. **The NBS cut interest rates and intervened substantially in the foreign exchange market in 2004** (text chart). The NBS reduced its main policy rate by a cumulative 200 basis points in the year through September (the month prior to the Article IV mission), initially in response to weak domestic demand, and later to contain the sharp rise in short-term capital inflows. The NBS also conducted extensive foreign exchange market interventions, enlarging its balance sheet and increasing the extent of its sterilization operations. By end-September, the NBS's sterilization position amounted to twice the monetary base and was costing about 1 percent of GDP annually. The exchange rate moved in a narrow range in the twelve months through September, as the koruna appreciated by about 3 percent against the euro.

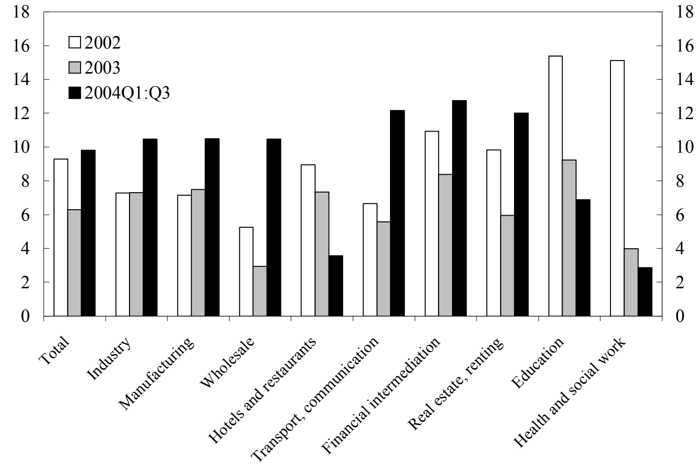
Slovak Republic: Monetary Policy Developments



13. **Inflation is expected to fall in 2005**. The 12-month core inflation[2] rate reached 1½ percent at end-2004, down from 2¾ percent at end-2003, largely reflecting falling food prices (Figure 1). Headline inflation remained high (about 6 percent at end-2004, against 9⅓ percent at end-2003), driven by administered price and indirect tax increases, but should fall in 2005 as these one-off effects wane (text chart). The NBS targets 3.5 percent for headline inflation with a ± 0.5 percent range at end-2005.

Slovak Republic: Nominal Wage Growth By Sector

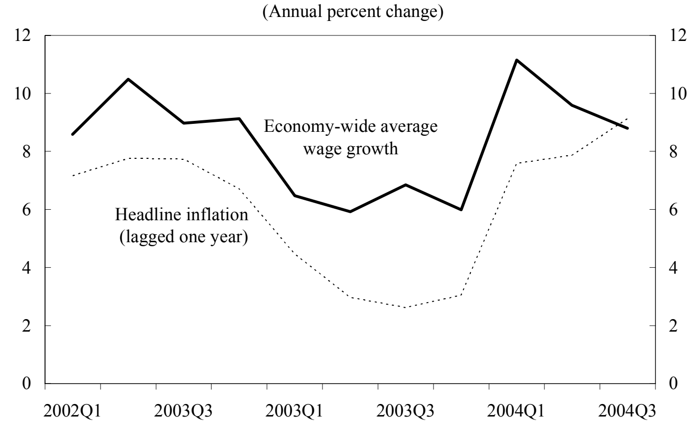
(average annual percent change)



14. **Several factors suggest that inflation risks are skewed to the upside**: (i) nominal wage growth was rapid in 2004 (text chart) and threatens to remain high in 2005, given backward-looking wage-setting behavior. Indeed, the correlation between lagged inflation and wages is 85 percent for the period 2002–04 (text chart), and this number is robust to shortening the series by up to six months; (ii) low food-price inflation might not persist in 2005, because it partly reflected a very good harvest that may not be repeated; (iii) the output gap is closing rapidly owing to rising domestic demand (see Box 3), supported by previous interest rate cuts; and (iv) given the declining economic slack, there could be substantial second-round effects from increases in oil and

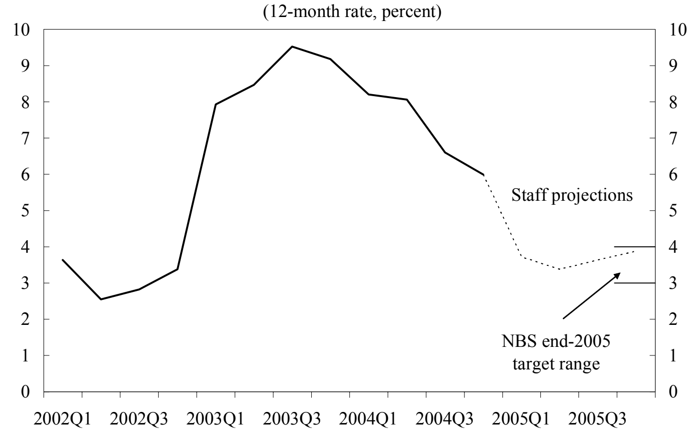
Slovak Republic: Wage Growth and Lagged Inflation

(Annual percent change)



Slovak Republic: Headline Inflation

(12-month rate, percent)



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[2] Excludes administered prices and indirect taxes.

administered prices,[3] particularly if wage setting remains backward looking. Staff thus expected that, on present trends, headline inflation would approach 4 percent in 2005, the top end of the NBS-targeted range, leaving no room for the materialization of upside risks (text chart).

15. **The NBS viewed its inflation target as attainable, and was more concerned about the negative effects of exchange rate appreciation on the competitiveness of traditional manufacturing sectors**. In this view, (i) the observed wage increases in 2004 were temporary, as they partly reflected delayed bonuses from 2003 to take advantage of the reduced income tax rate; and wage growth should remain moderate in 2005; (ii) food prices should also remain subdued given trends in world commodity prices and barring unforeseen adverse weather conditions in Slovakia; (iii) slack in the economy is substantial, with unemployment high; and (iv) given this slack, second-round inflationary effects should remain limited. Therefore, the NBS felt confident about its inflation target of 3.5 percent, and saw only minor risks of inflation reaching the upper bound of the range. It was, however, concerned about the pace of nominal appreciation against the euro, which was not commensurate with the improvement in economic fundamentals and therefore risked undermining the competitiveness of those manufacturing sectors where productivity growth is lagging—mostly local small- and medium-sized enterprises. It believed that a policy of slowing down nominal appreciation would mitigate these effects, and act as an insurance against adverse external current account shocks.

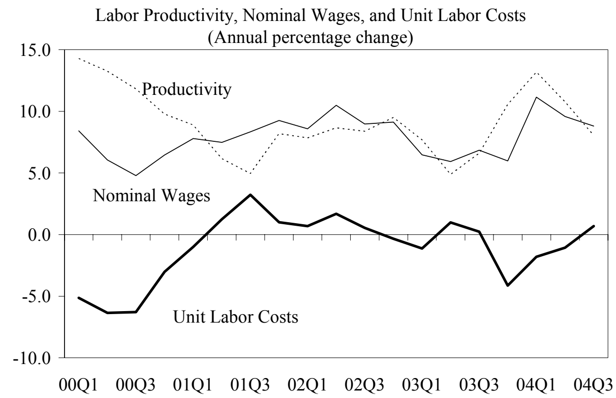
16. **While understanding these concerns, staff felt that the upside risk on inflation argued for a more flexible approach to the exchange rate in pursuing disinflation and for an enhanced communications policy to guide inflation expectations**. Productivity growth in Slovakia is expected to continue to exceed productivity growth in the euro area (Box 4), making room for real appreciation in the medium term.[4] While too rapid appreciation could be harmful to competitiveness, gradual real appreciation could also encourage enterprise restructuring needed in some sectors, such as light manufacturing. Staff therefore recommended to maintain a flexible approach to the management of the exchange rate, underscoring that intervention beyond smoothing could entrench inflationary expectations and be costly for the NBS. Exchange rate flexibility would also promote prudent risk management by market participants, thereby increasing Slovakia's resilience to volatile capital flows, and limit opportunities for one-way bets at the expense of the NBS. Market participants indicated that, at times, it had been difficult to decipher monetary policy

[3] The independent Regulatory Office for Network Industries announced utility price increases averaging about 8 percent as of January 2005, largely reflecting changes in world energy prices.

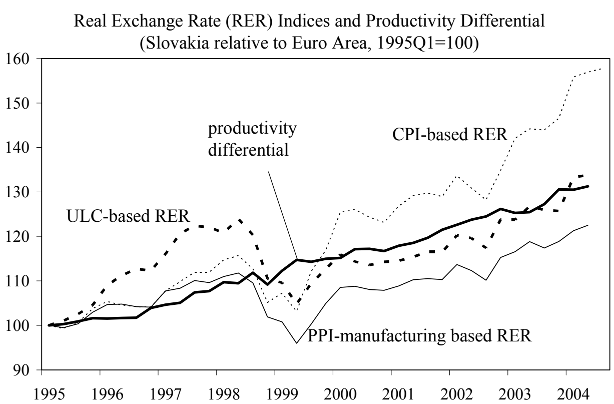
[4] See background paper on competitiveness.

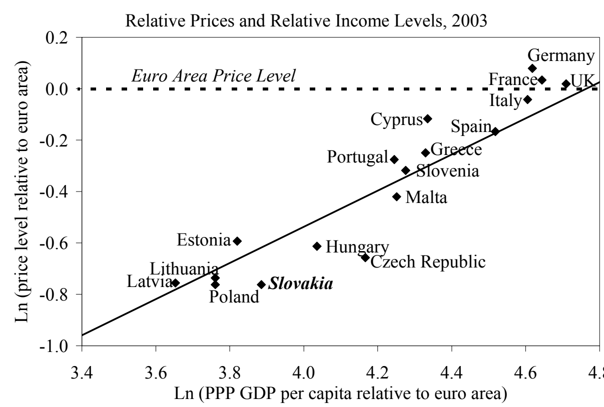
Box 4. Competitiveness

Slovak wages remain competitive. Compared with wages in other EU accession countries, Slovak wages are still relatively low, even when adjusting for labor productivity. Wage growth has been broadly in line with productivity growth, and unit labor costs even declined somewhat recently.



More broadly, other competitiveness indicators are also favorable. ULC-based and PPI-based real exchange rate measures have generally appreciated in line with productivity, and relative prices are still low given Slovakia's income level. While CPI-based real appreciation has accelerated recently, this has been largely due to sizeable administered price adjustments, bringing these prices into line with costs. Going forward, the influence of administered price adjustments on the CPI-based real exchange rate will gradually disappear. In any event, as Slovak productivity continues to grow faster than euro-area productivity (see productivity differential in chart), further real appreciation is natural and need not reduce competitiveness.



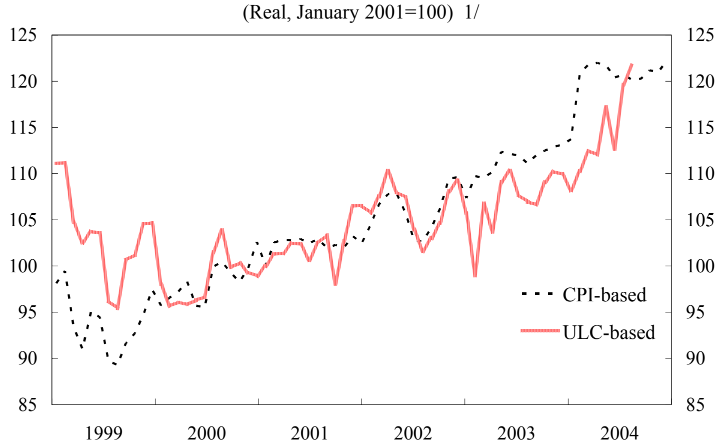


intentions because it was unclear if the NBS wanted to achieve certain inflation objectives or manage the exchange rate within a certain path. A suitable communications strategy should send coherent signals to the market, and thus reduce the costs of disinflation by guiding public inflation expectations.

17. **Given the inflation outlook and already low real interest rates, staff recommended that the authorities refrain from further reducing official interest rates to stem appreciation, while also emphasizing the merits of tightening fiscal policy to contain the risks of overheating**. If capital inflows remained strong and threatened competitiveness, monetary policy could not continue carrying all the burden of maintaining macroeconomic stability. Under this scenario, a tighter fiscal policy would have an important role to play (see below).

18. **The authorities reduced interest rates again in November to ward off excessive appreciation, but monetary conditions still tightened** (text chart). In the face of renewed rapid koruna appreciation against the euro, the NBS cut interest rates by another 50 basis points in late November, bringing the main policy rate to 4 percent. The koruna, nevertheless, continued to appreciate against the euro, in part reflecting the announcement of significant new FDI projects, Slovakia's sovereign debt rating upgrade by Standard and Poor's in mid-December, and increased inflows to the region as a whole. The authorities allowed the koruna to appreciate thereafter—thus tightening monetary conditions—intervening only sporadically in December in the face of persistent upward pressure in the foreign exchange market.

Slovak Republic: Monetary Conditions Index, 1999-2004
(Real, January 2001=100) 1/



1/ The index is a simple average of real interest and (ULC- or CPI-based) exchange rates, with the relative weights reflecting the openness of the Slovak economy.

19. **In a shift from past policy, the NBS announced in December explicit inflation targets for 2005–08, stating that the primary focus of monetary policy will be inflation, with exchange rate developments assessed depending on their inflationary impact.** This contrasts with the previous practice of publishing inflation forecasts, which were not strictly "targets" and were often revised midyear depending on economic developments. The

announcement was widely welcomed, including by staff, as a signal of more transparency in monetary policy-making. The new monetary policy framework—announced as part of the monetary program for 2005–08—adopted end-year inflation targets of 3 to 4 percent in 2005, and ambitious targets of below 2.5 percent in 2006 and below 2 percent thereafter.

C. Fiscal Policy

20. **The fiscal stance turned expansionary in 2004** (Table 3 and text table). The fiscal deficit widened to an estimated 3.8 percent of GDP from 3.4 percent of GDP in 2003. This reflected a reduction in revenues of over 1 percentage point of GDP, owing to the tax reform and lower social contributions (Box 5), offset by lower spending on wages, benefits, and interest. Taking into account net transfers from the EU—which add to domestic demand, even if the fiscal balance is unaffected—the fiscal impulse was 1 percent of GDP in 2004. This expansion followed a significant fiscal contraction in 2003.[5]

Slovak Republic: Fiscal Indicators
(In percent of GDP)

	2004	2005	2006	2007
	Proj.	Fiscal Framework		
Overall fiscal balance	-3.8	-3.8	-3.9	-3.0
Fiscal balance including second pillar 1/	-3.8	-3.4	-2.9	-1.9
Cyclically adjusted primary balance 1/ 2/	-1.7	-1.2	-0.8	-0.2
Net transfers from the EU	0.3	1.3	1.6	1.7
Fiscal impulse after net transfers from the EU 1/ 2/ 3/	1.1	0.4	-0.1	-0.4

1/ Includes revenues of second-pillar pension companies. These revenues are outside general government but increase private saving, implying little if any impact on national saving and domestic demand.
2/ Based on staff estimates of the output gap.
3/ This measure is equivalent to the change in the cyclically adjusted primary balance excluding net transfers from the EU.

21. **Going forward, fiscal consolidation will be constrained by the cost of reforms, as well as the need to reap the full benefits of EU accession**. The authorities estimated that the launch of a privately funded pension system pillar in January 2005 would cause a general government revenue loss of 0.4 percent of GDP in 2005, rising to about 1 percent of GDP in 2006 and beyond. These projections are uncertain and hinge on how many people will choose to join the second pillar.[6] The authorities estimated that greater than expected participation in the second pillar could imply annual transition costs reaching 1¾ percent of GDP in 2006 and beyond. The recently approved health insurance reforms, while hardening budget constraints in the health sector, will nevertheless entail higher public spending by

[5] The over 2 percent of GDP reduction in the fiscal deficit in 2003 (Table 3) reflected structural measures—including expenditure reduction in social benefits and health, and ending the practice of hidden spending by extending new government guarantees on loans unlikely to be repaid—as well as a fall in the interest bill.

[6] Baseline projections assume that about 50 percent of those entitled would shift from the first to the second pillar; participation in the second pillar is mandatory for new labor market entrants from January 2005.

Box 5. Effects of Slovakia's Tax and Welfare Reforms[1]

Tax revenues have fallen modestly as a share of GDP following the tax reform introduced in January 2004. With economic growth better than assumed in the budget, tax revenues in 2004 are estimated to have declined by only 0.3 percentage point of GDP from 2003 (Table 3). However, collections of social contributions have fallen by more than expected following the reduction in rates, reflecting other factors, including a deterioration in the administration of collections. On the other hand, the welfare reforms are projected to have generated savings of around 0.3 percent of GDP in 2004.

The reforms should reduce distortions in the economy and strengthen incentives to work and invest. The elimination of most exemptions under the new income tax system contributes to better resource allocation, and makes the system easier to administer—as does the single-rate VAT, which will help address long-standing problems with excessive refunds. The tax reforms may have limited effects on work incentives—for many taxpayers, the reform reduces labor taxes only modestly—though the welfare reforms do strengthen work incentives through both the activation programs and lower marginal effective tax rates on incomes of welfare recipients. However, taking into account the significant reductions in capital taxes, the tax burden has shifted from capital to labor, and the still-high tax wedge could continue to dampen employment demand.

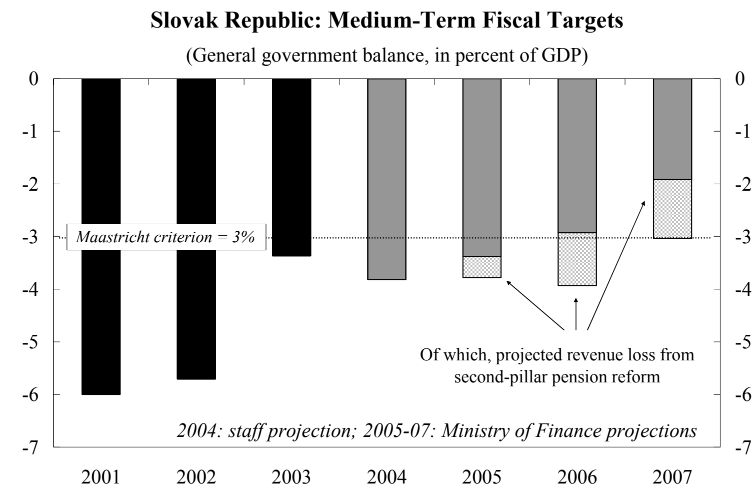
The tax system is less progressive than previously. The single-rate personal income tax includes large tax-free thresholds, ensuring the tax is progressive rather than proportional. Household spending data suggest that the single-rate VAT, and the higher excises, appear to have only limited distributional effects. However, social contributions—which are payable only up to a ceiling—remain a regressive component in the tax system.

The welfare reform has had different implications for different-size families. Assuming that parents participate in activation programs, social assistance benefits for smaller families remain near pre-reform levels. However, for families with four or more children, benefit reductions are significantly larger.

[1] See background paper for details on Slovakia's tax and welfare reforms.

0.3 percent of GDP from 2005,[7] though partly financed through higher contributions. Finally, although the opportunity to draw on structural funds implies a net flow of resources (after membership fees) from the EU to Slovakia, spending from the available structural funds requires Slovak government cofinancing.

22. **The 2005 budget envisages a deficit close to the estimated 2004 outcome, but implies some further fiscal expansion** (text chart). The 3.8 percent of GDP target reflects the additional costs mentioned above, including estimated second-pillar pension reform costs and higher EU-related expenditure. The authorities noted that, excluding second-pillar losses, the deficit would actually be reduced by ½ percent of GDP. Nonetheless, they acknowledged that most of the deficit reduction would require a recovery in social contributions following poor collections in 2004, and that spending would increase. They agreed that taking into account budgeted net transfers from the EU (1¼ percent of GDP), and adjusting for pension reform costs, the budget implies a small positive fiscal impulse, which staff estimates at around ⅓-½ percent of GDP.



23. **With the economy growing at rates above potential and capital inflows expected to be sustained in the next few years, staff argued for a tighter fiscal policy in 2005**. The 2005 budget is part of a three-year framework that envisages a declining fiscal deficit—to 3 percent of GDP in 2007, the Maastricht ceiling—even in the face of the transition costs from the introduction of the second pillar. Staff argued that an acceleration of fiscal consolidation in 2005 based on durable spending measures was needed to: (i) enhance the credibility of the medium-term fiscal framework; (ii) avoid a pro-cyclical fiscal policy; and (iii) support monetary policy by reducing the risk of overheating. While the authorities agreed that faster fiscal consolidation would be desirable, they felt that further structural fiscal measures would be politically difficult to introduce. In addition, they expected that current policies will achieve the targets under the 2005–07 budget framework helped by the cyclical upswing, as well as the public sector reform and the delayed effects on expenditures from ongoing health and welfare reforms. Still, staff argued that a tighter fiscal policy should remain an essential instrument in the policy mix to contain appreciation pressures.

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[7] Although the health reform is expected to eliminate arrears in the health system, in the short term it entails a higher budget allocation to the sector.

24. **Views differed on the path of fiscal adjustment over 2006–07**. The authorities' three-year fiscal framework implies that most of the adjustment would take place in 2007 (text chart). Abstracting from pension reform costs would yield a smoother fiscal adjustment path, although still back-loaded. While consistent with medium-term sustainability (Table 8), staff regarded this approach as risky given the 2007 test date for euro adoption. Targeting a test-date deficit with no margin risks missing the Maastricht criterion in case of even relatively minor shocks. Moreover, this approach leaves no room for implementation slippages, whether ahead of the 2006 elections or from delays that the next government could encounter preparing fiscal measures. Indeed, delaying most of the fiscal adjustment to 2007 could compound these risks. Therefore, staff supported a lower deficit target in both 2006 and 2007. While recognizing the desirability of tighter fiscal targets in these years, the authorities considered that their approach balanced a number of considerations, including the pace of EU-related spending and political-economy aspects associated with the elections in 2006, and preferred to maintain the current targets. Moreover, they expected that conservative budgeting, improved fiscal management systems in place (see below), and cutting waste would provide a margin on expenditures in 2007, thus containing the risk of slippages.

25. **A stronger fiscal framework would help ensure the needed deficit reduction**. Fiscal policy faces the difficult task of combining additional consolidation with welcome pension reform and higher spending on EU-financed projects. With recent direct-tax cuts constraining revenues, this will require a durable reduction in the growth of real primary spending by the general government from current annual rates of about 6 percent—albeit reflecting temporarily higher spending growth financed with EU resources—to about 1 percent to meet the recommended target for 2007. Staff encouraged the authorities to find growth-enhancing expenditure savings in areas unrelated to EU-financed projects. These could come from the continued restructuring of inefficient sectors, such as the railways, and from a careful review of spending on subsidies that seem unlikely to enhance potential economic growth, particularly agricultural subsidies. Staff also argued that, given the tight expenditure growth required, the medium-term fiscal framework should feature binding nominal expenditure ceilings to complement the deficit targets. The authorities noted that, although their framework does not contain formal expenditure ceilings, the budget law for 2005 allows for a nominal expenditure increase of only 1 percent compared to the budget baseline before resorting to a supplementary budget.

26. **Fiscal management has improved significantly, but challenges remain**. The authorities have already taken strong measures to improve fiscal transparency including abolishing most extrabudgetary funds at end-2001, and restricting the issue of new government guarantees from end-2002, and several other steps over the past two years.[8] In this context, staff and the authorities regretted parliament's decision to re-establish an extrabudgetary environmental fund, which would reduce oversight over environmental

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[8] See *Slovak Republic: ROSC—Fiscal Transparency Module Update* at: www.imf.org.

spending, and hoped that the new fund would not set a precedent for further reversals of transparency. The new Debt and Liquidity Management Agency is already generating significant savings on government debt, and the recently established State Treasury is also making an important contribution to fiscal control, notwithstanding some temporary gaps in state budget expenditure data. Meanwhile, decentralization is still in progress, with new funding formulas for education spending and revenue-sharing for personal income tax taking effect from 2005. So far, the ongoing transfer of spending responsibilities from central to local governments—including some education, healthcare, and transport responsibilities—has not affected fiscal discipline in most local governments, which operate within a framework of balanced current budgets. Subnational governments account for 16 percent of general government expenditures in the 2005 budget.

D. Euro Adoption

27. **The timetable for entering ERM2 and adopting the euro appears appropriate**. The authorities envisage ERM2 entry in 2006 and euro adoption in 2009. The goal of early euro adoption is ambitious and provides incentives to pursue an appropriate macroeconomic policy mix and persist with reforms. Staff and the authorities agreed that the preconditions for successful participation in ERM2 go beyond fiscal and monetary policies. In particular, the need to boost the economy's resilience to shocks—especially important after Slovakia loses the exchange rate instrument—calls for sustained structural measures.

E. Structural Issues

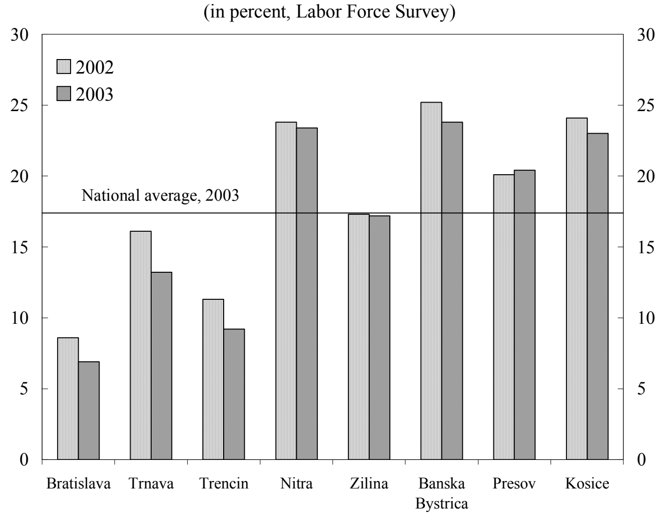
28. **Despite recent reforms, structural factors still hamper labor market flexibility**. The authorities argued that recent reforms to the labor code and the benefits system should encourage employment by reducing restrictions on part-time employment, easing separation arrangements, and improving incentives to work. However, they also acknowledged that reducing unemployment would require policies to address several remaining problems.

- First, employers reported that tertiary education reform was needed to keep up with evolving labor market demands and create adequate possibilities for life-long learning. In this respect, the authorities reported on recent agreements among the private sector, universities, and the Ministry of Education that should help tailor graduate training to market needs.

- Second, a lack of affordable new housing for low- and middle-income households has discouraged the unemployed from moving between regions to seek jobs. In addition, the rental market is small and illiquid, and a bias towards tenant rights remains an impediment to developing affordable rental housing.

- Third, regional mismatches are high, with economic activities and FDI concentrated in the western part of the country, particularly in the Bratislava region, where unemployment is low (text chart). To help reduce the regional mismatch of jobs and workers, policies not only need to ease constraints on labor mobility, but also support the provision of basic transport and business infrastructure to help attract jobs to high unemployment regions.

Slovak Republic: Regional Unemployment, 2002-03
(in percent, Labor Force Survey)



- Fourth, nonwage labor costs remain amongst the highest in the region, and the recent tax reforms have shifted the tax burden from capital toward labor, encouraging capital-intensive activity rather than job creation.

29. **Recent measures have promoted an efficient and predictable legal environment**. A World Bank study has singled out Slovakia as the world's top reformer in improving its investment climate over the past year. In 2004, the amount of time to start a business was cut in half, time to recover debt fell by three quarters, and a new private credit registry opened. Although investor representatives expressed some frustration with the excessive discretion of bankruptcy judges and inefficient legal procedures, they also applauded corrective steps taken by the authorities. The authorities argued that the draft bankruptcy law should overhaul current bankruptcy procedures by making them faster, improving creditor rights, and reducing judges' discretion, including by randomizing the process of case allocation to judges. Staff welcomed these initiatives as well as the new commercial registry act, which has considerably shortened (to two weeks) and simplified registration procedures. According to the World Bank, Slovakia witnessed a jump of 12 percent in new business registrations after simplifying entry procedures.

30. **Investment incentives need to be monitored to avoid an inefficient use of public resources**. The government intends to attract new investment, particularly in disadvantaged areas, through significant fiscal incentives, which are also widely used by other countries in the region. Staff encouraged the authorities to evaluate projects carefully to ensure that scarce public resources are not spent on the promotion of investments that would have taken place anyway.

31. **While the financial system appears sound** (Table 5)**, the ongoing strengthening of supervisory capacity should improve risk monitoring**. Bank profitability is solid, but lower than in comparable EU member states, and is expected to remain under pressure due to increased competition following EU entry (text table). Yet, Slovak banks—about 90 percent

Banking Sector Soundness and Profitability Indicators for Visegrad Countries, 2003

	Slovak Republic	Czech Republic	Hungary	Poland
Capital adequacy ratio (percent)	21.6	14.5	11.6	13.8
Nonperforming loans (percent of total loans)	6.4	4.9	3.4	20.9
Provisions (percent of nonperforming loans)	88.3	77.1	47.7	51.7
Return on assets (percent)	1.2	1.2	1.9	1.0
Return on equity (percent)	14.9	23.8	25.8	5.9

Sources: National Bank of Slovakia; and IMF Global Financial Stability Report, September 2004.

Banking Sector Soundness and Profitability Indicators, 2001-04

	2001	2002	2003	Aug 04
Capital adequacy ratio (percent)	19.8	21.3	21.6	21.0
Nonperforming loans (percent of total loans) 1/	12.3	9.2	6.4	5.4
Provisions (percent of nonperforming loans) 1/	79.7	86.1	88.3	89.1
Return on assets (percent)	1.0	1.2	1.2	0.9
Return on equity (percent)	15.4	17.1	14.9	11.9
Household loans (percent of total loans)	15.5	18.0	22.1	26.0
Mortgage loans (percent of total household loans)	8.6	18.4	29.2	32.4

Source: National Bank of Slovakia.

1/ Excluding Konsolidačná Banka in 2001.

of which are foreign-controlled—are amongst the best capitalized in the region, nonperforming loans are declining and well provisioned, and bank lending is rebounding, especially to households (Table 6 and text table). The authorities noted that banks' exposure to households is low, and that household credit growth is an expected move to equilibrium from a very low base. Staff agreed, but stressed that this growth exposes the financial sector to risks that may be underestimated because available statistics do not capture additional credit granted by nonbank institutions.[9] The authorities reported progress in banking supervision, noting they had completed examinations of all banks over the past two years. They also planned to improve the supervision of financial conglomerates and cross-border transactions, by integrating the Financial Markets Authority into the NBS in 2006.

32. **Plans to finalize privatization and speed up product market reform are on track**. The envisaged sale in 2005 of Slovenske Elektrarne—the electricity generation company—would successfully conclude major privatizations. The authorities reported that the electricity and gas markets will be liberalized for all commercial consumers from 2005. Staff, for its part, noted that high access fees for imported energy could still discourage the entry of foreign energy suppliers, which is necessary to increase competition.

[9] Including credit from manufacturing companies for purchases of consumer durables.

33. **Following EU accession, Slovakia adopted the EU's Common Commercial Policy**. Tariffs and preferential trade agreements were modified to ensure EU-conformity. Minor effects are expected from this process as Slovakia's tariff system was not significantly different from that of the EU, and its trade with third countries affected by the changes in the preferential agreements is small.

III. Staff Appraisal

34. **Slovakia's accession to the European Union took place amidst promising near-term prospects and a favorable medium-term outlook**. Despite a difficult external environment, growth has been resilient and core inflation has declined. Reforms to labor, product, and financial markets have increased the flexibility of the Slovak economy. With domestic demand recently gaining momentum and investors' continued interest in Slovakia, the prospects for strong balanced growth in the medium term remain favorable, provided pending reforms are completed and macroeconomic policies managed deftly.

35. **Given upside inflation risks and the need to progress in meeting the Maastricht criteria at a time when the output gap is closing, monetary conditions need to tighten**. The recent koruna appreciation is already contributing to tighter monetary conditions. Since inflation is likely to remain close to the upper end of the targeted range in 2005, with significant upside risks, interest rates should not be lowered. As now intended by the NBS, they should be guided in the future by the need to achieve inflation targets. On the exchange rate, although the NBS has a role to play in smoothing excessive exchange rate volatility, it should avoid fine-tuning, and have a flexible approach to the exchange rate in pursuing disinflation. In a context of strong competitiveness, as reflected in the dynamism of exports and growth, intervention beyond smoothing could be counterproductive and entrench inflationary expectations. Moreover, sustained interventions also enlarge the NBS balance sheet and increase its losses.

36. **Against this background, the new NBS monetary framework appears to appropriately place a clear emphasis on inflation targets**. This should contribute to anchoring inflation expectations, supported by a suitable NBS communications strategy, and also help generate more forward-looking wage-setting behavior, which, in turn, should help disinflation. In addition, the new framework is expected to provide a transparent foundation for monetary policy by relying primarily on the interest rate instrument, rather than foreign exchange intervention. In all, it should enhance the credibility of NBS policy making.

37. **A stronger fiscal stance than envisaged by the authorities would have clear benefits, and the authorities should therefore take any available opportunity to achieve this**. The deficit target for 2005 is reachable, provided the authorities take measures to ensure that the collections of social security contributions recover as the budget envisages. But additional adjustment would be desirable given projected above-trend growth, and to mitigate the risks arising from the back-loading of the adjustment in the three-year budget framework. The authorities, at a minimum, should therefore reduce the planned deficit if growth turns out to be higher than projected in the budget (4.5 percent), or if collections of some taxes, such as

the VAT, improve, as seems likely. Such a tightening, in a context where substantial capital inflows could continue, would help to reduce appreciation pressures while still supporting monetary policy in reducing inflation.

38. **More ambitious medium-term fiscal targets, and a strengthening of the fiscal framework, would reduce the risk of missing the Maastricht deficit criterion in 2007**. The European Commission recently concluded that Slovakia is on track to bring down the fiscal deficit to the Maastricht level of 3 percent of GDP by 2007. However, the current fiscal deficit target of 3 percent of GDP leaves no margin to deal with negative shocks. A more ambitious target, say 2½ percent of GDP, would enhance the credibility of the fiscal strategy, and minimize the possibility of a longer, and perhaps more difficult, stay in ERM2 if the 3 percent of GDP ceiling were breached. Additional measures to reach this objective should focus on eliminating subsidies that do not enhance potential economic growth. While the 2007 budget will be the responsibility of the next government, the current administration could help achieve Slovakia's medium-term objectives by strengthening the fiscal framework through the introduction of binding expenditure ceilings, to complement the nominal deficit targets. Establishing primary expenditure ceilings would clarify the basis for durable fiscal deficit reducing measures, and the need to elaborate the appropriate underlying policies. In this context, to smoothen the fiscal adjustment, it would be desirable to bring forward to 2006 some of the expenditure savings planned in 2007.

39. **Achieving fiscal objectives requires the participation of all levels of government, and the continued transparent implementation of fiscal policy**. More decentralization will bring the provision of services closer to those receiving them, but requires good fiscal management locally. The government also needs to ensure close cooperation between the central and local governments to ensure expenditure control at the general government level. The authorities have significantly improved fiscal transparency, essential for proper oversight over fiscal activities, though the recently established environmental fund represents a setback. It should remain an exception and its activities should be folded back into the state budget as early as possible.

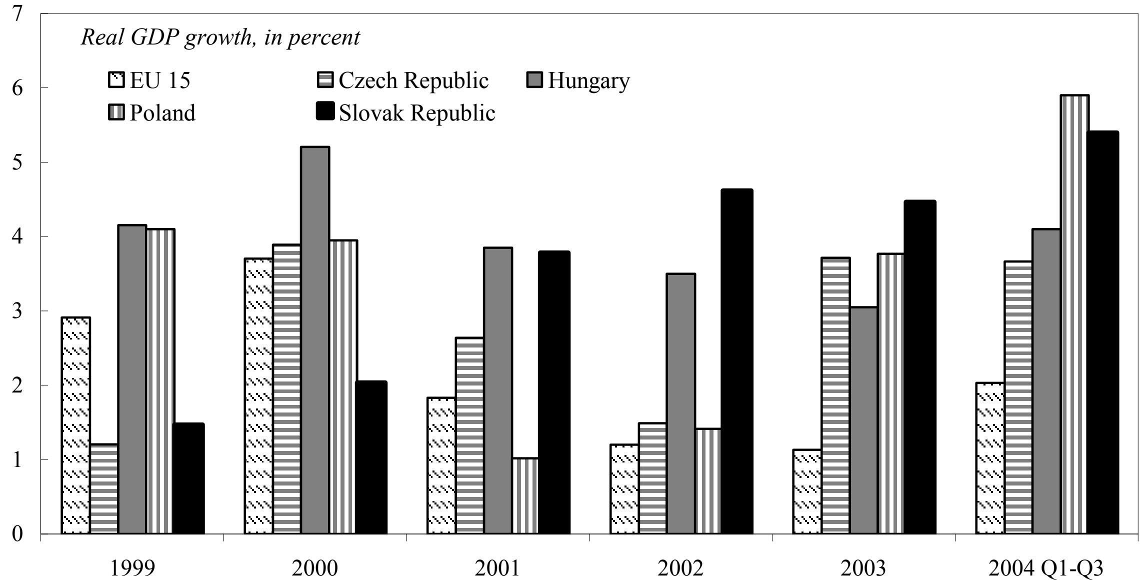
40. **Slovakia should continue to implement its successful structural reform program**. Privatization and restructuring have attracted needed investment in infrastructure, unleashed private sector initiative, strengthened the financial sector, and accelerated growth. While the imminent completion of the government's **privatization** program is welcome, the authorities should ensure that the relationship among the current buyers, providers, and alternative suppliers of energy will indeed encourage **competition**. The institutional labor market framework has become more flexible, and a key task ahead is to ensure that policies in other areas—such as the education system and public infrastructure—also support an environment that helps reduce high **unemployment**. It is essential to prepare projects that make full use of EU structural funds available for this purpose. High wage taxes from social contributions remain an impediment to employment, and any further tax reform should give priority to reducing labor taxation. The **legal framework** has improved significantly but implementation challenges remain, including improving the functioning of the courts.

41. **The NBS should strengthen the financial system by building supervisory capacity to monitor risks**. While the NBS has improved institutional supervisory capacity, greater risks arise from rapid credit growth to households, the operations of financial conglomerates, and cross-border transactions. More vigilance is needed on all these fronts, including by improving consolidated supervision, broadening the data coverage of household assets and liabilities, and reacting appropriately and promptly to examination findings. The plan to establish a single financial sector supervisor should be implemented with care not to distract from effective oversight of the financial sector.

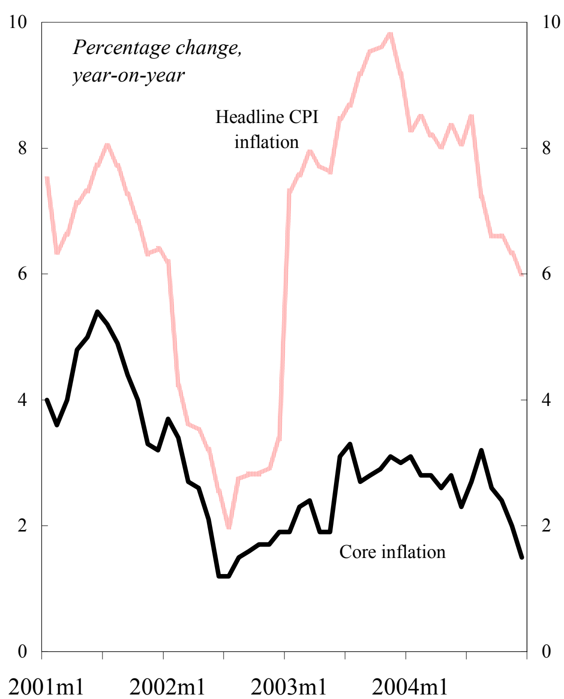
42. The next Article IV consultation with the Slovak Republic is expected to be conducted under the standard 12-month cycle.

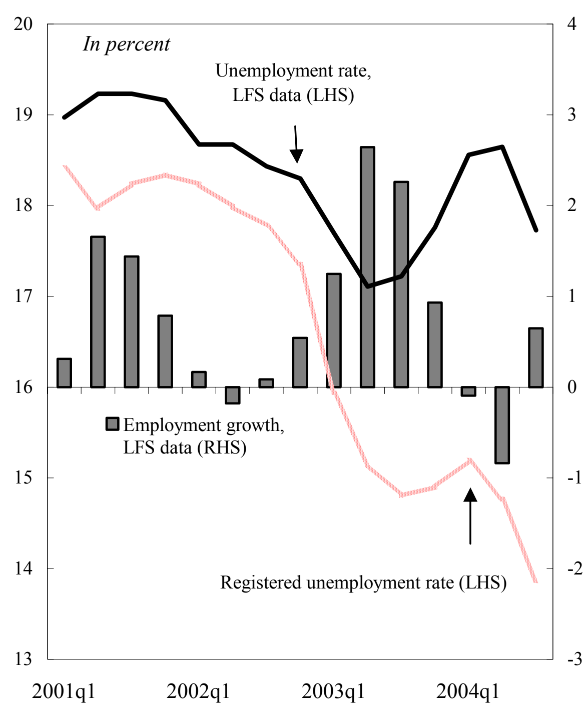
Figure 1. Slovak Republic: Macroeconomic Aggregates, 1999-2004

Slovakia's performance compares favorably with that of the CEC region despite the slowdown in Europe ...



... core inflation has remained low, but employment gains have been modest and unemployment is still high.

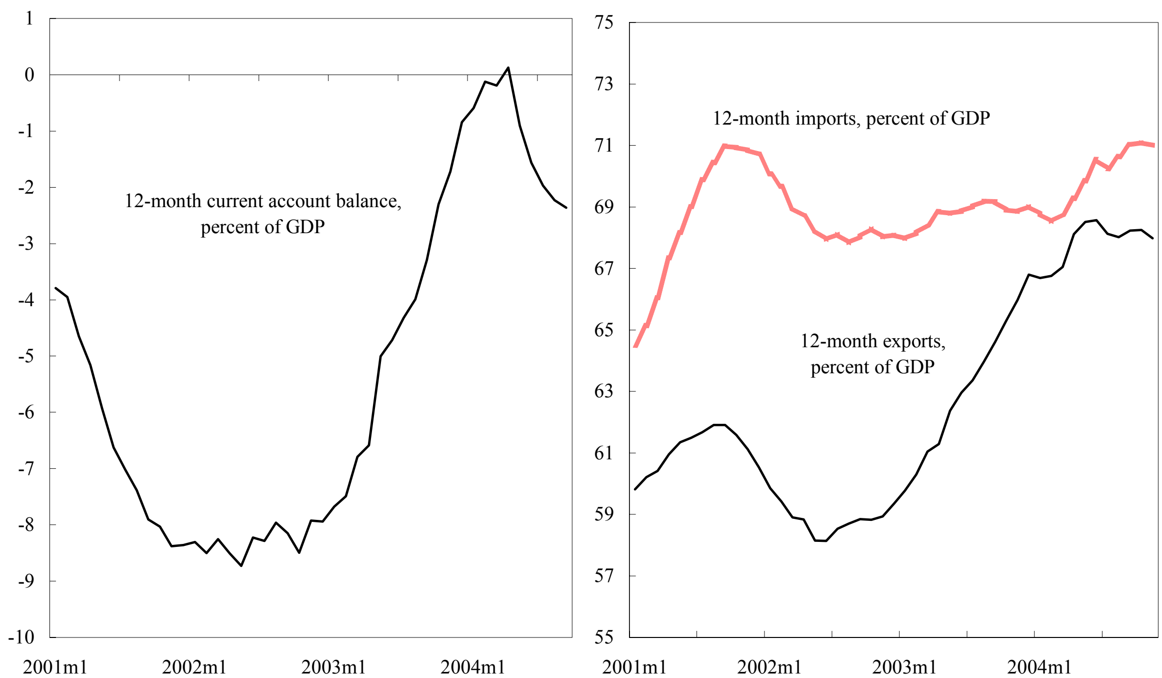




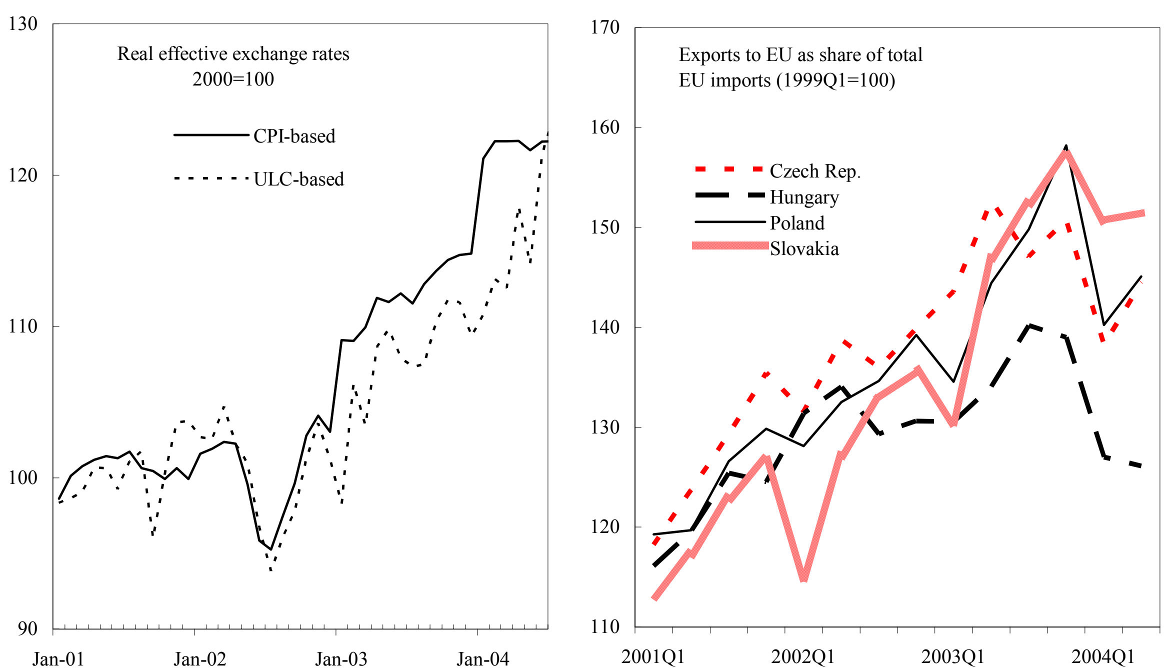
Sources: Slovak authorities; WEO; and IMF staff calculations.

Figure 2. Slovak Republic: External Sector Performance, 2001-04

The external current account deficit narrowed considerably, as exports soared ...



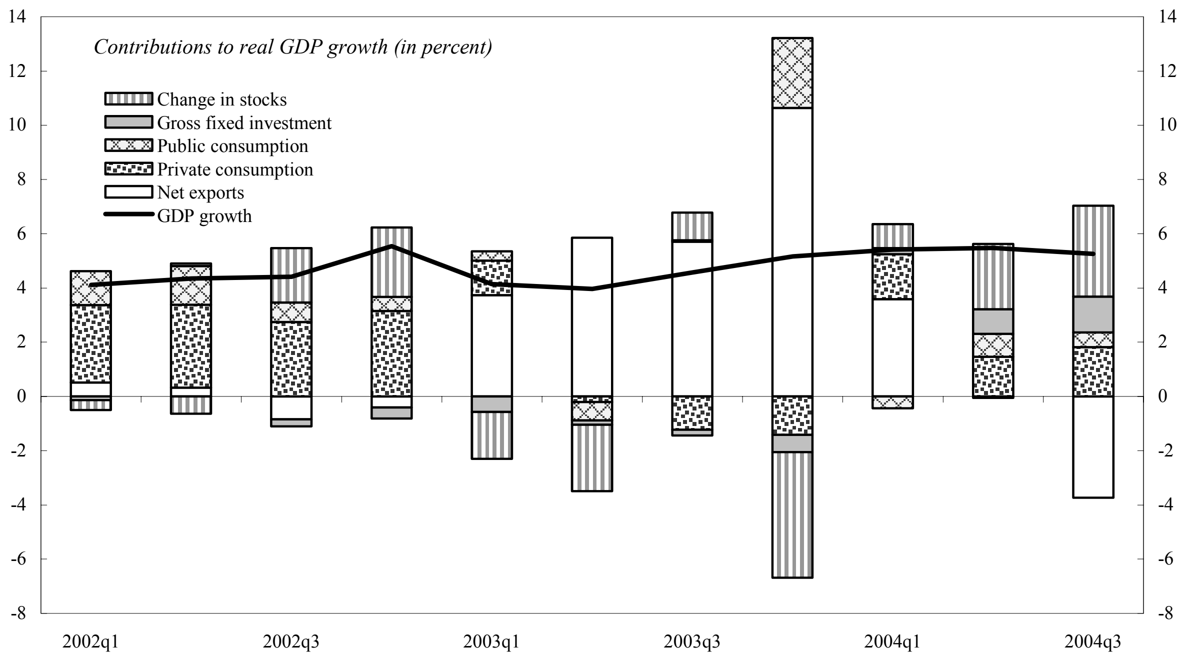
... despite real appreciation; and Slovakia has gained market share in Europe.



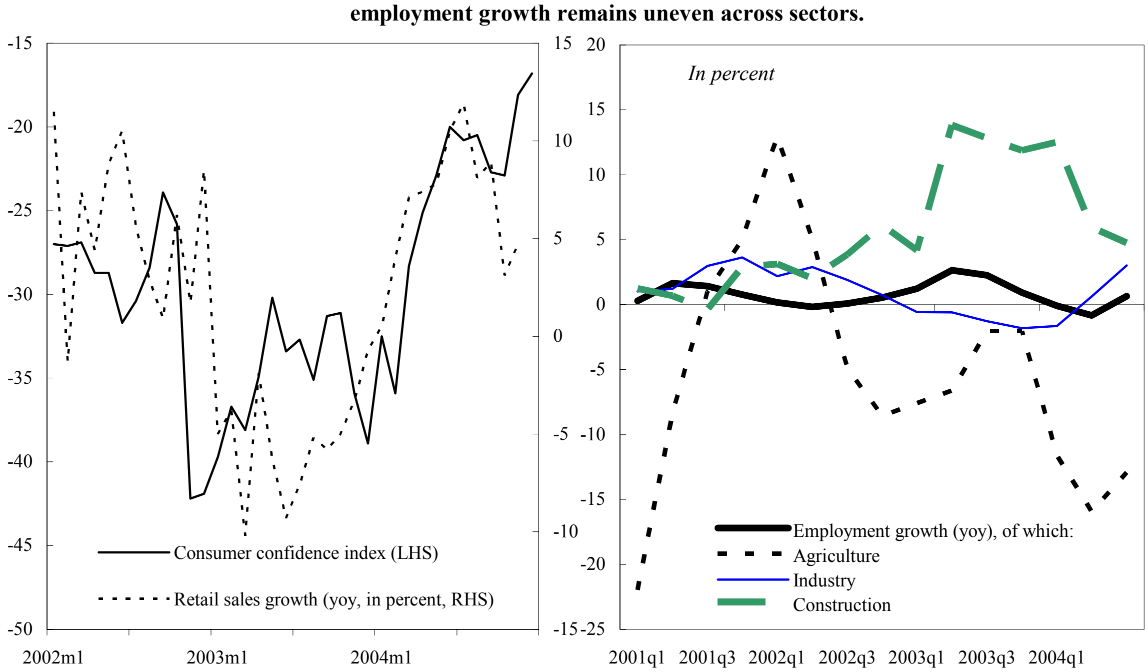
Sources: Slovak authorities; and IMF staff calculations.

Figure 3. Slovak Republic: Recent Trends, 2001-04

Real growth is increasingly driven by domestic demand ...



... as consumer confidence has improved and retail sales accelerated; but employment growth remains uneven across sectors.



Sources: Slovak authorities; and IMF staff calculations.

Table 1. Slovak Republic: Selected Economic and Financial Indicators, 2000-05

	2000	2001	2002	2003	Estimate 2004	Projection 2005
	(Percent change, period average)					
Real sector						
Real GDP	2.0	3.8	4.6	4.5	5.3	4.9
Consumer prices						
Period average	12.0	7.3	3.3	8.5	7.5	3.7
12 months to end of period	8.4	6.6	3.4	9.3	5.9	3.9
Gross industrial output (constant prices)	8.6	7.0	7.2	5.4	…	…
Real wages in industry						
PPI-based	0.4	4.1	4.4	6.1	…	…
CPI-based	-2.9	2.9	4.0	-1.3	…	…
Employment in industry	-3.0	1.0	0.2	0.5	…	…
Unemployment rate (LFS), period average	18.8	19.3	18.6	17.5	17.7	17.1
Real effective exchange rate 1/						
CPI-based	12.3	0.6	-0.1	11.6	…	…
ULC-based	2.1	0.3	0.0	7.4	…	…
	(In percent of GDP)					
Public finance (ESA 95 basis)						
General government balance	-12.3	-6.0	-5.7	-3.4	-3.8	-3.8
General government debt	49.9	48.7	43.3	42.6	43.5	44.9
	(Percent change, end of period, unless otherwise indicated)					
Money and credit						
Net domestic assets 2/	6.2	16.5	-13.0	18.1	13.3	…
Credit to enterprises and households 3/	7.0	8.1	12.0	13.7	12.5	…
Broad money	15.5	11.8	3.4	5.6	7.4	…
Interest rates (in percent, end-of-period)						
Lending rate (short-term)	10.7	8.8	7.5	7.2	…	…
Deposit rate (one-week)	6.0	6.0	4.0	4.2	…	…
NBS policy rate (two-week standard tender repo rate)	8.00	7.75	6.50	6.00	4.00	…
Velocity	-4.2	-3.3	5.2	3.5	3.0	…
	(US$ billion, unless otherwise indicated)					
Balance of payments						
Merchandise exports	11.9	12.6	14.4	21.8	27.8	31.4
(percent change)	(16.1)	(6.4)	(13.7)	(52.0)	(27.4)	(12.8)
Merchandise imports	12.8	14.8	16.5	22.5	29.1	33.6
(percent change)	(12.9)	(15.6)	(11.7)	(36.3)	(29.4)	(15.5)
Trade balance	-0.9	-2.1	-2.1	-0.6	-1.3	-2.2
Current account balance	-0.7	-1.8	-1.9	-0.3	-1.3	-2.6
(percent of GDP)	(-3.5)	(-8.4)	(-8.0)	(-0.9)	(-3.1)	(-5.2)
Official reserves, end-period	4.1	4.2	9.2	12.1	14.9	16.4
(in months of imports of GNFS)	(3.4)	(3.0)	(5.9)	(5.7)	(5.5)	(5.3)
(in percent of broad money)	(31.8)	(29.9)	(52.4)	(53.9)	…	…
Gross reserves of banking system	5.6	5.4	10.2	13.0	…	…
Gross external debt, end-period 4/	10.8	11.0	13.1	18.1	18.6	19.3
Gross external debt, end-period (in percent of GDP) 4/	53.4	52.9	54.1	55.4	45.1	38.4
Short-term debt (end of period) 5/	4.0	4.4	7.0	14.2	10.3	10.0
Short-term debt (end of period) 6/	2.4	3.1	4.2	7.8	6.7	7.6
Official reserves to short-term debt (in percent) 5/	102.0	95.2	132.1	85.3	145.0	163.9
Memorandum items:						
GDP, current prices (Sk billions)	934.1	1,009.8	1,098.7	1,201.2	1,328.2	1,438.6
Exchange rate (Sk/U.S. dollar)						
Period average	46.2	48.4	45.3	36.8	32.3	…
End of period	47.4	48.5	40.0	32.9	28.5	…

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 deposits of Sk 61.4 billion in privatization receipts at the pension fund account at the NBS in 2002.
3/ Adjusted for bank restructuring.
4/ Excludes domestic currency denominated debt.
5/ Short-term debt is defined to include medium- and long-term debt due in the subsequent year.
6/ Short-term debt is defined to exclude medium- and long-term debt due in the subsequent year.

Table 2. Slovak Republic: Medium-Term Macroeconomic Framework, 1999-2008

	1999	2000	2001	2002	2003	Estimate 2004	Projection 2005	2006	2007	2008
					(In percent)					
Real GDP growth	1.5	2.0	3.8	4.6	4.5	5.3	4.9	4.9	6.2	3.2
Inflation (CPI)	10.7	12.0	7.3	3.3	8.5	7.5	3.7	2.9	2.9	2.9
Inflation (CPI, end of period)	14.2	8.4	6.6	3.4	9.3	5.9	3.9	3.0	2.8	2.9
Core inflation (end of period)	7.0	4.6	3.3	1.8	2.7	1.5	2.7	2.6	2.6	2.4
Inflation (GDP deflator)	6.5	8.5	4.2	4.0	4.7	5.0	3.3	2.9	2.9	2.9
					(In percent of GDP)					
Gross national income	98.5	98.3	98.5	98.1	99.6	98.5	98.0	97.9	98.1	98.2
Gross national disposable income	99.5	98.8	99.5	98.9	100.4	99.3	98.6	98.8	99.1	99.2
Net exports of GNFS	-4.4	-2.5	-8.2	-7.1	-1.5	-2.4	-3.7	-4.0	-0.7	-0.5
Consumption	76.8	76.3	78.2	77.8	76.4	75.4	75.2	74.7	72.2	71.7
Nongovernment	57.0	56.5	58.0	57.7	56.4	56.2	56.2	56.0	54.3	54.2
Government	19.8	19.8	20.1	20.1	19.9	19.2	19.0	18.7	17.9	17.5
Gross national savings	22.7	22.5	21.4	21.2	24.0	23.9	23.4	24.1	27.0	27.6
Nongovernment	26.6	31.7	24.2	23.3	24.9	25.5	25.8	27.1	29.2	29.5
Government	-3.9	-9.2	-2.9	-2.2	-0.9	-1.7	-2.4	-2.9	-2.3	-1.9
Gross capital formation	27.6	26.1	30.0	29.3	25.1	27.0	28.6	29.3	28.5	28.8
Nongovernment	24.4	23.0	26.9	25.8	22.6	24.5	26.0	26.9	26.3	26.6
Government	3.1	3.1	3.1	3.5	2.5	2.5	2.5	2.4	2.2	2.2
Savings-investment gap (current account) 1/	-4.9	-3.6	-8.6	-8.2	-1.1	-3.1	-5.2	-5.2	-1.5	-1.2
Nongovernment net savings	2.2	8.7	-2.6	-2.5	2.3	1.1	-0.2	0.2	2.9	2.9
Government net savings 2/	-7.0	-12.3	-6.0	-5.7	-3.4	-4.2	-4.9	-5.3	-4.5	-4.1
					(Annual percentage change, constant prices, unless otherwise indicated)					
GDP	1.5	2.0	3.8	4.6	4.5	5.3	4.9	4.9	6.2	3.2
Domestic demand	-6.3	0.1	7.4	4.6	-2.0	6.1	6.4	5.4	0.3	2.6
Consumption	0.2	-0.2	4.7	5.3	0.3	2.6	4.1	4.2	2.5	2.4
Nongovernment	2.7	-0.9	4.9	5.5	-0.8	3.5	4.5	4.5	3.0	3.0
Government	-7.1	1.6	4.6	4.9	2.7	0.4	3.2	3.5	1.4	0.9
Gross capital formation	-21.0	1.0	15.2	2.6	-8.1	16.4	12.3	8.1	-4.8	3.1
Fixed investment	-19.6	-7.2	13.9	-0.6	-1.5	8.0	13.3	9.0	2.6	3.0
Change in stocks (Sk billion, constant prices)	-12.5	3.1	5.9	12.5	-2.1	14.4	14.0	13.0	-7.0	-7.0
Change in stocks (contribution to GDP growth) 3/	-0.2	2.3	0.4	0.9	-1.9	2.1	-0.1	-0.1	-2.2	0.0
Exports of GNFS	5.0	13.7	6.3	5.6	22.5	11.2	11.6	12.1	19.3	11.2
Imports of GNFS	-6.7	10.5	11.0	5.5	13.6	12.3	13.4	12.6	14.1	11.1
Households' disposable income	7.5	-1.0	1.1	5.7	-1.3	3.9	3.6	3.7	5.7	2.9
Gross saving (percent of disposable income)	10.1	10.1	6.6	6.6	6.2	6.3	5.4	4.6	6.8	6.6
Employment	-3.0	-1.4	1.0	0.2	1.8	0.1	0.9	0.9	1.2	0.2
Nominal wages	6.7	6.4	8.3	9.3	6.3	10.0	8.0	7.2	6.9	5.1
Productivity	4.5	3.5	2.7	4.5	2.7	5.2	4.0	4.0	5.0	3.0
Unemployment rate (percent)	16.4	18.8	19.3	18.6	17.5	17.7	17.1	16.5	15.7	15.7
Memorandum item:										
Gross domestic product (Sk billion, current prices)	844	934	1,010	1,099	1,201	1,328	1,439	1,552	1,696	1,801

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

1/ For actual data, the saving-investment gap for implied by national accounts data differs from the current account deficit reported in BOP statistics. The discrepancy is mostly due to different exchange rates employed in the calculations.
2/ General government balance excluding net grants and transfers from the European Union.
3/ Includes the statistical discrepancy.

Table 3. Slovak Republic: Fiscal Operations of the Consolidated General Government, 2002-07

(In millions of koruny, ESA 95 basis)

	2002	2003	2004		2005	2006	2007
	Outcome		Budget	Estimate 1/	2005 Budget		
Total revenue	420,191	436,244	468,180	465,475	515,871	539,468	576,682
Tax revenue	208,816	217,486	232,038	236,307	244,525	259,407	279,457
Personal income tax	37,403	39,835	27,083	33,900	33,366	35,498	38,998
Wage tax	32,161	35,858	23,283	29,959	29,966	31,798	34,898
Self-employment tax	5,242	3,977	3,800	3,941	3,400	3,700	4,100
Corporate profit tax	29,357	33,632	23,700	31,909	30,000	32,400	36,900
Withholding tax on capital income	9,343	9,143	11,400	5,675	6,400	6,700	7,000
VAT	83,375	80,654	113,800	106,000 2/	118,200	126,300	136,000
Excises	34,063	37,589	43,196	44,500	45,800	47,600	49,500
Import duties, property tax and other	15,275	16,633	12,859	14,323	10,759	10,909	11,059
Social contributions 3/	158,101	166,752	169,726	164,819	184,275	188,292	197,774
Grants and transfers	2,579	157	17,746	12,746	30,928	37,105	40,558
Of which: from European Union	0	0	17,626	12,626	30,928	37,105	40,558
Other revenue	50,695	51,849	48,670	51,603	56,143	54,664	58,893
Of which: interest	6,731	8,585	6,404	5,337	5,321	5,195	5,214
Total expenditure	482,865	476,660	520,163	516,161	569,072	598,568	625,552
Of which: primary expenditure	442,047	446,150	487,220	485,972	535,955	564,412	588,320
Current expenditure	421,096	439,570	471,281	468,029	512,938	539,128	562,512
Gross wages	82,772	88,933	92,683	92,783	99,589	104,284	109,282
Wages	61,428	65,957	69,229	69,308	74,380	78,331	81,730
Employer social security contributions	21,344	22,976	23,454	23,475	25,209	25,953	27,552
Goods and services	52,936	64,116	66,842	69,942	75,926	83,757	83,361
Subsidies and transfers	244,570	256,011	278,813	275,115	304,306	316,931	332,637
Agricultural subsidies	8,310	8,753	12,981	12,981	13,497	13,762	15,107
Transport subsidies	3,908	8,779	8,950	8,950	10,265	10,304	10,342
Health insurance companies	53,813	57,041	60,156	61,156	68,378	71,564	78,200
Sickness benefits	8,630	8,696	5,646	5,646	5,580	5,803	6,128
Old-age and disability pensions	84,303	89,025	97,184	98,434	106,218	113,476	119,092
Active labor market policies	3,483	2,808	3,368	3,368	4,701	4,865	5,824
Unemployment benefits	4,613	3,106	2,856	2,856	2,928	2,956	2,956
State benefits and social assistance	33,161	32,306	32,525	31,726	33,071	33,495	33,909
Social security contributions on behalf of certain groups	24,456	26,299	23,457	23,457	26,154	27,848	29,627
Transfers to the EU	0	0	9,013	7,993	13,189	13,510	13,926
Other subsidies and transfers	19,893	19,198	22,677	18,327	20,325	19,348	17,526
Interest	40,818	30,510	32,943	30,189	33,117	34,156	37,232
Capital spending	61,768	37,090	48,882	48,132	56,134	59,440	63,040
Capital assets	34,963	29,507	33,058	33,058	36,517	37,009	37,249
Capital transfers	26,805	7,583	15,824	15,074	19,617	22,431	25,791
Net lending/borrowing (+/-), ESA 95 basis	**-62,674**	**-40,416**	**-51,983**	**-50,686**	**-53,201**	**-59,100**	**-48,870**
Public debt, ESA 95 basis	475,387	511,770	571,217	577,839	631,463	690,502	741,585
Memorandum items:							
Nominal GDP 4/	1,098,658	1,201,196	1,293,200	1,328,231	1,407,382	1,503,762	1,611,260
Revenue flow to second pillar	0	0	0	0	5,596	15,056	17,951

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

1/ Excludes the impact of the end-2004 arbitration decision requiring Slovakia to pay Sk 24.8 billion (1.9 percent of GDP) to the CSOB bank.

2/ Includes estimated Sk 8 billion in revenues for which cash collection will be delayed due to EU accession.

3/ From 2005, excludes revenues of the second pillar of the pension system.

4/ 'Budget' columns refer to the authorities' budget projections for nominal GDP.

Table 3. Slovak Republic: Fiscal Operations of the Consolidated General Government, 2002-07 (continued)

(In percent of GDP, ESA 95 basis)

	2002	2003	2004		2005	2006	2007
	Outcome		Budget	Estimate 1/	2005 Budget		
Total revenue	38.2	36.3	36.2	35.0	36.7	35.9	35.8
Tax revenue	19.0	18.1	17.9	17.8	17.4	17.3	17.3
Personal income tax	3.4	3.3	2.1	2.6	2.4	2.4	2.4
Corporate profit tax	2.7	2.8	1.8	2.4	2.1	2.2	2.3
Withholding tax on capital income	0.9	0.8	0.9	0.4	0.5	0.4	0.4
VAT	7.6	6.7	8.8	8.0 2/	8.4	8.4	8.4
Excises	3.1	3.1	3.3	3.4	3.3	3.2	3.1
Import duties, property tax and other	1.4	1.4	1.0	1.1	0.8	0.7	0.7
Social contributions 3/	14.4	13.9	13.1	12.4	13.1	12.5	12.3
Grants and transfers	0.2	0.0	1.4	1.0	2.2	2.5	2.5
Of which: from European Union	0.0	0.0	1.4	1.0	2.2	2.5	2.5
Other revenue	4.6	4.3	3.8	3.9	4.0	3.6	3.7
Of which: interest	0.6	0.7	0.5	0.4	0.4	0.3	0.3
Total expenditure	44.0	39.7	40.2	38.9	40.4	39.8	38.8
Of which: primary expenditure	40.2	37.1	37.7	36.6	38.1	37.5	36.5
Current expenditure	38.3	36.6	36.4	35.2	36.4	35.9	34.9
Gross wages	7.5	7.4	7.2	7.0	7.1	6.9	6.8
Wages	5.6	5.5	5.4	5.2	5.3	5.2	5.1
Employer social security contributions	1.9	1.9	1.8	1.8	1.8	1.7	1.7
Goods and services	4.8	5.3	5.2	5.3	5.4	5.6	5.2
Subsidies and transfers	22.3	21.3	21.6	20.7	21.6	21.1	20.6
Agricultural subsidies	0.8	0.7	1.0	1.0	1.0	0.9	0.9
Transport subsidies	0.4	0.7	0.7	0.7	0.7	0.7	0.6
Health insurance companies	4.9	4.7	4.7	4.6	4.9	4.8	4.9
Sickness benefits	0.8	0.7	0.4	0.4	0.4	0.4	0.4
Old-age and disability pensions	7.7	7.4	7.5	7.4	7.5	7.5	7.4
Active labor market policies	0.3	0.2	0.3	0.3	0.3	0.3	0.4
Unemployment benefits	0.4	0.3	0.2	0.2	0.2	0.2	0.2
State benefits and social assistance	3.0	2.7	2.5	2.4	2.3	2.2	2.1
Social security contributions on behalf of certain groups	2.2	2.2	1.8	1.8	1.9	1.9	1.8
Transfers to the EU	0.0	0.0	0.7	0.6	0.9	0.9	0.9
Other subsidies and transfers	1.8	1.6	1.8	1.4	1.4	1.3	1.1
Interest	3.7	2.5	2.5	2.3	2.4	2.3	2.3
Capital spending	5.6	3.1	3.8	3.6	4.0	4.0	3.9
Capital assets	3.2	2.5	2.6	2.5	2.6	2.5	2.3
Capital transfers	2.4	0.6	1.2	1.1	1.4	1.5	1.6
Net lending/borrowing (+/-), ESA 95 basis	**-5.7**	**-3.4**	**-4.0**	**-3.8**	**-3.8**	**-3.9**	**-3.0**
Of which: revenue loss to second pillar	0.0	0.0	0.0	0.0	-0.4	-1.0	-1.1
Public debt, ESA 95 basis	43.3	42.6	44.2	43.5	44.9	45.9	46.0

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

1/ Excludes the impact of the end-2004 arbitration decision requiring Slovakia to pay Sk 24.8 billion (1.9 percent of GDP) to the CSOB bank.

2/ Includes estimated Sk 8 billion in revenues for which cash collection will be delayed due to EU accession.

3/ From 2005, excludes revenues of the second pillar of the pension system.

Table 4. Slovak Republic: Balance of Payments, 2000-08

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

					Estimate	Projection			
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Current account balance	-700	-1,756	-1,939	-280	-1,282	-2,599	-2,880	-966	-841
Trade balance	-904	-2,135	-2,131	-641	-1,273	-2,227	-2,602	-819	-741
Exports, f.o.b.	11,872	12,631	14,365	21,838	27,812	31,371	35,173	42,405	47,747
Imports, f.o.b.	-12,777	-14,766	-16,497	-22,479	-29,086	-33,597	-37,775	-43,224	-48,488
Services balance	439	480	456	237	297	349	378	401	421
Receipts	2,247	2,490	2,786	3,286	3,639	4,256	4,514	4,779	5,051
Payments	-1,807	-2,010	-2,330	-3,050	-3,343	-3,907	-4,136	-4,378	-4,630
Income balance	-353	-313	-456	-120	-626	-1,009	-1,157	-1,214	-1,228
Receipts	269	322	343	908	943	978	1,104	1,228	1,366
Payments	-622	-634	-800	-1,028	-1,569	-1,987	-2,261	-2,442	-2,593
Of which: Interest	-187	-267	-634	-536	-699	-745	-786	-864	-919
Current transfers	118	212	193	245	321	288	501	666	706
Official	-3	-9	-12	-13	13	-51	186	359	393
Private	121	221	205	258	308	340	315	307	313
Capital and financial account balance	1,511	1,719	5,175	1,738	4,045	4,107	5,276	2,524	2,381
Capital transfers	92	78	107	101	219	964	884	826	904
Direct foreign investment	2,096	1,137	3,963	580	1,295	2,366	2,751	1,031	916
Of which: Privatization	1,000	699	3,352	240	87	698	1,087	80	0
Greenfield investment	1,117	480	613	602	1,223	1,700	1,700	1,000	1,000
Portfolio investment	819	-217	554	-605	881	552	331	302	230
Credit extended (net): other investment assets	-159	-14	274	193	143	135	128	128	128
Credits received (net)	-429	-100	-247	-540	151	-725	244	300	217
Disbursements	1,254	1,482	1,082	2,182	6,604	2,847	2,621	2,587	2,515
Amortization	-1,683	-1,582	-1,329	-2,722	-6,453	-3,572	-2,377	-2,287	-2,298
Short-term capital (net)	-908	835	524	2,009	1,357	815	938	-62	-14
Errors and omissions	-32	180	409	35	0	0	0	0	0
Overall balance	779	143	3,645	1,493	2763	1508	2396	1558	1539
Financing	-779	-143	-3,645	-1,493	-2763	-1508	-2396	-1558	-1539
Gross reserves (- = increase)	-652	-143	-3,645	-2,954	-2763	-1508	-2396	-1558	-1539
Use of IMF credit	-127	0	0	0	0	0	0	0	0
Memorandum items:									
Current account balance (in percent of GDP)	-3.5	-8.4	-8.0	-0.9	-3.1	-5.2	-5.2	-1.5	-1.2
Trade balance (in percent of GDP)	-4.5	-10.2	-8.8	-2.0	-3.1	-4.4	-4.7	-1.3	-1.1
Export growth (US$ value)	16.1	6.4	13.7	52.0	27.4	12.8	12.1	20.6	12.6
Export growth (volume)	14.3	11.5	11.9	35.7	13.2	11.2	12.9	21.0	11.9
Import growth (US$ value)	12.9	15.6	11.7	36.3	29.4	15.5	12.4	14.4	12.2
Import growth (volume)	6.6	21.7	9.6	21.2	14.4	13.3	13.3	14.9	11.7
Gross official reserves (US$ million)	4,077	4,189	9,196	12,149	14,912	16,420	18,816	20,374	21,913
In months of imports of goods and services	3.4	3.0	5.9	5.7	5.5	5.3	5.4	5.1	5.0
Total external debt (US$ millions) 1/	10,804	11,042	13,107	18,090	18,574	19,262	20,858	21,501	22,098
(in percent of GDP)	53.4	52.9	54.1	55.4	45.1	38.4	37.4	34.2	32.1
Short-term external debt (US$ million) 2/	2,415	3,073	4,237	7,782	6,713	7,641	8,708	8,766	8,862
Short-term external debt adjusted (US$ million) 2/ 3/	3,997	4,402	6,959	14,235	10,285	10,018	10,995	11,064	11,123
Reserves/short-term debt (percent) 3/	102.0	95.2	132.1	85.3	145.0	163.9	171.1	184.1	197.0
Reserves/broad money (percent)	31.0	29.8	59.3	60.2	60.3	54.5	56.2	53.9	53.0
MLT External debt service/Exports of GNFS	14.1	12.2	11.4	13.0	22.7	12.1	8.0	6.7	6.1
GDP (US$ millions)	20,217	20,884	24,239	32,665	41,177	50,181	55,825	62,931	68,895

Sources: Data provided by the Slovak authorities; and IMF 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, 1998-2004
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	*Latest month available* 2004	
Financial indicators								
Public sector debt 1/	34.4	47.2	49.9	48.7	43.3	42.6	...	
Broad money (percent change, 12-month basis)	4.2	11.4	15.4	11.8	3.4	5.6	4.6	Oct
Private sector credit (percent change, 12-month basis)	5.8	4.5	7.0	8.1	12.0	13.7	12.3	Oct
Of which: credit to households (percent change, 12-month basis)	29.9	35.5	22.0	18.5	18.1	38.8	39.3	Oct
Domestic credit 2/	69.7	68.2	65.3	68.5	54.9	57.8	57.2	Sep
Six-months BRIBOR (end-of-period, in percent) 3/	19.4	13.7	7.8	7.7	5.7	5.7	3.5	Dec
Six-months BRIBOR, real (end-of-period, in percent) 4/	13.7	6.7	3.2	4.5	3.8	2.7	2.0	Oct
External indicators								
Merchandise exports (percent change, 12-month basis in US$)	11.2	-4.6	15.9	6.7	14.5	51.7	29.7	Nov
Merchandise imports (percent change, 12-month basis in US$)	11.9	-13.4	12.4	16.0	12.6	36.4	30.0	Nov
Terms of trade (percent change, 12-month basis)	1.6	-3.0	-4.4	0.5	-0.3	-0.4	...	
Current account balance	-9.6	-4.8	-3.5	-8.4	-8.0	-0.9	-2.8	Sep
Capital and financial account balance	8.8	10.5	7.5	8.2	21.4	5.3	...	
Capital transfers	0.3	0.8	0.5	0.4	0.4	0.3	...	
Portfolio investment, net	3.6	3.1	4.0	-1.0	2.3	-1.9	...	
Medium- and long-term credits + short-term credits	3.5	2.9	-7.4	3.5	2.3	5.1	...	
Direct investment, net	1.4	3.7	10.4	5.4	16.4	1.8	...	
Net foreign assets (NFA) of commercial banks (in US$ billions)	0.7	0.5	1.0	1.0	0.3	-1.1	...	
Gross official reserves (in US$ billions)	2.9	3.4	4.1	4.2	9.2	12.1	...	
Net international reserves (NIR) (in US$ billions)	3.7	2.8	3.8	3.9	8.8	11.1	...	
Central bank short-term foreign liabilities (in US$ billions) 5/	0.0	0.0	0.0	0.0	0.0	0.9	...	
Central bank foreign currency exposure (in US$ billions)	0.4	0.7	1.2	1.4	6.1	8.0	...	
Short-term foreign assets of commercial banks (in US$ billions) 6/	3.1	1.0	1.5	1.2	1.0	0.9	...	
Short-term foreign liabilities of commercial banks (in US$ billions) 6/	2.1	0.2	0.3	0.6	1.0	2.3	...	
Foreign currency exposure of commercial banks (in US$ billions)	0.7	0.5	1.0	1.0	0.3	-1.1	...	
Official reserves in months of imports of goods and services	2.3	3.1	3.4	3.0	5.9	5.7	...	
Reserve money to (gross official) reserves (percentage)	84.2	80.9	58.8	56.0	31.4	28.6	...	
Broad money to (gross official) reserves (percentage)	438.1	363.8	314.7	334.9	190.9	185.7	...	
Total short-term external debt to gross official reserves (percentage) 7/	204.4	128.1	98.0	105.1	75.7	117.2	...	
Total external debt	53.7	51.5	53.4	52.9	54.1	55.3	...	
Of which: public sector debt	11.3	13.8	16.7	16.5	15.4	16.1	...	
Total external debt to exports of goods and services (in percent)	91.4	85.6	76.5	73.0	76.4	72.0	...	
Total external debt service payments to exports of goods and services	14.3	16.2	14.1	12.2	11.4	13.0	...	
External interest payments to exports GS	4.1	4.6	3.8	3.7	3.5	2.9		
External amortization payments to exports GS	14.6	11.6	13.8	10.9	8.2	13.3		
Exchange rate (per US$, period average)	35.2	41.4	46.2	48.4	45.3	36.7	32.3	Jan-Dec
REER depreciation (-) (12-month basis; CPI-based)	0.4	-2.3	12.3	0.6	-0.1	11.6	9.1	Nov
REER depreciation (-) (12-month basis; ULC-based)	-2.1	-6.3	2.1	0.3	0.0	7.4	9.9	Jul
Financial market indicators (end-year)								
Stock market index	94.0	77.1	91.9	120.8	140.0	177.6	207.0	Nov
Foreign currency debt rating (Moody's)	Ba1	Ba1	Ba1	Baa3	A3	A3	A2	current
Spread of (five-year benchmark) bond (basis points) 8/	...	213	184	67	39	7.5	...	

Sources: Data provided by the Slovak authorities; and IMF 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/ Bratislava Interbank Offering Rate
4/ Backward looking, deflated by CPI until 1999, and by core CPI from 1999 onward.
5/ Includes short-term liabilities of the government.
6/ 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.
7/ Includes medium- and long-term debt due next year.
8/ Spread on five-year koruna-denominated Slovak bond over German five-year bond.

Table 6. Slovak Republic: Monetary Survey, 2000-05
(In actual exchange rates, Sk billion)

	Dec 1/ 2000	Dec 2001	Dec 2002	Dec 2003	Mar 2004	Jun 2004	Sep 2004	Estimate Dec 2004	Projection Dec 2005
Net foreign assets, NIR definition	104.1	119.3	253.5	227.4	247.3	256.0	249.9	233.6	259.7
Position of banks vis-à-vis nonresidents in Sk	17.8	2.2	-23.8	-35.2	-43.2	-54.0	-50.5	-35.2	-35.2
Bonds held by nonresidents	-11.0	-20.6	-21.0	-33.3	-45.2	-61.7	-62.8	-62.8	-86.2
Net foreign assets	110.9	101.0	208.6	158.9	158.9	140.3	136.7	135.6	138.3
Net domestic assets (M2)	497.1	578.9	494.3	583.6	563.8	602.4	623.1	661.5	716.5
Domestic credit	622.0	691.6	603.4	694.0	701.8	716.5	739.7	785.9	893.1
Net credit to government 2/	305.1	345.4	265.6 3/ 4/	309.6	311.9	325.3	333.6	356.7	407.1
From banking system	159.3	190.2	113.7	139.7	127.8	85.5	83.4	106.6	140.0
Foreign financing	133.4	136.7	128.6	134.6	142.7	190.6	191.3	196.2	212.2
In foreign currency	122.4	116.0	107.6	101.3	97.5	128.9	128.6	133.4	126.0
In Sk denominated bonds	11.0	20.7	21.0	33.3	45.2	61.7	62.8	62.8	86.2
Nonbank domestic financing	12.4	18.3	23.2	35.2	41.3	49.2	58.9	53.9	54.9
Net credit to National Property Fund 2/	0.1	10.4	-3.1	-3.1	-3.7	-14.0	-6.7	-6.7	-6.7
Credit to enterprises and households	316.8	335.8	340.9 5/	387.5	393.6	405.2	412.8	435.9	492.6
Other items, net (M2)	-124.9	-112.7	-109.1	-110.4	-138.0	-114.1	-116.6	-124.4	-176.6
Broad money (M2)	608.0	679.9	702.9	742.5	722.7	742.7	759.8	797.1	854.8
Koruna broad money	513.7	574.8	596.2	650.5	636.8	648.0	667.0	699.0	749.8
Currency	67.0	81.0	84.2	91.8	90.8	93.2	96.3	95.9	103.9
Deposits	541.0	598.9	618.7	650.7	631.9	649.5	663.5	701.2	750.9
Of which: in foreign currency	94.4	105.1	106.7	92.0	85.9	94.7	92.8	98.1	105.0
Memorandum items (year-on-year percentage change, unless otherwise indicated)									
Nominal GDP growth	10.0	9.1	8.8	9.3	10.3	10.8	10.7	10.6	8.3
M2	15.5	11.8	3.4	5.6	2.0	6.3	5.4	7.4	7.2
Change in M2 velocity, in percent, year-on-year	-4.2	-3.3	5.2	3.5	10.9	3.3	3.2	3.0	1.0
Koruna M2	14.0	11.9	3.7	9.1	4.5	6.8	6.7	7.5	15.9
M2-base money multiplier	5.4	5.98	6.1	6.5	6.6	6.9	6.5	6.4	6.3
Credit to enterprises and households 5/	2.6	6.0	12.1	13.7	12.9	14.3	12.1	12.5	13.0

Sources: National Bank of Slovakia; and IMF 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/ Includes accumulated interest payments on restructuring bonds.

3/ 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).

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

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

Table 7. Slovak Republic: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003			Estimate 2004	Projections 2005	2006	2007	2008	2009	
											I. Baseline Projections			**Debt-stabilizing non-interest current account 6/**
1 **External debt**	51.6	53.4	52.9	54.1	55.4			**45.1**	**38.4**	**37.4**	**34.2**	**32.1**	**28.4**	**-2.7**
2 Change in external debt	-2.0	1.8	-0.6	1.2	1.3			-10.3	-6.7	-1.0	-3.2	-2.1	-3.7	
3 Identified external debt-creating flows (4+8+9)	5.0	-6.9	-1.5	-16.4	-14.1			-10.6	-7.1	-3.5	-4.2	-3.0	-3.6	
4 Current account deficit, excluding interest payments	2.1	0.8	5.7	5.5	-1.4			1.4	3.7	3.8	0.2	-0.1	-0.7	
5 Deficit in balance of goods and services	4.3	2.3	7.9	6.9	1.2			2.4	3.7	4.0	0.7	0.5	0.0	
6 Exports	60.4	69.8	72.4	70.8	76.9			76.4	71.0	71.1	75.0	76.6	76.3	
7 Imports	64.6	72.1	80.3	77.7	78.2			78.8	74.7	75.1	75.6	77.1	76.3	
8 Net nondebt creating capital inflows (negative)	-3.7	-10.2	-7.9	-17.4	-1.9			-2.9	-4.7	-4.9	-1.6	-1.3	-1.2	
9 Automatic debt dynamics 1/	6.6	2.4	0.7	-4.5	-10.8			-9.1	-6.1	-2.4	-2.7	-1.5	-1.8	
10 Contribution from nominal interest rate	2.8	2.6	2.7	2.5	2.2			1.7	1.5	1.4	1.4	1.3	1.2	
11 Contribution from real GDP growth	-0.9	-1.1	-2.0	-2.1	-1.8			-2.3	-1.8	-1.7	-2.0	-1.0	-1.2	
12 Contribution from price and exchange rate changes 2/	4.7	0.9	0.0	-4.9	-11.2			-8.5	-5.8	-2.1	-2.1	-1.9	-1.8	
13 Residual, incl. change in gross foreign assets (2-3)	-7.0	8.7	0.9	17.6	15.4			0.3	0.4	2.5	1.0	0.9	-0.1	
External debt-to-exports ratio (in percent)	85.6	76.5	73.0	76.4	72.0			59.1	54.1	52.6	45.6	41.9	37.2	
Gross external financing need (in billions of US dollars) 3/	7.0	5.3	5.8	6.4	7.9			20.3	16.6	17.6	17.6	17.5	17.2	
in percent of GDP	34.4	26.5	27.8	26.5	24.1			49.2	33.1	31.6	28.0	25.4	22.5	
Key macroeconomic assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	1.5	2.0	3.8	4.6	4.5	4.3	1.6	5.3	4.9	4.9	6.2	3.2	4.3	4.8
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-15.0	-10.3	-4.5	6.7	23.3	-1.2	11.1	14.0	12.5	3.1	3.2	3.1	3.1	6.5
GDP deflator in U.S. dollars (change in percent)	-9.5	-2.7	-0.5	10.9	29.0	5.4	11.5	19.7	16.2	6.0	6.2	6.1	6.1	10.1
Nominal external interest rate (in percent)	4.7	5.1	5.2	5.5	5.5	5.2	0.9	3.9	4.0	4.1	4.1	4.3	4.2	4.1
Growth of exports (U.S. dollar terms, in percent)	-5.6	14.9	7.1	13.4	46.5	13.8	14.4	25.2	13.3	11.4	18.9	11.9	10.2	15.1
Growth of imports (U.S. dollar terms, in percent)	-14.2	10.8	15.0	12.2	35.6	13.0	14.3	27.0	15.7	11.8	13.6	11.6	9.5	14.8
Current account balance, excluding interest payments	-2.1	-0.8	-5.7	-5.5	1.4	-2.7	5.2	-1.4	-3.7	-3.8	-0.2	0.1	0.7	-1.4
Net nondebt creating capital inflows	3.7	10.2	7.9	17.4	1.9	4.6	5.6	2.9	4.7	4.9	1.6	1.3	1.2	2.8
										II. Stress Tests for External Debt Ratio				**Debt-stabilizing non-interest current account 6/**
A. Alternative scenarios														
A1. Key variables are at their historical averages in 2005-09 4/								**45.1**	**42.2**	**41.4**	**39.0**	**36.5**	**33.0**	**-6.0**
A2. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) 5/								**45.1**	**38.7**	**38.0**	**35.5**	**33.0**	**29.3**	**-2.8**
B. Bound tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**45.1**	**39.5**	**39.4**	**36.1**	**33.9**	**30.1**	**-2.8**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**45.1**	**39.7**	**39.8**	**36.3**	**34.1**	**30.2**	**-2.9**
B3. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**45.1**	**50.9**	**59.5**	**54.2**	**50.9**	**45.1**	**-4.6**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**45.1**	**47.8**	**55.6**	**51.1**	**48.2**	**43.6**	**-3.6**
B5. Combination of B1-B4 using one standard deviation shocks								**45.1**	**52.8**	**62.7**	**57.4**	**54.0**	**48.2**	**-4.4**
B6. One time 30 percent nominal depreciation in 2005								**45.1**	**56.8**	**53.2**	**48.5**	**45.5**	**40.3**	**-4.1**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ 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, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) 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.
4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
5/ Real GDP growth drops to 4 percent throughout 2005-09.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and nondebt inflows in percent of GDP) remain

Table 8. Slovak Republic: Public Sector Debt Sustainability Framework, 1999-2009

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003			Estimate 2004	Projections 2005	2006	2007	2008	2009	
									I. Baseline Projections					**Debt-stabilizing primary balance 9/**
1 **Public sector debt 1/**	47.2	49.9	48.7	43.3	42.6			**43.5**	**43.9**	**44.5**	**43.7**	**42.9**	**41.7**	**-0.9**
Of which: foreign-currency denominated	6.2	7.4	7.9	13.4	11.3			16.5	16.6	17.3	17.8	18.6	1.9	
2 Change in public sector debt	12.8	2.7	-1.1	-5.5	-0.7			0.9	0.4	0.6	-0.8	-0.8	-1.2	
3 Identified debt-creating flows (4+7+12)	2.3	1.0	13.0	15.3	-3.2			-5.2	-1.4	0.1	-1.4	-0.5	-1.0	
4 Primary deficit	0.6	4.7	3.5	2.0	0.8			1.5	1.4	1.6	0.7	0.4	0.4	
5 Revenue and grants	41.2	38.6	36.7	39.3	36.3			35.0	35.9	34.8	34.0	33.8	33.4	
6 Primary (noninterest) expenditure	41.8	43.3	40.2	41.3	37.1			36.6	37.3	36.4	34.7	34.1	33.8	
7 Automatic debt dynamics 2/	1.4	-1.0	-0.4	-1.7	-3.6			-3.2	-2.8	-1.5	-2.1	-0.9	-1.4	
8 Contribution from interest rate/growth differential 3/	0.6	-1.7	-0.6	-0.2	-1.2			-1.8	-1.0	-1.0	-1.6	-0.4	-0.8	
9 Of which: contribution from real interest rate	1.0	-0.9	1.1	1.8	0.6			0.2	0.9	1.0	0.9	0.9	0.9	
10 Of which: contribution from real GDP growth	-0.5	-0.9	-1.7	-2.1	-1.8			-2.0	-2.0	-2.0	-2.5	-1.3	-1.7	
11 Contribution from exchange rate depreciation 4/	0.9	0.7	0.2	-1.4	-2.5			-1.4	-1.8	-0.5	-0.5	-0.5	-0.5	
12 Other identified debt-creating flows	0.2	-2.7	9.9	14.9	-0.4			-3.6	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-0.3	-4.3	-3.6	14.7	-1.0			-3.6	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.5	1.7	0.8	0.3	0.6			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (bank recapitalization)	0.0	0.0	12.7	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3)	10.6	1.7	-14.1	-20.7	2.5			6.1	1.8	0.5	0.6	-0.2	-0.3	
Public sector debt-to-revenue ratio 1/	114.5	129.1	132.7	110.2	117.3			124.1	122.4	128.0	128.6	127.2	124.8	
Gross financing need 5/	13.7	19.4	19.3	17.5	16.1			16.2	16.4	16.7	15.6	15.2	14.8	
in billions of U.S. dollars	2.8	3.9	4.0	4.2	5.3			6.7	8.2	9.3	9.8	10.5	11.3	
Key macroeconomic and fiscal assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	1.5	2.0	3.8	4.6	4.5	4.3	1.6	5.3	4.9	4.9	6.2	3.2	4.3	4.8
Average nominal interest rate on public debt (in percent) 6/	9.8	6.6	6.8	8.3	6.4	9.0	2.8	5.9	5.7	5.4	5.4	5.2	5.2	5.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.4	-1.9	2.6	4.3	1.8	2.3	2.3	0.9	2.4	2.6	2.5	2.3	2.3	2.2
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-12.7	-10.8	-2.2	21.1	21.6	0.8	12.5	14.0	12.5	3.1	3.2	3.1	3.1	6.5
Inflation rate (GDP deflator, in percent)	6.5	8.5	4.2	4.0	4.7	6.7	3.1	5.0	3.3	2.9	2.9	2.9	2.9	3.3
Growth of real primary spending (deflated by GDP deflator, in percent)	2.6	5.7	-3.6	7.4	-6.0	3.0	7.9	3.7	6.8	2.4	1.3	1.6	3.4	3.2
Primary deficit	0.6	4.7	3.5	2.0	0.8	1.3	2.3	1.5	1.4	1.6	0.7	0.4	0.4	1.0
									II. Stress Tests for Public Debt Ratio					**Debt-stabilizing primary balance 9/**
A. Alternative scenarios														
A1. Key variables are at their historical averages in 2005-09 7/								**43.5**	**43.9**	**44.3**	**44.8**	**44.4**	**44.0**	**-0.9**
B. Bound tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**43.5**	**45.6**	**47.9**	**47.0**	**46.1**	**44.8**	**-0.9**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**43.5**	**46.8**	**51.8**	**53.3**	**54.9**	**55.8**	**-1.2**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**43.5**	**48.4**	**53.0**	**51.9**	**50.9**	**49.4**	**-1.0**
B4. Combination of B1-B3 using one standard deviation shocks								**43.5**	**47.8**	**52.1**	**51.0**	**50.0**	**48.6**	**-1.0**
B5. One time 30 percent real depreciation in 2005 8/								**43.5**	**53.7**	**54.0**	**52.7**	**51.8**	**50.3**	**-1.0**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**43.5**	**53.9**	**54.1**	**52.9**	**51.9**	**50.4**	**-1.0**

1/ Gross debt. Public sector refers to general government. Assumes the authorities' 2005 budget projections for (nominal) fiscal deficit and debt for 2005-07.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ 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 $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.

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

7/ The key variables include real GDP growth, real interest rate, and primary balance in percent of GDP.

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

9/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Slovak Republic: Fund Relations

(As of December 31, 2004)

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

II. **General Resources Account**:

	SDR Million	%Quota
Quota	357.50	100.0
Fund Holdings of Currency	357.50	100.0

III. **SDR Department**:

	SDR Million	%Allocation
Holdings	0.87	N/A

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:

The currency of the Slovak Republic is the Slovak koruna, created on February 8, 1993 upon the 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 is set in the foreign exchange market and stood at Sk 28.496 per U.S. dollar and Sk 38.796 per euro on December 31, 2004. The National Bank of Slovakia (NBS) does not support the koruna's exchange rate, but intervenes primarily to smooth large fluctuations in the exchange rate and when the exchange rate moves to an unacceptable level. The exchange rate regime is currently classified as a managed float with no preannounced path for the exchange rate.

The Slovak Republic continues to maintain an exchange system free of restrictions on payments and transfers for current international transactions consistent with its Article VIII obligations.

VIII. **Article IV Consultation**:

The last consultation with the Slovak Republic was concluded on July 23, 2003 (EBM 03/72).

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

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

Slovak Republic: Technical Assistance, 1991–2004[10]

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

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

Department	Timing	Purpose
	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
	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 2002	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 followup
	April 2001	Public Finance Management followup
	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 followup, tax investigation/fraud issues
	June 2002	Mission to prepare Report on the Observance of Standards and Codes

Department	Timing	Purpose
		(ROSC), Fiscal Transparency Module
	February 2003	Tax policy
	March 2003	Tax administration
	May 2003	Expenditure policy
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
	February–March 2004	Data ROSC Mission

Slovak Republic: Statistical Issues

1. From the point of view of macroeconomic analysis and policy making, the quality of the data, in particular of the national accounts, has improved in recent years. A Data ROSC mission to Bratislava during February–March 2004 found that the quality, integrity, soundness and reliability of the data were overall satisfactory, despite some shortcomings in the data revision policy. The main issues remaining are: (i) weaknesses in the data on prices and volumes of imports and exports; (ii) a lack of timely data on the overall general government operations; and (iii) slow compilation cycle of the annual national accounts and lack of proper benchmarking of quarterly data. Slovakia subscribes to the Special Data Dissemination Standard (SDDS) since 1996 and observes or exceeds all related standards. Finalization of the Data ROSC report is pending the authorities' response to the draft.

2. With regard to timeliness and public access, the authorities in general follow a free and open data publication policy. Data are promptly released to news services, and are also published regularly in various monthly and quarterly statistical publications, and on the Internet[11] 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 foreign exchange reserves; a month 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. However, the 2004 Data ROSC mission reported difficulties in reconciling balance of payments statistics with national accounts, monetary, or government finance statistics.

Real sector and prices

3. Significant progress has been made in the elaboration of the Slovak national accounts statistics. However, output estimates for the last few years may yet have to be revised in the future. The quarterly national accounts data on expenditures exhibit weaknesses and there is a significant statistical discrepancy between the supply side and the demand side (representing more than 1 percent of GDP in 2003Q2 and 2003Q4).[12] An important outstanding issue is the compilation of reliable price deflators for imports and exports that would enable better decomposition into volume and price changes. The unit value trade price

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

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

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.

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.

Fiscal sector

7. General government statistics are compiled annually in accordance with the methodology of the *1986 Manual on Government Finance Statistics* (GFSM 1986) for internal use, publication in the *GFS Yearbook*, and dissemination on the Ministry of Finance (MoF) website in compliance with the SDDS. In accordance with the EU *acquis communautaire,* the authorities report semi-annually on general government net lending/borrowing. Monthly reconciliation of government operations above and below the line is restricted to budget transactions. A modern treasury system began operating in January 2004. The new system will improve fiscal control by providing a means of recording expenditures at the planning and commitment stages. However, from mid-2004, monthly state budget data have not included breakdowns of revenues or expenditures. It is not yet clear whether these new data gaps reflect teething problems with the treasury system, or other factors related to EU accession.

8. The MoF is converting its fiscal accounts to ESA 95 standards. The MoF has also begun compiling statistics in accordance with the methodology of the *Government Finance Statistics Manual 2001* (GFSM 2001); data are available on a cash basis for 2000–02, and on an accrual basis for 2003.

External sector

9. 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 monthly basis. Banks are now reporting their arbitrage transactions accurately. Improvements have also been made in reporting nonresidents' claims and liabilities in domestic currency. Balance of payments statistics are compiled and disseminated monthly on a cumulative basis during the year; however, dissemination on a cumulative basis does not follow best practices. 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 recording of most interest payments on a cash basis; and (ii) the need to disseminate discrete balance of payments statistics as required by the SDDS.

Monetary sector

10. Monetary statistics are of good quality, and are reported on a timely basis to the Fund. The 2004 Data ROSC mission found that the two sets of monetary data compiled by the National Bank of Slovakia (NBS)—the national monetary statistics (NMS), for internal use, and the harmonized monetary statistics (HMS), submitted to international organizations—are broadly in line with the IMF Monetary and Financial Statistics Manual. One exception was the treatment, in the NMS, of government's foreign liabilities as part of the NBS foreign liabilities, with a counterpart adjustment in NBS claims on the government. In response to the mission's comments, the authorities changed this treatment to exclude government foreign liabilities from NBS foreign liabilities. Another exception was the exclusion of money market funds from the NMS, but the authorities recently started including these funds as a memo item in the NMS. A third exception is that market valuation is not applied to certain financial instruments under both the NMS and HMS.

Slovak Republic: Core Statistical Indicators
(As of January 5, 2005)

	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	1/5/05	12/31/04	10/31/04	10/31/04	10/31/04	1/5/05	11/04	10/04	9/04	12/04	Q3/04	Q3/04
Date Received	1/5/05	12/31/04	12/7/04	12/7/04	12/7/04	1/5/05	12/9/04	12/17/04	12/31/04	1/3/05	12/10/04	12/31/04
Frequency of Data 3/	D	W	M	M	M	D	M	M	M	M	Q	Q
Frequency of Reporting 3/	D	W	M	M	M	D	M	M	M	M	Q	Q
Source of Data 5/	N	A	A	A	A	N	N	N	N	A	N	N
Mode of Reporting 6/	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality 7/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 3/	D	W	M	M	M	D	M	M	M	M	Q	Q

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

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2004 Article IV Consultation with the Slovak Republic

On February, 11, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Slovak Republic.[1]

Background

Slovakia's economic performance has improved since the 2003 Article IV consultation. Output has expanded strongly and fiscal and external balances have narrowed substantially in recent years. These developments were assisted by large foreign direct investments and an improved business climate following important reforms—including to taxation, welfare, pensions, healthcare, and the labor market—that are supporting convergence to western European income levels.

Economic activity was entirely export-driven in 2003; real GDP increased by 4.5 percent despite a contraction in domestic demand. But activity broadened to the domestic sector in 2004, supported by accommodating macroeconomic policies, and real GDP grew by an estimated 5.25 percent. The external current account deficit widened in 2004 to an estimated 3 percent of GDP, still well within sustainable bounds. Despite the strong economic

[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.

performance, however, employment gains have been uneven across sectors, and unemployment remains high at 17.75 percent.

Headline inflation remained high (5.9 percent at end-2004, against 9.3 percent at end-2003), driven by administered price and indirect tax increases, but should fall in 2005 as these one-off effects wane. Core inflation was low, at 1.5 percent at end-2004, below the end-2003 outcome of 2.7 percent owing largely to falling food prices. For end-2005, the National Bank of Slovakia's (NBS) target range for headline inflation is 3.5 plus/minus 0.5 percent, and core inflation is expected to fall within the range 1.1 to 3.4 percent.

The NBS reduced its main policy rate by a cumulative 250 basis points between September 2003 and end-2004, initially in response to weak domestic demand, and later to counter the appreciation pressures arising from significant short-term capital inflows. The NBS also conducted extensive foreign exchange market interventions, enlarging its balance sheet and increasing its sterilization position. Nevertheless, the Slovak koruna appreciated by about 6 percent against the euro during 2004.

Following a sharp contraction in 2003, the fiscal deficit widened slightly in 2004 to an estimated 3.8 percent of GDP (European System of Accounts 1995 basis). This reflected a small reduction in revenues as a share of GDP following the 2004 tax reform, only partly offset by lower spending on wages, benefits and interest. Taking into account net transfers from the EU, the fiscal impulse was about 1 percent of GDP in 2004.

The authorities have released a strategy for euro adoption in 2009, based on Exchange Rate Mechanism 2 (ERM2) entry in 2006, and meeting the Maastricht fiscal deficit and inflation criteria in 2007.

Executive Board Assessment

Executive Directors commended the Slovak authorities' sound macroeconomic management and exemplary progress on structural reform over the past few years. This has resulted in an impressive performance of the Slovak economy, with strong productivity and economic growth and declining fiscal and external imbalances. Structural reforms have increased the economy's flexibility, large foreign investments have expanded production capacity, and investor confidence is growing as a result of the remarkable improvement of the business climate. Slovakia's accession to the EU in May 2004 set the stage for a continued robust economic performance, supported by an increasing contribution of domestic demand to broad-based growth over the medium term.

Despite these favorable prospects, Directors noted that challenges remain. The inflation rate, though falling, is still well above the euro-area average, and strong growth poses upside risks to the central bank's inflation target for 2005. Further fiscal consolidation to reduce the still substantial fiscal deficit will require perseverance. Also, the unemployment rate remains high, particularly in eastern regions. More generally, the achievement of income convergence to western European levels will require maintaining the strong momentum of structural reform.

Directors recognized that the authorities face a challenging monetary policy environment. They elcomed the National Bank of Slovakia's adoption of a monetary policy framework that will give disinflation priority over exchange rate considerations. With the support of an effective communication strategy, the explicit inflation targets announced for 2005-08 should increase the transparency of monetary policy, help anchor inflation expectations, and encourage forward-looking wage-setting behavior. Given the rapid productivity growth and favorable competitiveness indicators, Directors supported a more flexible approach to the exchange rate in pursuing disinflation. Directors noted that the upside risks to inflation and record-low interest rates leave little room, if any, for further interest rate cuts to limit exchange-rate appreciation. They emphasized that, in a context where substantial capital inflows could continue, a tighter fiscal policy should remain an essential instrument in the policy mix to reduce inflation.

Accordingly, Directors encouraged the authorities to aim for a tighter fiscal policy than currently planned for 2005-07, although it was recognized that this will require careful preparation to preserve public support for the Maastricht convergence process in the upcoming election year. They considered a more ambitious fiscal consolidation path to be desirable in light of the projected above-trend output growth and Slovakia's planned adoption of the euro in 2009. For this year, Directors encouraged the authorities to reduce the planned deficit if economic growth and revenues exceed expectations . Looking ahead, they highlighted the risks involved in back-loading the fiscal adjustment, noting, in particular, that the 2007 deficit target of 3 percent of GDP will leave no margin with respect to the Maastricht criterion to deal with negative shocks or policy slippages. Directors advised the authorities to strengthen the medium-term budgetary framework to help ensure that the Maastricht criteria will be met in a sustainable way.

Directors generally welcomed the comprehensive tax reform introduced in 2004, which should reduce distortions in the economy and strengthen incentives to work, although some concern was expressed about the decline in the progressiveness of the tax system. They recognized that the upfront cost of these and some other structural reforms, and spending on EU-financed projects, make further fiscal adjustment more difficult. At the same time, they observed that additional growth-enhancing expenditure savings could come from the continued restructuring of inefficient sectors and the reduction of remaining subsidies, including agricultural subsidies, that do not contribute to Slovakia's growth potential. Directors also emphasized the need for continued close cooperation at all government levels and the continued transparent implementation of fiscal policy to support the achievement of fiscal objectives.

Directors welcomed the results of the updated fiscal module of the Report on the Observance of Standards and Codes, which show that further progress has been made in bringing fiscal transparency close to international best practice, including through improvements in the coverage and availability of fiscal information. However, they regretted that the establishment of the extra-budgetary environmental fund is a slippage in fiscal transparency.

Directors noted that the authorities' timetable for entering ERM2 and adopting the euro will require, in addition to sound macroeconomic policies, continued structural reform. They welcomed recent reforms to the legal framework and improvements to the investment climate, and looked forward to steps to improve the functioning of the courts. They also asked that fiscal incentives for regional investment should be applied carefully, and that remaining privatizations should be undertaken in a way that encourages competition.

Directors also welcomed recent reforms to the labor code and the benefits system that reduce employment restrictions and improve incentives to work. At the same time, Directors stressed that further structural measures are needed to deal with the high unemployment. They highlighted the importance of improving education, upgrading public infrastructure, and developing the housing market for low- and middle-income households to facilitate labor mobility and reduce the regional mismatch of jobs and workers. Further efforts will also be needed to reduce the still-high labor tax wedge.

Directors commended Slovakia's solid bank soundness indicators and the ongoing improvements to banking supervision. They encouraged a further strengthening of supervisory capacity, including through appropriate follow-up on audit findings, and the collection of comprehensive data on household assets and liabilities to better monitor risks stemming from rapid household credit growth. Directors welcomed the planned consolidation of financial sector supervision in the National Bank of Slovakia, while cautioning that organizational changes should not distract from effective oversight.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Slovak Republic: Selected Economic Indicators

	2000	2001	2002	2003	Estimate 2004
	(Percent change, period average)				
Real sector					
Real GDP	2.0	3.8	4.6	4.5	5.3
Consumer prices					
Period average	12.0	7.3	3.3	8.5	7.5
12 months to end of period	8.4	6.6	3.4	9.3	5.9
Gross industrial output (constant prices)	8.6	7.0	7.2	5.4	…
Real wages in industry					
PPI-based	0.4	4.1	4.4	6.1	…
CPI-based	-2.9	2.9	4.0	-1.3	…
Employment in industry	-3.0	1.0	0.2	0.5	…
Unemployment rate (LFS), period average	18.8	19.3	18.6	17.5	17.7
Real effective exchange rate 1/					
CPI-based	12.3	0.6	-0.1	11.6	…
ULC-based	2.1	0.3	0.0	7.4	…
	(In percent of GDP)				
Public finance (ESA 95 basis)					
General government balance	-12.3	-6.0	-5.7	-3.4	-3.8
General government debt	49.9	48.7	43.3	42.6	43.5
	(Percent change, end of period, unless otherwise indicated)				
Money and credit					
Net domestic assets 2/	6.2	16.5	-13.0	18.1	13.3
Credit to enterprises and households 3/	7.0	8.1	12.0	13.7	12.5
Broad money	15.5	11.8	3.4	5.6	7.4
Interest rates (in percent, end-of-period)					
Lending rate (short-term)	10.7	8.8	7.5	7.2	…
Deposit rate (one-week)	6.0	6.0	4.0	4.2	…
NBS policy rate (two-week standard tender repo rate)	8.00	7.75	6.50	6.00	4.00
Velocity	-4.2	-3.3	5.2	3.5	3.0
	(US$ billion, unless otherwise indicated)				
Balance of payments					
Merchandise exports	11.9	12.6	14.4	21.8	27.8
(percent change)	(16.1)	(6.4)	(13.7)	(52.0)	(27.4)
Merchandise imports	12.8	14.8	16.5	22.5	29.1
(percent change)	(12.9)	(15.6)	(11.7)	(36.3)	(29.4)
Trade balance	-0.9	-2.1	-2.1	-0.6	-1.3
Current account balance	-0.7	-1.8	-1.9	-0.3	-1.3
(percent of GDP)	(-3.5)	(-8.4)	(-8.0)	(-0.9)	(-3.1)
Official reserves, end-period	4.1	4.2	9.2	12.1	14.9
(in months of imports of GNFS)	(3.4)	(3.0)	(5.9)	(5.7)	(5.5)
(in percent of broad money)	(31.8)	(29.9)	(52.4)	(53.9)	…
Gross reserves of banking system	5.6	5.4	10.2	13.0	…
Gross external debt, end-period 4/	10.8	11.0	13.1	18.1	18.6
Gross external debt, end-period (in percent of GDP) 4/	53.4	52.9	54.1	55.4	45.1
Short-term debt (end of period) 5/	4.0	4.4	7.0	14.2	10.3
Short-term debt (end of period) 6/	2.4	3.1	4.2	7.8	6.7
Official reserves to short-term debt (in percent) 5/	102.0	95.2	132.1	85.3	145.0
Memorandum items:					
GDP, current prices (Sk billions)	934.1	1,009.8	1,098.7	1,201.2	1,328.2
Exchange rate (Sk/U.S. dollar)					
Period average	46.2	48.4	45.3	36.8	32.3
End of period	47.4	48.5	40.0	32.9	28.5

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 deposits of Sk 61.4 billion in privatization receipts at the pension fund account at the NBS in 2002.
3/ Adjusted for bank restructuring.
4/ Excludes domestic currency denominated debt.
5/ Short-term debt is defined to include medium- and long-term debt due in the subsequent year.
6/ Short-term debt is defined to exclude medium- and long-term debt due in the subsequent year.

Statement by Willy Kiekens, Executive Director for Slovak Republic
and Juraj Sipko, Advisor to Executive Director
February 11, 2005

The Slovak authorities are grateful for the extensive consultations and discussions with the staff and for the well written and balanced Staff Report and the Selected Issues Papers.

Introduction

The continuation of consistent macroeconomic policies, supported by comprehensive structural reforms, has borne fruit. The fiscal deficit shrank from 5.7 percent of GDP in 2002 to 3.4 percent in 2003, while the external current account deficit fell from 8.0 percent of GDP to 0.9 percent during the same period.

A broad-based privatization program, a sharp reduction of government expenditure on subsidies and transfers, radical reforms to the pension and healthcare systems, and the adoption of a single tax rate for personal and corporate income taxes and VAT, earned Slovakia recognition as the World Bank's "top reformer of the year" in 2004.

May 1, 2004 was the historic date on which Slovakia and other advanced transition countries joined the European Union. Accession took place during a period of strong economic growth largely resulting from prudent macroeconomic stabilization policies and a broad-based framework aimed at medium-term sustainability.

In December 2004, Standard and Poor's upgraded Slovakia's sovereign rating to A-, with a positive outlook. In January 2005, Moody’s upgraded Slovakia to A2.

Real Sector Development

Slovakia is one of the fastest growing economies in Central and Eastern Europe. The higher-than-expected growth of about 5.3 in 2004 was driven by strong domestic demand, higher wages, a vigorous export performance, and high nonprivatization FDI. The authorities' medium-term projection for GDP growth is around 5 percent in the period 2005-2007.

Last year, the external current account deficit widened by more than 2 percentage points. This deterioration was due mainly to strong investment inflows and strong outflows of profits being repatriated to foreign companies operating in Slovakia. The authorities expect that in 2005, imports connected with the construction of Peugeot, Kia, Ford, and other greenfield investments will increase the external current account deficit to 5 percent of GDP, but this will be fully financed by FDI inflows. For 2006, the authorities project a current account deficit of about 4.5 percent of GDP. In 2007-2008, the current account deficit is expected to be less than 2 percent of GDP.

To make the economy more competitive, the authorities have adopted the Lisbon Strategy and will implement it through 2010. They are convinced that the only way to guarantee Slovakia's long-term competitiveness is to create the structural conditions essential for developing a knowledge-based economy. In particular, the authorities intend to concentrate their efforts on four areas: improving education and human resources, ensuring that Slovak citizens develop information technology skills, ensuring the development of Slovakia's scientific potential, and continuing to develop a business environment that promotes market competition.

Fiscal Policy

With a view to adopting the euro as soon as possible, the authorities succeeded in building support for their plans to meet the Maastricht criteria. A first step towards that goal was bringing the ESA-95 (European System of Accounts) general government deficit below 4 percent of GDP in 2004.

The overall fiscal deficit in 2004 turned out better than budgeted and is estimated at 3.8 percent of GDP. The authorities agreed with the staff that further consolidation will be needed. But given the election cycle, it will be difficult to reduce the deficit faster than the authorities already envisage in their Convergence Programme.

The update of this program covers the period 2004 to 2007 and provides indicative projections until 2010. The budget plans for 2005 and 2006, as specified in the three-year fiscal policy framework, are in line with the Convergence Programme. Based on this framework, the authorities target the general fiscal deficit for 2005 and 2006 to be 3.8 percent and 3.9 percent of GDP, respectively. The target for 2007 is to reduce the fiscal deficit to 3 percent of GDP reference value, which the European Council of Ministers supported in their statement of December 2004.

Monetary Policy

Slovakia's strong competitive position vis-à-vis other EU members, strong capital inflows, and EU membership have caused the Slovak koruna to strengthen vis-à-vis the euro and the US dollar. In response, the National Bank of Slovakia (NBS) cut interest rates by a cumulative 250 basis points and intervened substantially in the foreign exchange markets in 2004. Nevertheless, the appreciation in 2004 exceeded 6 percent vis-à-vis the euro, which was much higher than the NBS's expectation.

In 2004, headline inflation dropped to 5.9 percent and core inflation to 1.5 percent. This was significantly lower than the inflation in 2003, but still relatively high because of administered price increases toward cost-recovery levels and indirect taxes.

In December 2004, the National Bank of Slovakia approved the monetary program and the new monetary policy framework for 2005-2008. Within this framework, monetary policy will focus primarily on inflation, and the NBS has announced explicit inflation targets for 2005-2008. This conforms to the authorities' strategy for euro adoption. The inflation targets are 3.5 percent within a ± 0.5 percent range for 2005, and below 2.5 percent for 2006, and below 2 percent thereafter.

Banking Sector

Slovakia's banking sector has been successfully restructured and brought in line with EU and Basel requirements. The World Bank has supported an Enterprise and Financial Sector Adjustment Loan which has supported the re-capitalization and privatization of formerly state-owned banks, and the overhaul of the legal frameworks for banking, insurance and the securities market. Slovakia's banking sector is now on a sound footing: it is profitable, the best capitalized banking sector in the region, and is almost fully owned by foreign partners.

To improve supervision in the financial sector as a whole, the authorities and the NBS have decided to integrate the Financial Markets Authority into NBS's Banking Supervision Department in 2006.

Foreign Direct Investment

Overall, today's stable macroeconomic framework, supported by strong and comprehensive structural reforms, an improved investment climate, in particular the tax reform, have created an environment attractive to foreign investors. This environment is now further strengthened by EU membership, which provides a powerful stimulus for private sector development. New greenfield investments, particularly in the automotive industry, will make Slovakia the largest *per capita* car producer in the world by 2007.

Reform Agenda

The ambitious reform agenda has been almost fully implemented within the first two years of this government's term (the next election will take place in September 2006). The only item still outstanding is the reform of the education system, and the authorities expect that this part of the agenda will be discussed again in parliament within the next two or three weeks.

Tax Reforms

A comprehensive tax reform was introduced in 2004 to improve incentives for entrepreneurship and work by making the tax system more transparent and reducing distortions caused by exemptions and double taxation. The reform is based on a single flat rate of 19 percent for all personal and corporate incomes taxes and also for VAT. In addition, almost all tax exemptions have been eliminated, and the estate transfer, gift, and inheritance taxes have been abolished.

Social Protection

The Government has established a modern, cost-effective, and efficient social protection system. In particular, reforms in 2004 corrected the disincentives to work, while still providing needed assistance to poorer Slovaks. This includes a multi-pillar pension reform, improvements in the collection and administration of social contributions, and strengthening the institutional capacity of the Ministry of Labor, Social Affairs and the Family, and of the Social Insurance Agency and the National Labor Office.

Public Finance

The Public Finance reform has strengthened the institutional capacity for budgetary and financial management of government operations, and has improved the macro-economic analysis and forecasting capabilities of the Ministry of Finance. In addition, a Debt Management Agency and the State Treasury System have been established.

Pension Reform

The pension reform applicable from 2004 has enhanced the public pay-as-you-go (PAYG) balances by gradually increasing the statutory retirement age from the previous 60 years for men and 55 years for women to 62 for both genders. A fully-funded second pillar was introduced in January 2005.

Health Sector

A comprehensive health sector reform was launched to promote the sector's fiscal sustainability while maintaining the quality of health care and increasing the capacity of the health sector.

Legal and Judicial Systems

All aspects of the legal and judicial systems and institutions have been assessed by the World Bank, and their strengths and weaknesses identified, and the Ministry of Justice has begun implementing the World Bank's recommendations. Despite considerable progress in this area, weaknesses remain. The authorities are committed to addressing these weaknesses and strengthening the business, and legal environment.

Unemployment

The authorities agree with the staff that notwithstanding the amendment of the Labor Code reform in July 2003, unemployment is still a major concern. Unemployment is still relatively high, even by regional standards, although some improvement is visible.

With a view to reducing unemployment by improving labor mobility, the World Bank approved a Human Capital Technical Assistance Project for the Slovak Republic on January 25, 2005. This project will help the government to strengthen its ability to promote employment, education, and social cohesion by establishing an effective policy infrastructure to implement, manage, and evaluate reforms in the Ministry of Labor, Social Affairs and Family, and in the Ministry of Education. The authorities intend to address the issue of skills and regional mismatches pointed out by staff through improvements in the education system and infrastructure development that gives priority to the less-developed regions in the country.

Euro Adoption

In anticipation of euro adoption, the authorities approved an updated Convergence Programme in November 2004. It is expected that Slovakia will join ERM-II during the first half of 2006, and will adopt the euro in 2009. Moreover, the Ministry of Finance envisages having the general government finances in balance by 2010. The authorities are strongly committed to fulfilling all Maastricht criteria for euro adoption in a timely manner. This goal is also supported by the opposition parties.

Conclusion

The generally positive trend of recent economic developments and favorable outcomes of structural reforms, observed in the Slovak Republic since the last Article IV consultation (concluded in July 2003), would not have been possible without the broad-based technical assistance, useful advice, and strong support provided by both the Bretton Woods institutions. This does not mean that Slovakia considers reforms and adjustments it needs as being already complete. But the authorities are confident that they can complete the remaining part of their agenda: Reforming the education system, reducing unemployment, strengthening the judiciary and law enforcement, and improving the knowledge-based economy. And the main medium-term challenge for the Slovak Republic is still to fulfill all of the criteria for adoption of the euro.