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Slovak Republic: 2005 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with the Slovak Republic, the following documents have been released and are included in this package:

- the staff report for the Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 14, 2005, 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 March 2, 2006. 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 March 20, 2006 discussion of the staff report that concluded the Article IV consultation.

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

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INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the
2005 Consultation with the Slovak Republic

Approved by Susan Schadler and Anthony Boote

March 2, 2006

- The consultation discussions were held in Bratislava during November 29–December 14, 2005. The mission met with Deputy Prime Minister and Minister of Finance Mikloš, National Bank of Slovakia (NBS) Governor Sramko, other senior government and NBS officials, parliamentarians, and representatives of financial institutions, trade unions and employers' association.

- The mission comprised Messrs. Banerjee (head), Konuki, Dalgic (all EUR) and Crowley (MFD). Mr. Rosenberg (Senior Regional Representative) and Mr. Sipko (Advisor to the Executive Director for Slovakia) participated in the discussions.

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

- Slovakia has accepted the obligations of Article VIII, sections 2, 3, and 4, and maintains no restrictions on the making of payments and transfers for current international transactions, except for those imposed in compliance with applicable UN Security Council resolutions. All such restrictions have been notified to the Fund pursuant to Decision No. 144 (52/51).

- Slovakia has subscribed to the Special Data Dissemination Standard. Coverage, periodicity, and timeliness of the data are adequate for surveillance.

- Following the withdrawal of the Christian Democratic Movement (KDH) from the ruling coalition, parliamentary elections originally scheduled for September 2006 have been brought forward to June.

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EXECUTIVE SUMMARY

Background: Real GDP growth accelerated to 6 percent in 2005, driven by an improvement in the contribution of net foreign demand while domestic demand growth maintained momentum. However, the external current account deficit doubled to about 7¼ percent of GDP, owing to a deterioration in the terms of trade and higher reinvested earnings on foreign investment. External competitiveness remains satisfactory. Inflation declined to 3.9 percent at end-2005, and the fiscal deficit fell to an estimated 3.1 percent of GDP. Slovakia entered ERM2 on November 28, 2005. Parliamentary elections are scheduled for June 2006.

Outlook: Economic growth supported by strong exports is projected to reach 6¾ percent in 2007. The current account deficit is projected to narrow to about 5 percent of GDP over the medium-term. Continued positive sentiment of investors toward Slovakia together with Balassa-Samuelson effects are likely to result in some appreciation of the koruna. The NBS expects inflation to fall to 2¾ percent at end-2006 and has announced a target of below 2 percent for end-2007, which is ambitious when viewed against the structural influences stemming from the catching-up process and the upside risks to the inflation outlook. The 2006–08 budget framework envisages the general government deficit declining progressively to about 1¼ percent of GDP, but the implied fiscal stance is expansionary in 2006 and broadly neutral in 2007.

Policy Discussions

Euro adoption: Slovakia is well poised to adopt the euro, planned for January 2009, but challenges lie ahead. Securing a successful experience in the monetary union will require further efforts to strengthen fiscal policy and enhance structural flexibility. More immediately, policies need to focus on meeting the Maastricht criteria quickly so as to avoid a prolonged stay in ERM2. A major challenge will be to bring down inflation in a manner that does not undermine exchange rate stability and competitiveness.

Monetary and exchange rate policy: NBS officials were less concerned than the staff about the risks to the disinflation objective and believed that Slovakia still had some cushion on competitiveness. They were ready to increase interest rates at the first signs of second-round effects from higher energy prices and of demand and wage pressures, as demonstrated in the increase in NBS's key policy interest rate in end-February 2006. Staff were concerned that the scope for sustained real appreciation was small, and stressed the importance of ensuring that appreciation under ERM2 was not excessive, as this would bite into competitiveness and risk producing an overly strong conversion rate.

Fiscal policy: Greater priority needs to be put on tightening fiscal policy to support the disinflation goal while containing koruna appreciation. Staff recommended that the authorities avoid a pro-cyclical stimulus in 2006 and aim for a significant withdrawal of stimulus in 2007. The authorities agreed with staff's proposal to safeguard the anticipated revenue over-performance. They also recognized the benefits of more durable expenditure restraint than included in the budget framework. However, they indicated that additional

measures would not be forthcoming ahead of the parliamentary elections, but would be given consideration by the newly elected government during the preparation of the 2007–09 budget.

Wage policy: The authorities are encouraging social partners to adopt forward-looking wage adjustment to inflation. They agreed that public sector wage restraint can be a useful signaling mechanism for wage moderation. Staff suggested that a slower pace of minimum wage increases and greater enterprise-level wage bargaining would also help moderate wage growth and enhance wage flexibility.

Banking sector and other structural issues. The banking system is healthy, but the increased exposure of banks to credit risk arising from rapid household credit growth calls for vigilance. The NBS has initiated steps to strengthen oversight. In January 2006, the NBS unified supervision of the entire financial sector. The authorities are continuing with efforts to stimulate job creation and address the high unemployment problem.

I. Background

1. **The discussions took place against the backdrop of Slovakia's entry into ERM2 on November 28, 2005**. The authorities' goal is to adopt the euro in January 2009.

2. **Slovakia is well poised to adopt the euro, but challenges lie ahead**. Sound macroeconomic management and a wide range of fundamental structural reforms over the past few years are supporting nominal convergence with European Union (EU) norms and enhancing the flexibility of labor and product markets. Slovakia already meets the Maastricht criteria for long-term interest rates and the public debt ratio. The fiscal deficit and headline inflation have been on a downward trend and are close to euro zone-compatible levels (text table). However, a key challenge will be dealing with the likely tensions between the inflation and exchange rate objectives under ERM2, at a time when real GDP growth is expected to be at or above estimates of potential. Also, to ensure a successful experience in the euro area, further efforts will be required to strengthen fiscal policy and enhance structural flexibility for absorbing asymmetric shocks in the absence of monetary policy.

Slovak Republic: The Maastricht Criteria

	2004		2005		2006	
	Criterion	Estimate	Criterion	Estimate	Criterion	Forecast
Average HICP inflation (percent) 1/	2.3	7.5	2.5	2.8	2.9	3.6
Long-term interest rate (percent) 2/	6.28	5.02	5.37	3.52	6.8	n.a.
General government deficit (in percent of GDP) 3/	3.0	4.0	3.0	3.8	3.0	4.2
General government debt (in percent of GDP)	60.0	42.6	60.0	36.8	60.0	35.8

1/ 1.5 percentage points above the three lowest inflation rates in the EU. For 2006, criterion based on WEO projections.
2/ Two percentage points above the rates in the three lowest inflation rate countries in the EU. For 2006, criterion based on WEO projections.
3/ ESA-95 basis. The 2005 estimate and 2006 forecast of the deficit include second-pillar pension costs.

3. **Economic performance in 2005 continued to be strong** (text table). Real GDP growth accelerated to 6 percent, and the output gap narrowed (Figure 1). Domestic demand growth maintained momentum while the contribution of net foreign demand improved. Private consumption strengthened appreciably, fueled by rapid growth in bank lending and large increases in real wages and employment (Tables 1 and 2). Fixed investment also picked up markedly, but the contribution from inventory accumulation fell. Exports continued to grow in the double digits, as exports of cars and machinery and equipment speeded up. However, the external current account deficit doubled to about 7¼ percent of GDP, owing to a deterioration in the terms of trade and higher reinvested earnings on foreign investment (Table 3).

Contributions to Growth, 2003–08
(percentage points)

	2003	2004	2005	2006	2007	2008
			Estimate	Staff Projections		
Real GDP growth	4.5	5.5	6.0	6.3	6.7	5.7
Domestic demand	-2.1	6.3	6.3	5.1	4.7	4.5
Of which:						
Private consumption	-0.4	1.8	3.0	2.5	2.5	2.4
Fixed investment	-0.4	0.6	2.9	1.9	1.7	1.5
Change in stocks	-1.9	3.6	0.1	0.0	0.0	0.0
Net foreign demand	6.5	-0.8	-0.3	1.2	2.0	1.2
Memorandum item:						
Output gap (in percent of potential GDP)	-0.5	-0.4	-0.2	0.0	0.6	0.4
Trade balance (in percent of GDP)	-2.0	-3.5	-5.1	-4.8	-3.9	-3.3
Current account balance (in percent of GDP)	-1.1	-3.5	-7.2	-6.4	-5.5	-4.9

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

4. **The strength of the economy was visible in labor market conditions**. Real wage growth is estimated to have accelerated to about 6½ percent in 2005, from 2½ percent in 2004, with the pace in tradable and nontradable sectors continuing to be broadly similar. Of note, from the standpoint of future inflationary pressures, real wage increase in the nontradable sector exceeded productivity gains for the first time in many years (text table, and Figure 2). Real wage increase in the tradable sector fell short of productivity gains but by a narrower margin than in previous two years. Large increases were recorded in both self-employment and wage-employment. Thus, the economy-wide unemployment rate declined by 2 percentage points to about 15½ percent in September 2005, with considerable regional variation in the level and trend. In high-growth areas like Bratislava the unemployment rate fell to about 5¼ percent and there were reports of specific skill shortages, whereas in the eastern regions new employment opportunities were fewer and the unemployment rate remained around 22–24 percent.

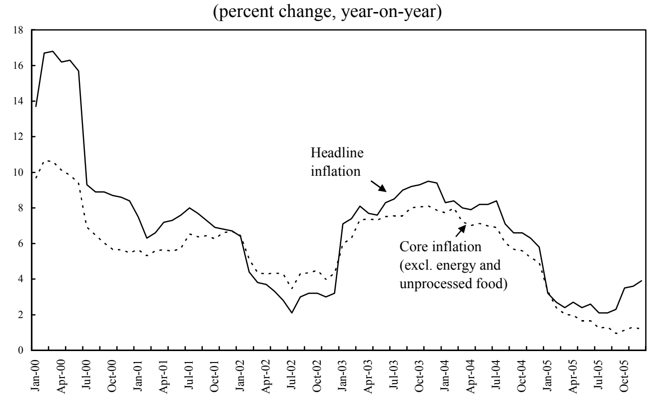
Wages and Productivity, 2000–05
(percent change)

	2000	2001	2002	2003	2004	2005 Jan-Sep
All sectors						
Nominal wage	6.4	8.3	9.3	6.3	10.2	9.4
Real wage	-5.0	0.9	5.8	-2.1	2.5	6.8
Productivity	3.9	3.2	5.2	2.6	5.9	4.2
Real unit labor cost 2/	-8.6	-2.2	0.6	-4.6	-3.2	2.4
Tradable sector 1/						
Nominal wage	8.5	9.1	6.8	6.8	10.3	7.4
Real wage	-3.1	1.6	3.4	-1.6	2.6	4.8
Productivity	7.4	8.8	1.0	5.6	12.0	8.3
Real unit labor cost 2/	-9.8	-6.6	2.4	-6.9	-8.4	-3.3
Nontradable sector 1/						
Nominal wage	6.2	7.9	10.0	6.2	10.4	8.8
Real wage	-5.2	0.6	6.5	-2.2	2.7	6.1
Productivity	1.7	0.2	7.0	1.1	2.9	2.1
Real unit labor cost 2/	-6.7	0.4	-0.5	-3.2	-0.2	3.9

Sources: Statistical Office of the Slovak Republic; and IMF staff estimates.
1/ Tradable sector comprise agriculture, hunting, forestry and fishing; mining and quarrying; manufacturing; and construction. All other sectors are classified as nontradable.
2/ Real unit labor cost is defined as real wage divided by productivity.

5. **Inflation declined further in 2005**. Headline consumer price inflation (HICP basis)[1] fell by 1.9 percentage points to 3.9 percent at end-December—at the upper end of the NBS's target range of 3–4 percent. Core inflation (i.e., excluding energy and unprocessed food) fell to a historical low of 1.2 percent at end-2005 (text figure), mainly reflecting the impact of koruna appreciation and increased competition at the retail level subsequent to EU membership. Lower increases in regulated utility prices also contributed to disinflation in 2005, though there was a turnaround in their impact in the fourth quarter. Higher gasoline prices (which are not regulated) restrained the progress with disinflation (Figure 3).

Headline and Core Inflation (HICP basis)
(percent change, year-on-year)



Source: Eurostat.

[1] Compliance with the Maastricht inflation criterion will be judged on the basis of the harmonized index of consumer prices (HICP).

6. **The fiscal outturn in 2005 was better than envisaged in the budget and implied a substantial withdrawal of stimulus (1 percent of GDP), complementing the authorities' disinflation efforts**. The general government deficit (ESA-95 basis) as a ratio to GDP is estimated at 3.1 percent in 2005, compared with 3.4 percent envisaged in the budget and an outturn of 4 percent in 2004.[2] Collections in most tax categories surpassed expectations, owing to stronger-than-expected growth in their underlying bases and allaying earlier staff fears about the possibility of lagged adverse impact of the introduction of the flat tax regime in 2004 on revenue performance.[3] Non-tax revenue received an unexpected boost from higher dividend payout by a telecom firm. In addition, interest payments came in lower than expected and, with receipts from the EU budget amounting to only 60 percent of the envisaged level, there was some saving on co-financing of EU-funded projects. These gains were partly offset by forgiveness of foreign debt claims on Afghanistan and Sudan not envisaged in the budget (Table 4). The withdrawal of fiscal stimulus in 2005 was the net outcome of two opposing influences: a negative impulse from a reduction in the cyclically adjusted primary fiscal deficit (reflecting structural improvement in revenue performance) partly neutralized by the positive impulse from higher net transfers from the EU and associated expenditures.

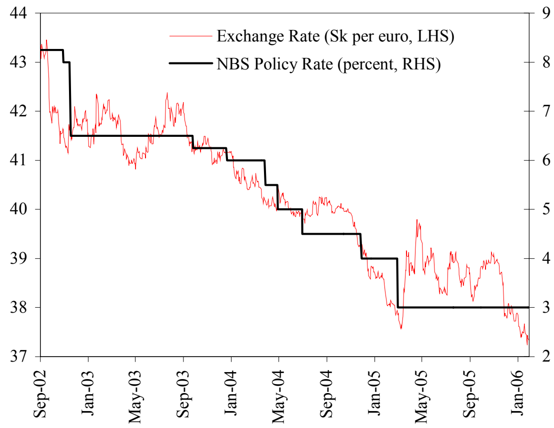
7. **In January 2005, the NBS adopted a hybrid monetary framework of "inflation targeting under ERM2 conditions**."[4] It announced explicit end-year inflation targets for 2005–08 and began quarterly publication of medium-term inflation projections. At the same time, the NBS's concern with the exchange rate has been evident in its intervention policy. Facing substantial portfolio inflows and persistent appreciation pressures in the first quarter of 2005, the NBS intervened in the foreign exchange market and lowered its policy interest rate in end-February by 100 basis points to 3 percent. Consequently, the koruna retreated from an all-time high reached in February. Thereafter, when investors' sentiments toward all emerging markets became bearish in April and October and the koruna came under downward pressure, the NBS intervened to support the currency (see text figure on the next page). Since the interventions were effective in containing depreciating pressures quickly, the NBS kept its policy rate unchanged. Upon ERM2 entry in late-November, the

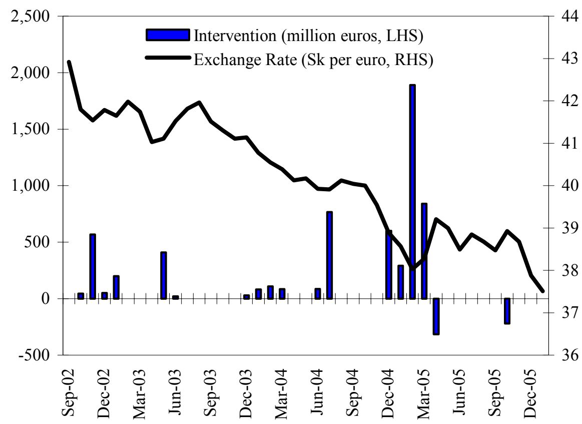
[2] The deficit for 2004 is different from that shown in the latest Convergence Programme update (3.2 percent of GDP) as it includes forgiveness of debt claims on the health sector amounting to 0.8 percent of GDP. The deficit in 2005 including payments to the newly-established second pillar pension funds was 3.8 percent of GDP. Under the SGP, these payments will count toward the deficit, though they can be partially deducted under certain conditions.

[3] For a detailed assessment of the 2004 tax reform, see "First Year of the Tax Reform, or 19 percent at Work," Financial Policy Institute, Ministry of Finance of the Slovak Republic, September 2005.

[4] See "Monetary Programme of the NBS until the Year 2008", National Bank of Slovakia, December 2004.

Monetary Policy Developments





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

central parity was set at Sk 38.455 per euro, equal to the then-prevailing market rate. The koruna appreciated in the immediate aftermath and strengthened further in January 2006, in step with other currencies in the region, to nearly 3 percent above the central parity. Reflecting these developments, monetary conditions eased slightly in the second half of the year (Figure 4).

8. **Bank credit to the private sector accelerated in 2005**. The main contributory factors were further convergence of koruna lending rates with euro area rates and heightened competition in the banking sector (Figures 5 and 6). Credit to households was boosted by a surge in consumer loans. Housing loans increased at a slower pace but still accounted for three-fifths of new loans to households. Banks also stepped up foreign-currency financing of corporations and began expanding their exposure to small and medium-sized enterprises; this followed several years of negative real credit growth, when banks were cleaning-up their balance sheets and were cautious about lending to enterprises. The share of foreign currency loans, virtually all of which were to enterprises, in total bank credit

Bank Financing (Annual Net Flows) 1/

	2001	2002	2003	2004	2005 Jan-Nov
	(in billions of koruny)				
Total liabilities 2/	78.6	86.0	63.0	168.0	227.9
Liabilities to residents 2/	48.0	65.3	11.9	102.9	87.5
Of which: non-government deposits	58.0	19.8	32.1	34.1	-2.7
Liabilities to nonresidents	30.6	20.7	51.1	65.1	140.4
Net flow of bank credit to private sector	19.0	40.7	46.6	28.7	98.3
Memorandum items:					
Net flows into mutual funds 3/	6.2	5.3	19.7	26.0	24.6
	(in percent)				
Bank credit growth to private sector (in real terms)	0.6	10.5	4.6	1.7	20.2
Households	11.0	14.3	27.4	29.3	33.8
Enterprises	-1.5	9.7	-0.7	-6.6	14.6
Share of foreign currency credit in total credit	18.7	16.6	18.3	20.6	21.4
Households	0.2	0.2	0.4	0.3	0.9
Enterprises	22.9	20.5	23.8	29.1	31.2
	(percent of GDP)				
External debt stock of commercial banks 4/ 5/					
Total	4.2	5.5	8.6	13.2	22.6
Short-term	3.7	4.9	7.7	12.1	21.1

Sources: National Bank of Slovakia; and IMF staff estimates.
1/ Flows are estimated from the changes in stocks, and thus include the effects of valuation changes.
2/ Change in stocks between 2002 and 2003 is adjusted for a methodological change: In 2003, banks started reporting securities received from repo transactions with NBS off their balance sheet.
3/ Figure for 2005 refers to flows during January-June.
4/ Figure for 2005 refers to stock at end-September.
5/ External debt excludes some items included in liabilities to nonresidents such as share capital.

increased slightly to about 21 percent.[5] With slow growth in resident deposits on account of lower interest rates and increased channeling of household saving to mutual funds, banks funded their lending activities largely through foreign financing from parent banks (see text table on previous page and Table 5). [6]

9. **Competitiveness remains satisfactory**. The CPI-based and unit labor cost (ULC)-based real effective exchange rates (REER) appreciated further in 2005, but the relative profitability index remained close to the reference level of 1998 (Figures 7 and 8). A recent staff study[7] suggests that appreciation of the REER was largely a manifestation of convergence toward the equilibrium level: the koruna was undervalued by about 25 percent during 1997–2002, but the amount of undervaluation started to decline steadily from 2003 and was expected to disappear in 2005. Slovakia's market share in the EU-15 countries has increased rapidly in recent periods and has outpaced that of the neighboring new EU-member states (Figure 9). The pace of export market penetration is likely to be sustained on account of the market linkages created by large inflows of foreign direct investment (FDI) and the scheduled commencement of production in many large FDI-supported projects. With the exchange rate close to its estimated equilibrium and a very strong export performance, competitiveness has not been a problem. However, it still bears close watching as Slovakia's bilateral real exchange rate and relative profitability index vis-à-vis neighboring new EU-member states have deteriorated.

10. **The increased foreign financing of banks boosted the external debt ratio**. Total external debt increased to about 56 percent of GDP at end-2005, from 54 percent of GDP at end-2004, but the net debt position was only 2 percent of GDP. Foreign debt exposure of the public and non-bank corporate sectors declined in 2005. About ninety percent of banks' foreign debt was short-term. Consequently, short-term debt (remaining-maturity basis) exceeded the level of gross official reserves at end-2005 (Table 6). Slovakia's reserve coverage of short-term debt was smaller than that of neighboring new EU-member states and the gap had widened during the past year (see text table on next page). However, in terms of reserve coverage of imports, Slovakia stood ahead of the others, with about 5 months equivalent. Slovakia's external debt service ratio remained unchanged at 12 percent in 2005.

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[5] Unlike in some other new EU-member states, foreign currency-denominated loans to households are negligible in Slovakia. This is explained by the relatively low interest rates on koruna-denominated loans and aversion of households to foreign exchange risk. There are no regulatory restrictions on foreign currency-denominated lending to households.

[6] The Slovak banking system is largely under foreign ownership (see Table 8).

[7] Nienke Oomes, "Maintaining Competitiveness Under Equilibrium Real Appreciation: The Case of Slovakia," IMF Working Paper No. 05/65, March 2005.

Reserve Indicators in Selected New EU-Member States, 2001–05

	2001	2002	2003	2004	2005
Poland					
Reserves/Short-term debt in original maturity (percent)	238.5	214.7	173.1	152.8	175.8
Reserves/Short-term debt in remaining maturity (percent)	119.1	122.5	100.0	100.5	120.0
Reserves in months of imports of goods and services	5.5	5.6	5.2	4.4	4.5
Hungary					
Reserves/Short-term debt in original maturity (percent)	210.0	218.5	152.5	159.3	169.6
Reserves/Short-term debt in remaining maturity (percent)	121.6	111.6	88.1	87.4	112.3
Reserves in months of imports of goods and services	3.3	2.9	2.7	2.8	3.0
Czech Republic					
Reserves/Short-term debt in original maturity (percent)	152.1	227.2	192.9	166.5	195.1
Reserves/Short-term debt in remaining maturity (percent)	119.6	175.0	153.8	136.5	145.0
Reserves in months of imports of goods and services	4.1	6.1	5.6	4.4	4.6
Slovakia					
Reserves/Short-term debt in original maturity (percent)	136.3	217.0	156.1	142.7	114.7
Reserves/Short-term debt in remaining maturity (percent)	95.2	132.1	108.4	104.4	93.6
Reserves in months of imports of goods and services	3.0	5.9	5.7	5.5	4.9

Sources: National authorities; and IMF staff estimates.

II. Report on the Discussions

11. **The discussions centered on policy priorities for ensuring a smooth transition to euro adoption and for strong performance in the monetary union**. The immediate challenges are to bring down average inflation to a rate that meets the Maastricht criterion,[8] maintain exchange rate stability within ERM2 for at least two years; and reduce the fiscal deficit (including the adjusted cost of the second pension pillar) to well below the Maastricht limit of 3 percent of GDP. Thereafter, maintaining growth and ensuring adequate competitiveness in the monetary union would be continuing challenges. The authorities were optimistic about achieving all the ERM2 requirements and were less concerned than the staff about the risks to the disinflation objective. The staff highlighted the risk of an overly strong conversion rate when the euro is adopted and noted that a tighter fiscal stance than envisaged in the 2006–08 budget framework was the best way to minimize tensions between the inflation and exchange rate objectives.

[8] The authorities intend to request a convergence report for euro adoption in April 2008. The assessment period would thus be April 2007–March 2008. The recent *World Economic Outlook* projections of the three lowest inflation rates in the EU during 2007–08 suggest a reference rate of 3 percent. The criterion based on current inflation rates in the EU would be 2.5 percent.

12. **Over a number of years, the authorities have implemented policies generally in line with the Fund's advice** (Box 1).

Box 1. Policy Recommendations and Implementation

In concluding the last Article IV consultation with Slovakia, Executive Directors focused on policies to address three main challenges: lowering inflation to eurozone compatible levels, securing further fiscal consolidation, and addressing the high unemployment problem. (http://www.imf.org/external/pubs/ft.scr/2005/cr0571.pdf).

During the past year, the authorities have switched to a monetary framework that places added emphasis on inflation targets and, in line with the Fund advice, have maintained a flexible approach to exchange rate management.

Fiscal policy in the past few years was tighter than envisaged in the budget. In line with Fund advice, the authorities saved much of the revenue over-performance arising from stronger-than-expected economic growth. However, in contrast to staff recommendation, progress in restraining spending on subsidies has not been ambitious, and the envisaged restraint in the 2006–08 budget framework is back-loaded.

A wide array of labor market reforms were initiated in 2003–04. Since then, the focus has been on increasing the efficiency of the policy measures.

The authorities have strengthened the financial system and supervisory capacity significantly since the FSAP in 2002.

A. Growth and External Outlook

13. **There was consensus that economic growth would strengthen more than assumed in the 2006–08 budget framework and the latest Convergence Program update**. Real GDP growth is projected by the staff to increase to about 6¼ percent in 2006 and 6¾ percent in 2007 (about 1 percentage point and ½ percentage point, respectively, above the budget projections) and to moderate to 5¾ percent in 2008. The impetus is expected to come from the commencement of production at two new automobile plants in 2006 and 2007 and the associated pick up in exports. Export volume growth is projected to accelerate to 14 percent in 2006 and 21½ percent in 2007 before easing to about 8¾ percent in 2008. Domestic demand should remain an important driving force but its contribution may weaken slightly. The pace of real wage increase was somewhat exceptional in 2005—a result of backward-looking indexation of nominal wages when average inflation was falling sharply—and is expected to slow. On this basis, and assuming a stable household saving propensity, private consumption growth is projected to moderate somewhat. With the completion of several FDI-financed projects, some easing of investment growth is anticipated. The authorities agreed with the staff's projections and the assessment that they may be subject to upside potential. Specifically, there were risks that household saving propensity might continue to decline and that real wage increases would be higher than assumed. Higher oil prices and a deteriorating external environment were the main downside risks to the projections.

14. **However, there were differences in view regarding the degree of economic slack**. Staff estimates as well as Ministry of Finance estimates (reported in the Convergence Program update) show the output gap turning positive around 2006–07. However, NBS

estimates show the output gap remaining negative in the next few years, narrowing only in 2008.[9]

15. **The external outlook appears upbeat and external debt sustainability is not an imminent concern**. On the basis of rising car exports and an unchanged import intensity of absorption, the external current account deficit is projected to narrow progressively to about 5 percent of GDP in 2008. With stronger economic prospects and the upgrading of its sovereign debt rating, Slovakia is likely to remain an attractive destination for foreign investors and record large surpluses in the financial account (Table 7). Thus, even assuming that foreign financing of banks will continue at a steady pace, the external debt ratio is projected to decline over the medium-term to below 50 percent of GDP (Appendix III). The baseline scenario would worsen significantly in the event of a sizeable depreciation of the currency or a combination of shocks to nominal interest rate, real growth, the terms of trade, and the overall external environment. Under these adverse conditions, the external debt-to-GDP ratio would rise temporarily to 70–80 percent and fall to around 63 percent over the medium term (text table). However, the likelihood of a depreciation scenario would seem small, as the anticipated productivity gains and capital inflows are likely to result in some nominal and real appreciation of the koruna, with the potential for overshooting. The authorities acknowledged that uncertainties surrounding the forthcoming parliamentary elections and developments in other foreign exchange markets in the region may have a temporary impact on the Slovak koruna, but were hopeful that Slovakia's ERM2 entry would decouple the koruna to some extent from regional influences.

Stress Tests for External Debt-to-GDP Ratio

	2005	2006	2007	2008	2009	2010
	(In percent)					
Baseline scenario	56.2	56.5	55.5	54.2	51.4	48.1
1. Nominal interest rate is at historical average (4.9 percent) plus two standard deviations in 2006 and 2007.	56.2	57.7	57.8	56.3	53.4	50.0
2. Real GDP growth is at historical average (4.3 percent) minus two standard deviations in 2006 and 2007.	56.2	59.2	60.9	59.1	55.8	52.1
3. Change in euro GDP deflator is at historical average (3.7 percent) minus two standard deviations in 2006 and 2007.	56.2	61.5	65.0	62.9	59.2	55.1
4. Non-interest current account deficit is at historical average (3.5 percent of GDP) minus two standard deviations in 2006 and 2007.	56.2	63.6	70.2	68.0	64.3	60.2
5. Combination of 1-4 using one standard deviation shocks.	56.2	65.3	73.7	71.7	67.9	63.6
6. One time 30 percent nominal depreciation in 2006.	56.2	78.6	75.8	72.8	68.0	63.0

Source: IMF staff projections.

B. Monetary and Exchange Rate Policy

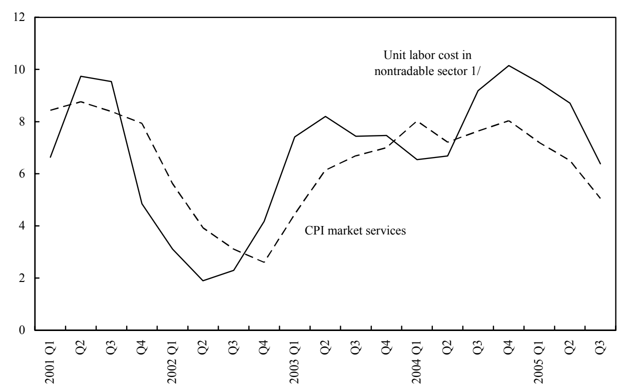
16. **NBS officials agreed that the inflation targets for 2006–08 were ambitious, but were optimistic about meeting the Maastricht inflation criterion**. They explained that their targets of below 2½ percent for end-2006 and below 2 percent thereafter were influenced by the uncertainty about the reference rate for the Maastricht inflation criterion.

[9] The differences between the estimates are explained by differences in methodology and measurement of variables. See Box 3 of the Staff Report for the 2004 Article IV Consultation (IMF Country Report No. 05/71, March 2005). The high unemployment rate is not a good indicator of slack in the Slovak economy as much of the unemployment is structural in nature.

Their baseline inflation projection assumed some nominal appreciation of the koruna, a gradual fall in the contribution of oil prices to inflation, continued influence of retail competition, the output gap remaining negative, and wage moderation. In addition, the new monetary framework was expected to anchor inflation expectations. NBS officials considered higher prices of oil and regulated energy items as the main threats to the achievement of the inflation targets. In this context, they acknowledged that the end-2006 inflation target would likely be breached by a narrow margin on account of higher-than-expected increases in regulated utility prices in January 2006.[10] However, they deemed the risk of possible second-round effects to be small, noting that efforts were ongoing to change the basis for wage bargaining from backward-looking to forward-looking adjustment to inflation, and believed that the end-2007 target of below 2 percent could be met.

17. **The staff observed that there were uncertainties about lowering inflation further to the NBS's end-2007 target**. The main impediments were likely to be structural influences stemming from the catching-up process and the upside risks to the inflation outlook. Rising ULC in the non-tradable sector was a risk for inflationary pressures. This would be the case especially if wage growth in tradable and non-tradable sectors stayed the same in the face of faster productivity growth in the tradable sector (as shown in the text table for ¶4).[11] Indeed, historical data show a strong correlation between developments in ULC in the non-tradable sector and prices of market services (text figure). Declining economic slack was an additional risk, although its impact on inflation had been muted thus far and there were uncertainties involved in its quantification. In all, staff projected inflation remaining at about 2½ percent in 2007—within the projected reference rate for the Maastricht criterion—and considered this scenario to be subject to evenly balanced risks.

Unit Labor Costs and Prices in the Nontradable Sector
(percent change, year-on-year)



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

1/ Four-quarter moving average. Nontradable sector includes the following sectors: Wholesale and retail trade, repair of motor vehicles, and personal goods; Hotels and restaurants; Transport, storage and communication; and Real estate, renting and business activities; Education; and Health and social work; Public administration and defence; and other services.

18. **NBS officials agreed on the need to remain vigilant about inflationary pressures**. They indicated that they would closely monitor developments in bank credit to the private sector, inflation excluding fuel and energy, and wages, and would increase interest rates if

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[10] Indeed, after the mission, the NBS forecast inflation to reach 2.8 percent at end-2006 in its January 2006 quarterly report.

[11] Real wage increases in excess of productivity gains, as occurred in the nontradable sector in 2005, would also accentuate risks.

necessary.[12] The staff noted that should it prove difficult to achieve the NBS's inflation target, it would still be important to ensure that inflation did not exceed the structural rate.

19. **NBS officials noted that a major challenge was how to meet the inflation goal while ensuring a viable exchange rate**. There was consensus that the choice of central parity equal to the market exchange rate just prior to ERM2 entry was appropriate, given the estimated proximity of the actual real exchange rate to the real equilibrium exchange rate. Looking ahead, NBS officials thought it likely that the European Commission and European Central Bank would take real exchange rate appreciation generated by structural factors into account in the assessment of exchange rate stability. Accordingly, with an eye on the inflation objective, the NBS has not intervened in the foreign exchange market to counter the appreciation of the koruna since ERM2 entry. During the mission, the NBS was oriented toward signaling to the market its support for a stronger koruna through its communications. However, subsequently on January 31, 2006, the NBS publicly announced that it would no longer comment on exchange rate developments. The staff emphasized the importance of ensuring that appreciation under ERM2 was not excessive (measured in relation to the equilibrium real appreciation), as this would bite into competitiveness and risk producing an overly strong conversion rate, with potential serious long-term consequences.

20. **The authorities agreed that excessive appreciation should be avoided, but believed that Slovakia still had some cushion on competitiveness**. In particular, they observed that current profit margins in the automotive and metal processing industries—which accounted for 40 percent of Slovak exports and were the most dynamic—were substantial. Staff were concerned that the scope for sustained real appreciation was small. Appreciation could risk undermining the competitiveness of traditional manufacturing firms as well as small and medium-sized enterprises, where productivity gains were lower. Furthermore, while ULC (in euros) in manufacturing in Slovakia still was lower than in some of the largest trading partners in the euro area, Slovakia's initial advantage vis-à-vis neighboring new EU-member states had disappeared, which would eventually figure in the decision-making of potential investors interested in the region (text table and Figure 10).

Share of Labor Compensation in Manufacturing Sector Value Added in Selected EU Member States
(In percent)

	2002	2003	2004
Germany	73.4	72.6	69.4
France	65.2	68.8	67.4
Slovenia	64.8	62.3	63.3
Estonia	64.5	64.4	62.1
Netherlands	62.6	62.4	60.9
Italy	56.5	58.1	57.8
Latvia	56.8	59.7	57.5
Austria	57.7	57.4	54.1
Slovak Republic	52.9	55.0	54.0
Czech Republic	54.4	52.0	51.8
Poland	60.1	57.3	49.1
Hungary	54.4	51.2	48.3

Sources: European Commission, Directorate General of Economic and Financial Affairs, AMECO database; and IMF staff estimates.

[12] With real GDP growth in Q4, 2005 (7.5 percent, year-on-year) and inflation in January 2006 (4.1 percent, year-on-year) turning out to be higher than expected, on February 28 the NBS increased its key policy interest rate by 50 basis points to 3.5 percent.

C. Fiscal Policy

21. **The staff indicated that the hybrid monetary framework would be compatible with meeting the multiple targets under ERM2 only if strong support came from fiscal policy.** Accordingly, the staff advocated orienting fiscal policy not only toward meeting the Maastricht deficit criterion, but also toward supporting the disinflation goal while containing koruna appreciation.

22. **The authorities noted that fiscal policy was on track to meet the Maastricht deficit criterion in 2007**. The 2006–08 budget framework[13] envisaged the headline general government deficit declining progressively to about 1¼ percent of GDP in 2008. Including the cost of the second pension pillar, the deficit would rise to 4¼ percent of GDP in 2006 and decline to 3 percent of GDP in 2007 and 2¾ percent of GDP in 2008. Fiscal consolidation would rely mainly on expenditure restraint on subsidies and transfers (spread across many categories) and goods and services.

23. **However, the staff observed that the implied fiscal stance in the 2006–08 budget framework could complicate the achievement of the inflation and exchange rate objectives**. The deficits envisaged in the budget framework implied an expansionary fiscal stance in 2006, a broadly neutral stance in 2007, and a withdrawal of stimulus in 2008 (text table). The budget framework understated revenue prospects because, relative to the budget assumptions, the actual 2005 revenue base was higher for structural reasons and economic growth was anticipated to be stronger. Another source of positive impulse in the budget was the large increases in net transfers from the EU in 2006 and 2007, assuming full execution.

Fiscal Outlook: Budget Framework and Adjustment Scenario, 2006–08
(In percent of GDP)

	2005 Estimate	2006	2007	2008
		Budget Framework		
Total Revenue	37.0	36.9	37.1	36.4
Total Expenditure	40.1	39.8	38.8	37.7
Headline fiscal balance	-3.1	-2.9	-1.6	-1.3
Primary fiscal balance 1/	-0.8	-1.3	0.1	0.5
Fiscal balance including second pension pillar cost	-3.8	-4.2	-3.0	-2.7
Cyclically adjusted primary fiscal balance 1/	-0.8	-1.2	-0.1	0.3
Net transfers from the EU	0.4	1.3	2.2	2.1
Fiscal impulse including the impact of net transfers from the EU 2/	-1.0	1.4	-0.2	-0.5
		Adjustment Scenario		
Total Revenue	37.0	36.1	36.0	35.2
Total Expenditure 3/	40.1	38.1	36.2	35.3
Headline fiscal balance	-3.1	-2.0	-0.2	-0.1
Primary fiscal balance 1/	-0.8	-0.4	1.4	1.6
Fiscal balance including second pension pillar cost	-3.8	-3.2	-1.6	-1.4
Cyclically adjusted primary fiscal balance 1/	-0.8	-0.4	1.2	1.5
Net transfers from the EU 4/	0.4	0.7	1.5	1.4
Fiscal impulse including the impact of net transfers from the EU 2/	-1.0	0.0	-0.8	-0.3
Memorandum items:				
Real GDP growth (budget framework)	5.1	5.4	6.1	5.6
Real GDP growth (IMF staff projections)	6.0	6.3	6.7	5.7
Output gap (in percent of potential GDP)	-0.2	0.0	0.6	0.4

1/ The primary balance for 2005 excludes forgiveness of external debt claims on Afghanistan and Sudan.
2/ Change in the cyclically adjusted primary balance plus the change in net transfers from the EU. Receipts from the EU budget generally have a counterpart on the expenditure side. Thus, there is no effect on the fiscal deficit but there is an expansionary impact since the receipts do not withdraw resources from the private sector like normal revenue. Payments to the EU budget raise the measured deficit but do not increase domestic demand.
3/ Assuming a permanent cut, relative to the budget, in subsidies and transfers in 2007 equivalent to 0.5 percent of GDP.
4/ Execution rate of receipts from EU, EU-earmarked spending, and co-financing is assumed at 75 percent of the budgeted level in 2006 and 2007, and 80 percent in 2008.

24. **The staff recommended that the authorities avoid a pro-cyclical stimulus in 2006 and aim for a significant withdrawal of stimulus in 2007**. This

[13] Only the budget for 2006 is binding. The projections for 2007–08 are indicative.

would counter the upside risks to inflation, ease the burden on monetary policy during the assessment period, and provide a cushion against breaching the SGP limit of 3 percent deficit in the event of a possible downturn in the future. Accordingly, the staff advocated a two-pronged strategy:

- Safeguarding additional revenues. This would entail adhering to the nominal expenditure targets specified in the budget framework.
- Durable expenditure saving. The staff thought that there was scope for restraining expenditure through cutting waste, continued restructuring of inefficient sectors (such as the railways), and keeping real growth of subsidy expenditures well below the growth of real GDP.

25. **The authorities acknowledged that additional fiscal tightening was desirable**. They agreed with the staff's proposal to safeguard the anticipated revenue over-performance, at least at the central government level, noting that this had been the practice in the past few years. It was also their intention to safeguard saving in interest payments that they considered likely. The authorities recognized the benefits of more durable expenditure restraint than included in the budget framework and that there was room for it. However, they indicated that additional expenditure-side measures would not be forthcoming ahead of the elections, but would be given consideration by the newly-elected government during the preparation of the 2007–09 budget. Though, they cautioned that the post-election political configuration may have some bearing on the implementation of additional measures. In this context, the authorities noted that the execution of EU-funded projects would likely fall short of the budgeted levels, which would serve to lower the fiscal impulse and reduce the need for additional expenditure-side measures.[14]

26. **Saving revenue over-performance would require the participation of all levels of government**. Following the launch of fiscal decentralization in 2005, some 94 percent of personal income tax collections accrue to local governments. However, fiscal rules applicable to local governments do not prevent revenue over-performance from funding additional spending and do not ensure operation of automatic fiscal stabilizers.[15] The authorities planned to take steps aimed at improving fiscal management at the local government level and ensuring the expenditure control necessary to achieve the fiscal consolidation objective and to enhance the flexibility of fiscal policy. However, the authorities noted that, because of the technical complexities and need for legal changes and political consensus, it would not be feasible to introduce any new measures in 2006. They added that efforts were continuing to strengthen financial management at the central

[14] This assumption is incorporated in the adjustment scenario shown in the text table for ¶23.

[15] Fiscal rules applicable to local governments are based on ceilings on their debt stock.

government level. In particular, steps had been initiated to speed up the diffusion of results-oriented budgeting in all departments.

27. **Public debt sustainability is not a major concern**. At end–2005, general government debt stood at about 37 percent of GDP—well below the Maastricht limit. Over nine-tenths of the debt is long-term and the repayment profile does not entail significant bunching. Assuming that fiscal consolidation proceeds as per staff recommendation, the debt ratio is projected to gradually decline to below 30 percent in 2010 (Appendix III). Vulnerability of government debt to changes in interest rates and the exchange rate is low. Currently, about two-thirds of general government debt is at fixed interest rates. Foreign currency-denominated debt (mainly in euros) stood at about 10 percent of GDP at end–2005 and this ratio is projected to remain steady over the medium-term. In the longer-term, from 2020 onward, the budget will come under pressure because of an ageing population.[16] To address this problem, the authorities intend to implement further pension reform that would entail an increase in the retirement age to 65 years and a change in the indexation of pensions to only the inflation rate.

D. Price Policy and Wage Issues

28. **The staff saw a need for improvement in policy communication with regard to adjustments in regulated prices**. Unanticipated increases in regulated prices that lead to overshooting of the inflation target (see ¶16) could undermine the role of the NBS's inflation targets in anchoring inflation expectations. Accordingly, the staff suggested that consideration be given to preparing plans for adjustments in regulated prices in a multi-year framework that clearly specified the circumstances under which actual changes could deviate from the planned changes. The authorities noted that regulated prices were typically set on the principle of cost recovery, but agreed that it would be useful to undertake a review to determine the scope for efficiency gains and commensurate cost saving in sectors subject to regulated pricing. They acknowledged that the impending privatization of the largest electricity producer and the six largest heating plants should contribute to higher efficiency.

29. **The authorities are seeking to moderate wage increases mainly through their communications efforts, but there is scope for additional initiatives**. In meetings with representatives of employers and trade unions, NBS officials have been pushing for the adoption of forward-looking adjustment to inflation in the wage bargaining process. The authorities agreed that public sector wage restraint can be a useful signaling mechanism for wage moderation, and indicated that appropriate action would be initiated if the inflation outlook warranted it and provided the post-election political situation was conducive. Responding to the staff's suggestion that a slower pace of minimum wage increases would be helpful, as this was given attention in the private sector wage bargaining process, the authorities noted that this should be possible with the introduction of earned income tax

[16] See November 2005 update of the Convergence Program.

credit for low-income earners, currently under consideration. Also, representatives of employers believed that, although a large part of wage-setting was decentralized, there was scope for expanding enterprise-level wage bargaining and ensuring greater productivity-based wage adjustments.

E. Financial Sector Issues

30. **The authorities considered the banking system fundamentally sound**. Banks remained adequately capitalized and profitable. With interest margins shrinking during the convergence process and in a competitive environment, banks had begun to shift their focus to retail banking and higher-risk category clients.[17] However, the data do not show any evidence of deteriorating asset quality—the share of non-performing loans in total loans declined further in 2005 (Table 8). NBS officials were not concerned about a sizeable negative net open foreign exchange position of banks, and noted that much of it represented contingent liabilities. Banks emphasized that foreign currency-denominated loans and guarantees were mainly provided to exporters or firms that had access to reliable stream of foreign currency revenue. Stress testing by the NBS indicated that the banking system was resilient to increases in non-performing loans, to changes in the exchange rate, and to other macroeconomic shocks.[18]

31. **NBS officials were concerned about the increased exposure of banks to credit risk and had initiated steps to strengthen oversight**. They deemed risk management practices of banks to be generally adequate and did not consider increased foreign financing from parent banks as a vulnerability. In addition, NBS officials saw rapid growth of bank credit as an inevitable process of intermediation moving from a very low base to equilibrium levels. Still, to guard against risk of stresses on the banking sector, the NBS had introduced new reporting forms and six-monthly bank lending surveys to improve data collection, and was meeting more frequently with banks. The NBS also was assessing risk management according to loan categories, instead of on the aggregate, during on-site inspections of banks. NBS officials were satisfied with the state of cross-border supervision, and indicated that they regularly interacted with home country supervisors at different levels. In this context, they noted that preparations for the introduction of Basel II standards, planned for January 2007, were on track. In parallel with these initiatives, the NBS also was publicizing the risks to which the household sector was exposed.

32. **In January 2006, the NBS unified supervision of the entire financial sector**. NBS officials planned to extend the risk-based forward-looking supervision approach to non-bank financial institutions, and noted that the task would be complicated because of the fragmented nature of this sector. They saw a particular need to strengthen supervisory

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[17] Also, banks had offset the reduction in net interest income by higher fee income.

[18] For details, see "Analysis of the Slovak Banking Sector," National Bank of Slovakia, June 2005.

oversight of pension funds, which were growing rapidly. The staff noted that ongoing steps were needed to support financial integrity in Slovakia, and encouraged the authorities to develop a more unified and consistent approach to issues related to anti-money laundering and combating financial terrorism, as recommended by MONEYVAL examiners. The authorities agreed with the staff's recommendation to undertake a FSAP update in 2006 prior to the next Article IV consultation discussions.

F. Other Issues

33. **The authorities acknowledged that employment creation and addressing the high unemployment problem would be a continuing challenge**. They had introduced a wide array of reforms in the past few years to improve labor market flexibility, increase incentives to seek work, and stimulate job creation. As a result, the employment rate had increased (text table), but a further step up was needed for a rapid catch-up with the income level in the euro area.[19] Also, long-term structural unemployment remained high, particularly in the central and eastern regions and among those with low skill levels. The authorities indicated that they were furthering reform efforts and improving the efficiency of policy implementation. In this context, they highlighted the following initiatives:

Employment Rate and Unemployment, 2000-05
(Annual average)

	2000	2001	2002	2003	2004	2005 Jan-Sep
Employment rate	(In percent of working age population)					
Czech Republic	65.0	65.0	65.4	64.7	64.2	64.7
Hungary	56.3	56.2	56.2	57.0	56.8	56.8
Poland	55.0	53.4	51.5	51.2	51.7	52.5
Slovak Republic	56.5	56.5	56.7	57.6	56.9	57.8
Euro area	61.5	62.2	62.4	62.6	63.0	63.5
Unemployment rate	(In percent of labor force)					
Czech Republic	8.7	8.0	7.3	7.8	8.3	7.9
Hungary	6.4	5.7	5.8	5.9	6.1	7.1
Poland	16.1	18.2	19.9	19.6	19.0	17.7
Slovak Republic	18.8	19.3	18.6	17.5	18.1	16.4
Euro area	8.2	7.9	8.3	8.7	8.9	8.6
Memorandum item:						
Employment growth in Slovak Republic (annual percent change)	-1.4	1.0	0.2	1.8	0.3	2.0

Source: Eurostat

- In November 2005, the authorities adopted new criteria for providing investment incentives with the aim of promoting greater investment in high-unemployment regions and in the high-tech and R&D areas (text table).

Maximum Investment Incentives According to Regions and Sectors 1/
(percent of project cost)

	Regional Unemployment Rate (percent)		
Type of Investment 2/	<10	10—15	>15
Manufacturing and distribution	0	35	40
High-tech industries & business services	20	40	45
Research and development centres	20	50	50

Source: Slovak Investment and Trade Development Agency (SARIO).
1/ The limits apply to the sum of incentives under programs of tax relief, real estate provision, and grants (lump-sum and in proportion to new employees and training costs).
2/ For each type of investment, eligibility also requires a certain minimum education level for the workforce.

[19] For more on this point, see Susan Schadler et al., "Growth in the Central and Eastern European Countries of the European Union: A Regional Review," www.imf.org

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- A scheme is being developed to improve access to capital for start-up small and medium-sized enterprises. It would be partially funded from the structural funds from the EU.
- The authorities are considering the introduction of earned income tax credit for low-income workers from 2007, which should further increase the incentive to seek work as well as slow down the growth in minimum wages. They do not favor reducing labor costs through targeted cuts in social security contributions because contributions are linked to benefits and the measure lacks political support.
- Active labor market policy will focus on better targeting of job-training and on increasing financial and logistical support for fostering labor mobility.

The authorities agreed that more attention needs to be given to reducing bureaucracy in the issuance of licenses and permits and to further speeding up enforcement of contracts at courts. With regard to the latter, according to a recent World Bank study, Slovakia lags behind other EU countries (text table).

Economy Rankings According to Selected Business Regulation Indicators, 2006 1/

	Slovakia	EU-15 (average) 2/	New EU-member states (average) 3/
Hiring and Firing	74	98	93
Starting a Business	48	45	61
Dealing with Licenses	40	37	64
Closing a Business	44	19	46
Enforcing Contracts	81	24	40
Protecting Investors	118	62	50

Source: World Bank, Doing Business in 2006.
1/ The rankings are on the basis of quantitative indicators of regulations compiled for 155 countries. Lower numbers indicate better performance.
2/ Excludes Luxembourg.
3/ Include Poland, Czech Republic, Hungary, Slovenia, Lithuania, Latvia, and Estonia.

III. Staff Appraisal

34. **With ERM2 entry accomplished, the authorities now have to focus on implementing policies that ensure a smooth transition to euro adoption and strong performance in the monetary union**. Sound macroeconomic management and fundamental structural reforms over the past few years have positioned Slovakia well for euro adoption, but challenges lie ahead. A major challenge will be to bring down inflation in a manner that does not undermine exchange rate stability and competitiveness. Progress toward disinflation could be thwarted by potential upside risks—arising from higher energy prices, strong economic growth, and rising unit labor costs in the non-tradable sector. Fiscal policy will, therefore, need to be oriented toward supporting disinflation and minimizing the inherent tensions between the inflation and exchange rate objectives. The authorities also face the task of ensuring a sufficient buffer in the fiscal position to allow automatic fiscal stabilizers to operate without breaching the SGP deficit limit.

35. **Thus, a tighter fiscal stance than envisaged in the 2006–08 budget framework is necessary**. The authorities should avoid a pro-cyclical stimulus in 2006 and aim for a significant withdrawal of stimulus in 2007. It will be important to ensure additional fiscal

tightening by saving the anticipated revenue over-performance—arising from a higher base-period outturn and a stronger economic growth outlook—as well as undertaking durable expenditure restraint beyond that included in the budget framework. The efforts on both fronts will require participation of all levels of government. Fiscal management at local government levels will have to be consistent with the national fiscal consolidation strategy. Continued resolute political commitment to further fiscal consolidation will remain essential.

36. **The NBS also should guard against upside risks to inflation as well as ensure exchange rate viability**. NBS's readiness to increase interest rates at the first signs of second-round effects from higher energy prices and of demand and wage pressures is welcome. Better policy communication on adjustments of regulated prices would help to safeguard the role of NBS's inflation targets in anchoring expectations. While the economic outlook and the likely continued positive sentiment of rating agencies and foreign investors toward Slovakia make room for some nominal and real appreciation of the koruna, these factors also create the potential for overshooting. Excessive appreciation under ERM2 would bite into competitiveness and risk producing an overly strong conversion rate. Slovakia's prevailing level of competitiveness is adequate, but its initial cushion of lower unit labor costs vis-à-vis competitors has faded. It will therefore be important to ensure that real exchange rate developments remain in line with the economic fundamentals.

37. **Wage moderation would contribute importantly to disinflation and safeguarding competitiveness**. The authorities are encouraging social partners to adopt forward-looking adjustment of wages to inflation. They also should aim to influence wage drift by restraining wage increases in the public sector and negotiating a slower pace of minimum wage increase. Social partners are encouraged to expand the scope of enterprise-level wage bargaining so as to ensure greater productivity-based wage adjustments and enhance wage flexibility.

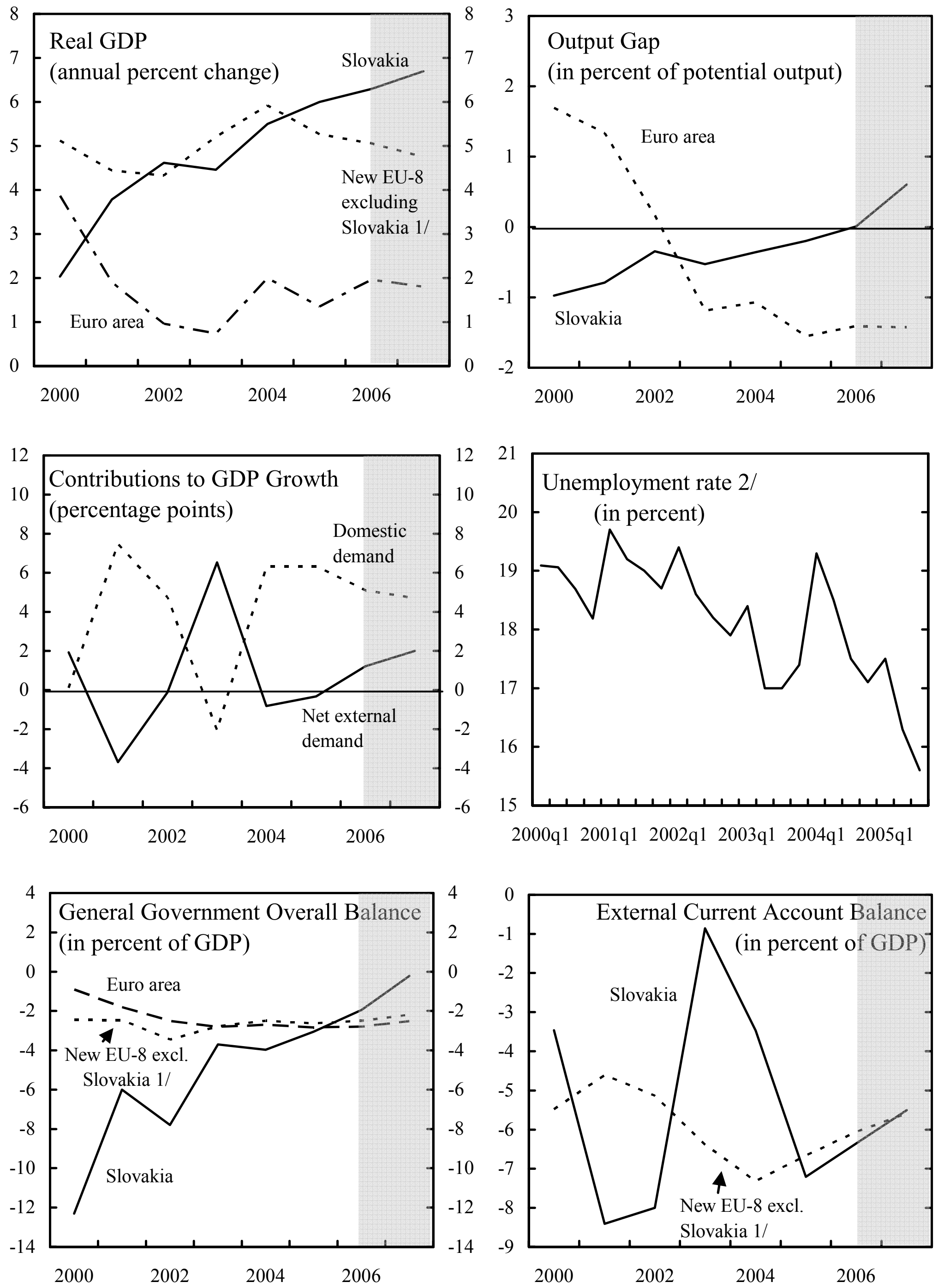
38. **While Slovakia's banking system is generally sound, new challenges call for vigilance**. Banks are extending credit to households at a rapid pace in a competitive environment and assuming higher credit risk. The NBS's initiatives to improve data collection, monitor risk management practices of banks more closely, and regularly interact with home supervisors of foreign-owned banks are appropriate. The inherent risks in increased foreign financing by banks are mitigated as these represent transactions with parent banks. However, the NBS should ensure that these borrowings are based on proper risk analysis by the parent bank and domestic subsidiary, to minimize any vulnerabilities to the banking system. Unified supervision of the financial sector will be demanding, given the fragmented nature of the non-bank financial sector. NBS's intention to extend the risk-based supervision approach to non-bank financial institutions is welcome. The NBS is encouraged to speedily enhance the supervision of pension funds, which are growing rapidly, and to continue addressing the money laundering risk in all areas of the financial sector.

39. **The momentum behind structural reforms in other areas should be maintained**. Labor market reforms have contributed to a pick up in the employment rate. Nevertheless, the unemployment rate remains very high among the low-skilled and in the less advanced regions. The adoption of new rules on investment incentives according to regional criteria

and project profile should help attract greater investment in high-unemployment regions and in high value-added projects. Considerations being given to improving access to capital for start-up companies and to introducing earned income tax credit for low-income workers, with a view to stimulating job creation and further increasing incentive to work, are welcome.

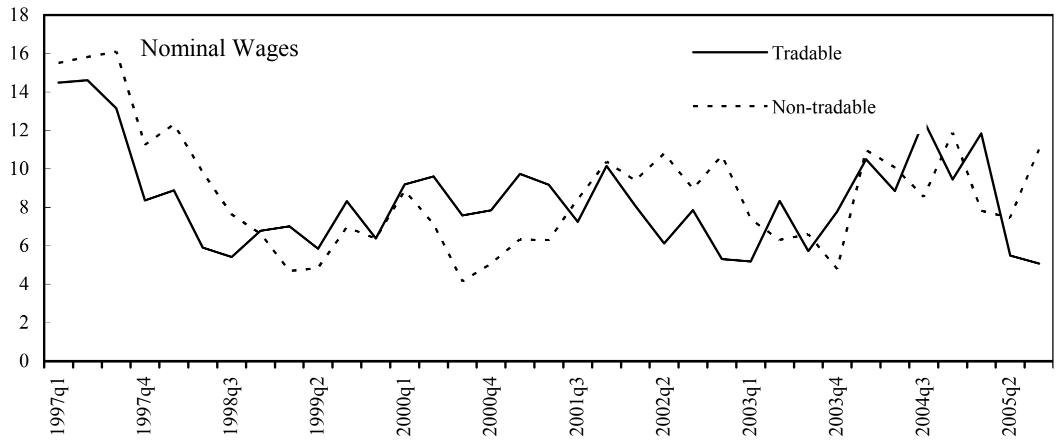
40. It is recommended that the Article IV consultation with Slovakia remain on the standard 12-month cycle.

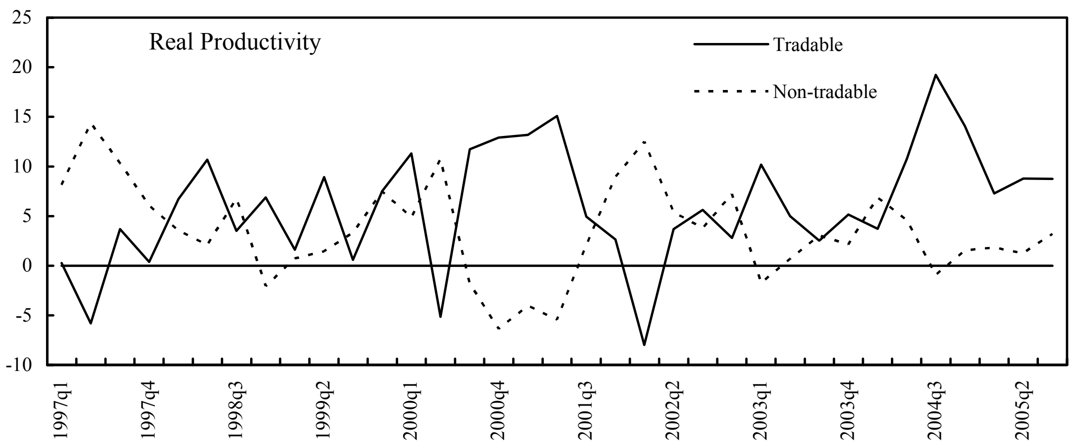
Figure 1. Slovak Republic: Economic Indicators, 2000–2007

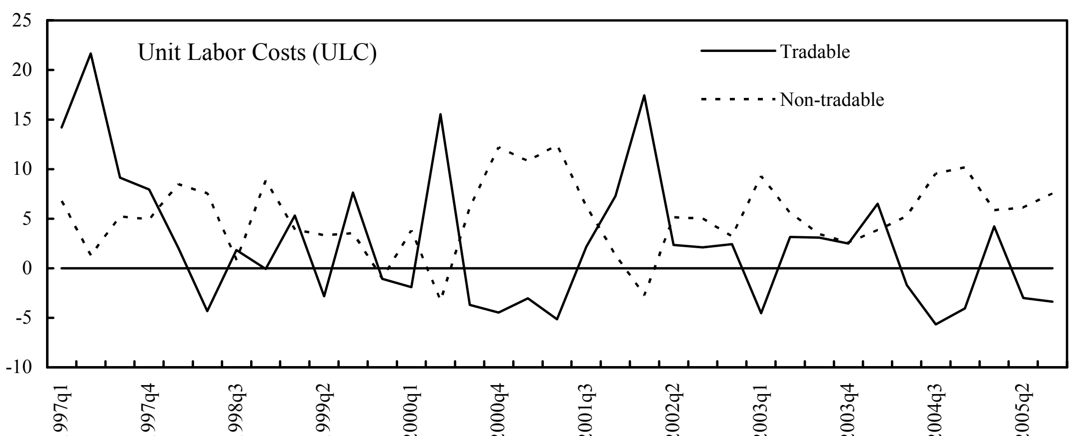


Sources: National Bank of Slovakia; World Economic Outlook; and IMF staff projections.
1/ New EU-8 include Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.
2/ Labor Force Survey data.

Figure 2. Slovak Republic: Wages and Productivity, 1997-2005
(Year-on-year change, in percent)

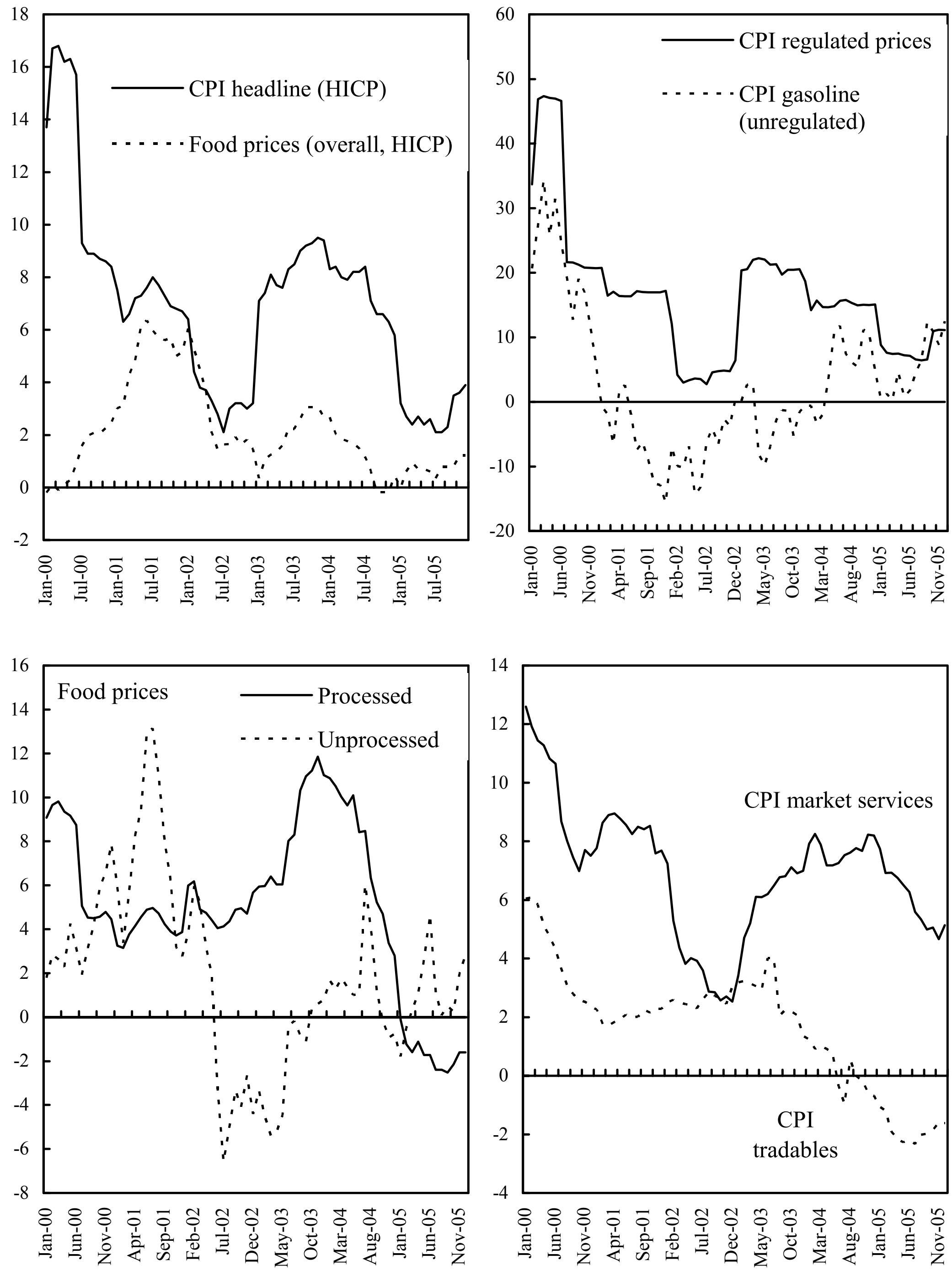






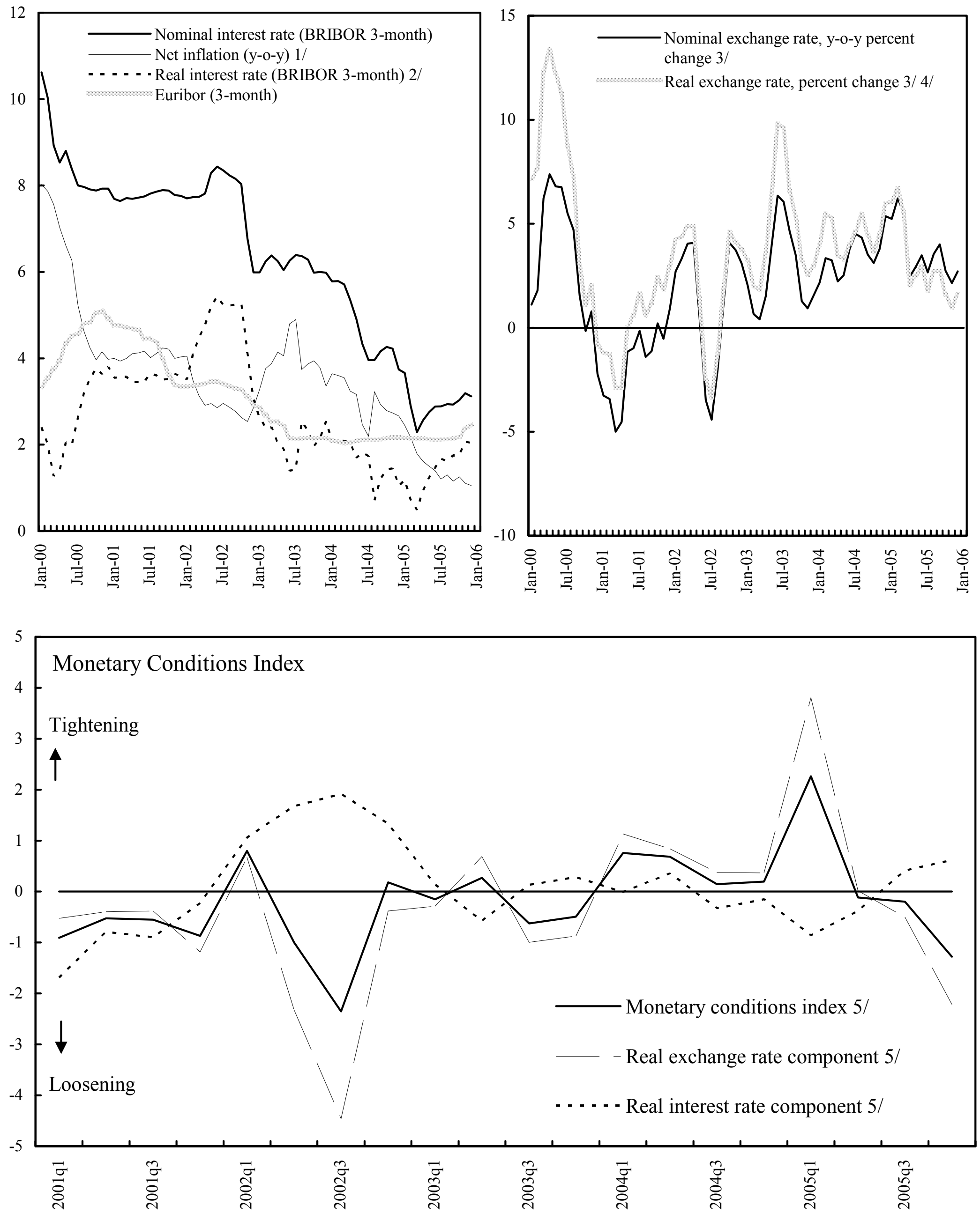
Source: Statistical Office of the Slovak Republic; and IMF staff calculations

Figure 3. Slovak Republic: Components of CPI Inflation, 2000-05
(Year-on-year change, in percent)



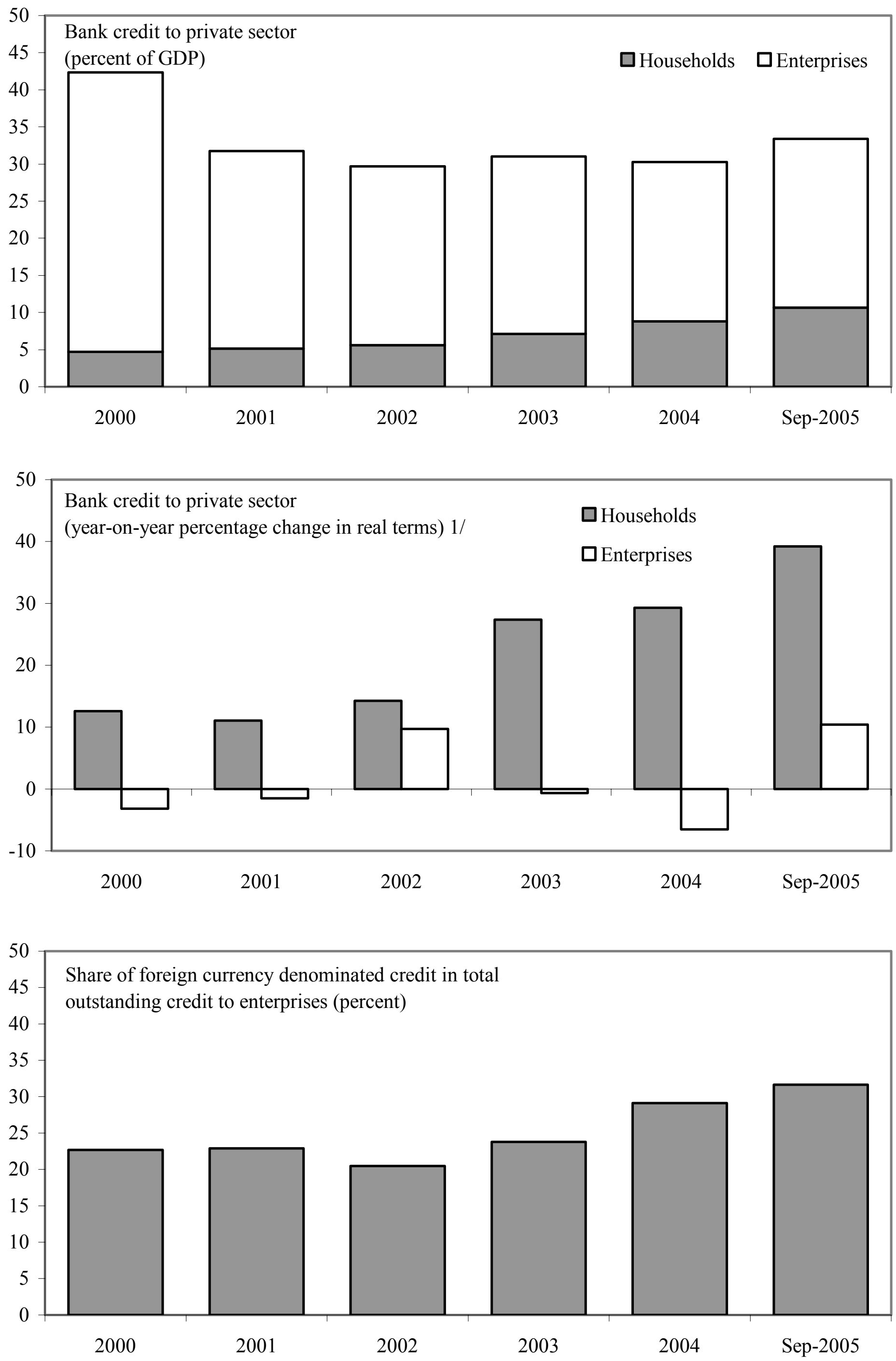
Sources: Statistical Office of the Slovak Republic, and Eurostat.

Figure 4. Slovak Republic: Monetary Conditions, 2000-05
(In percent)



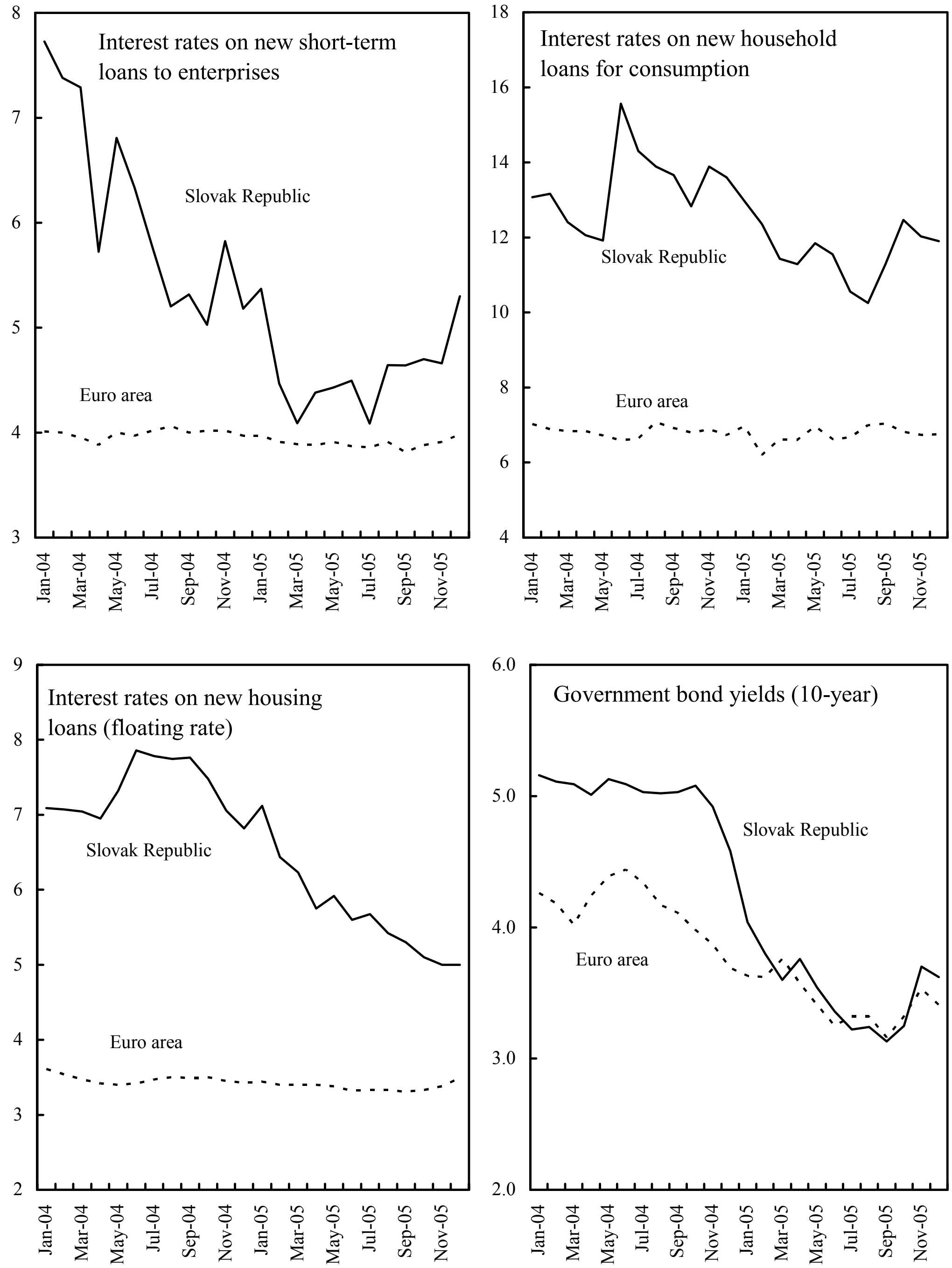
Sources: National Bank of Slovakia; Eurostat; and IMF staff calculations.
1/ CPI excluding the effects of indirect tax changes and regulated prices.
2/ Deflated by net inflation.
3/ Vis-à-vis the euro. Positive value indicates appreciation.
4/ Calculated using net inflation for Slovakia and HICP inflation for Euro area.
5/ Real exchange rate and real interest rate components are calculated as deviations from the trend. Monetary Conditions Index is the weighted sum of the real exchange rate component (weight of 0.67) and the real interest rate component (weight of 0.33).

Figure 5. Slovak Republic: Bank Credit to Private Sector, 2000-05



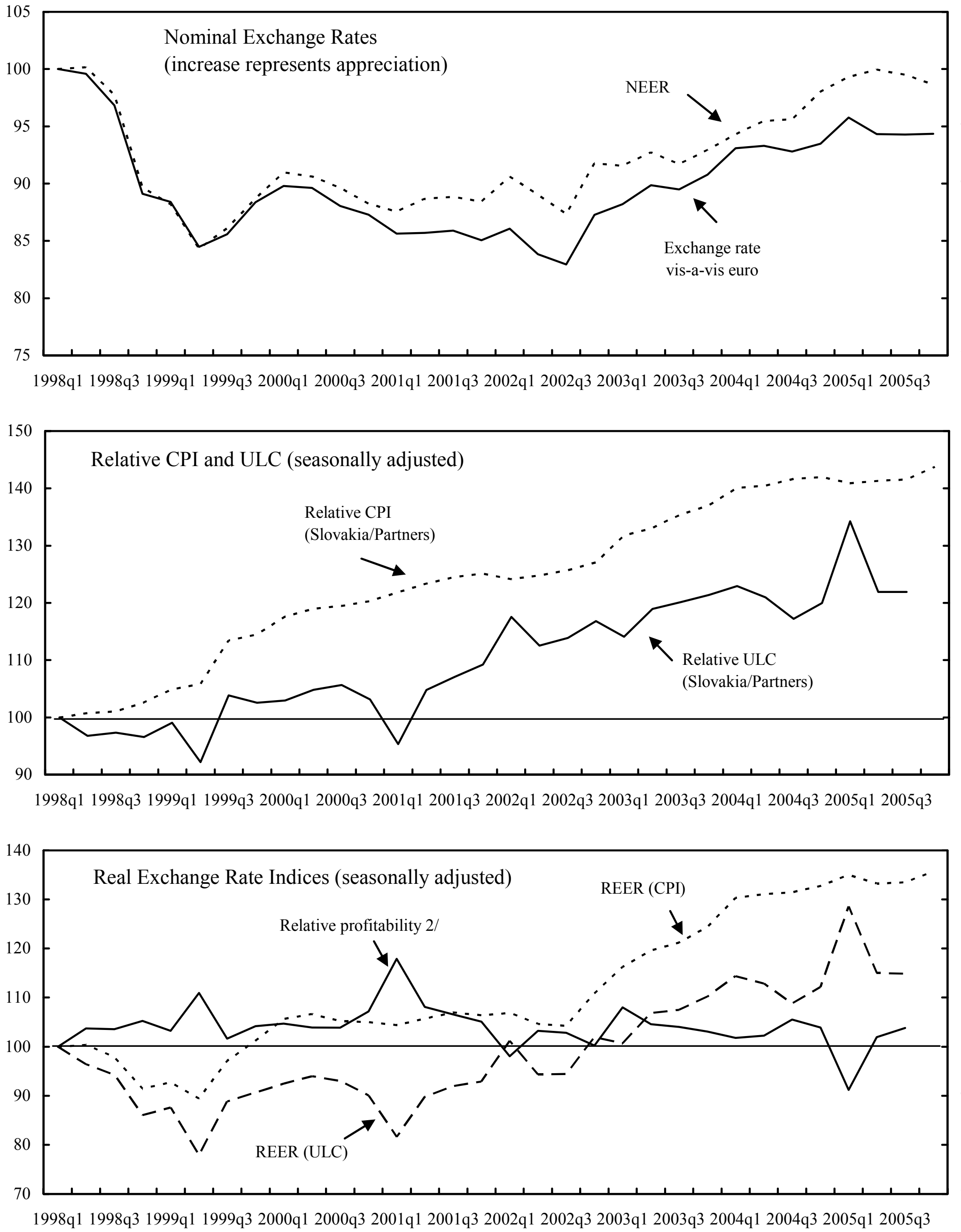
Source: National Bank of Slovakia; and IMF staff estimates.
1/ Deflated by CPI. Adjusted for bank restructuring and reclassification of loans.

Figure 6. Slovak Republic: Interest Rates, 2004-05
(In percent)



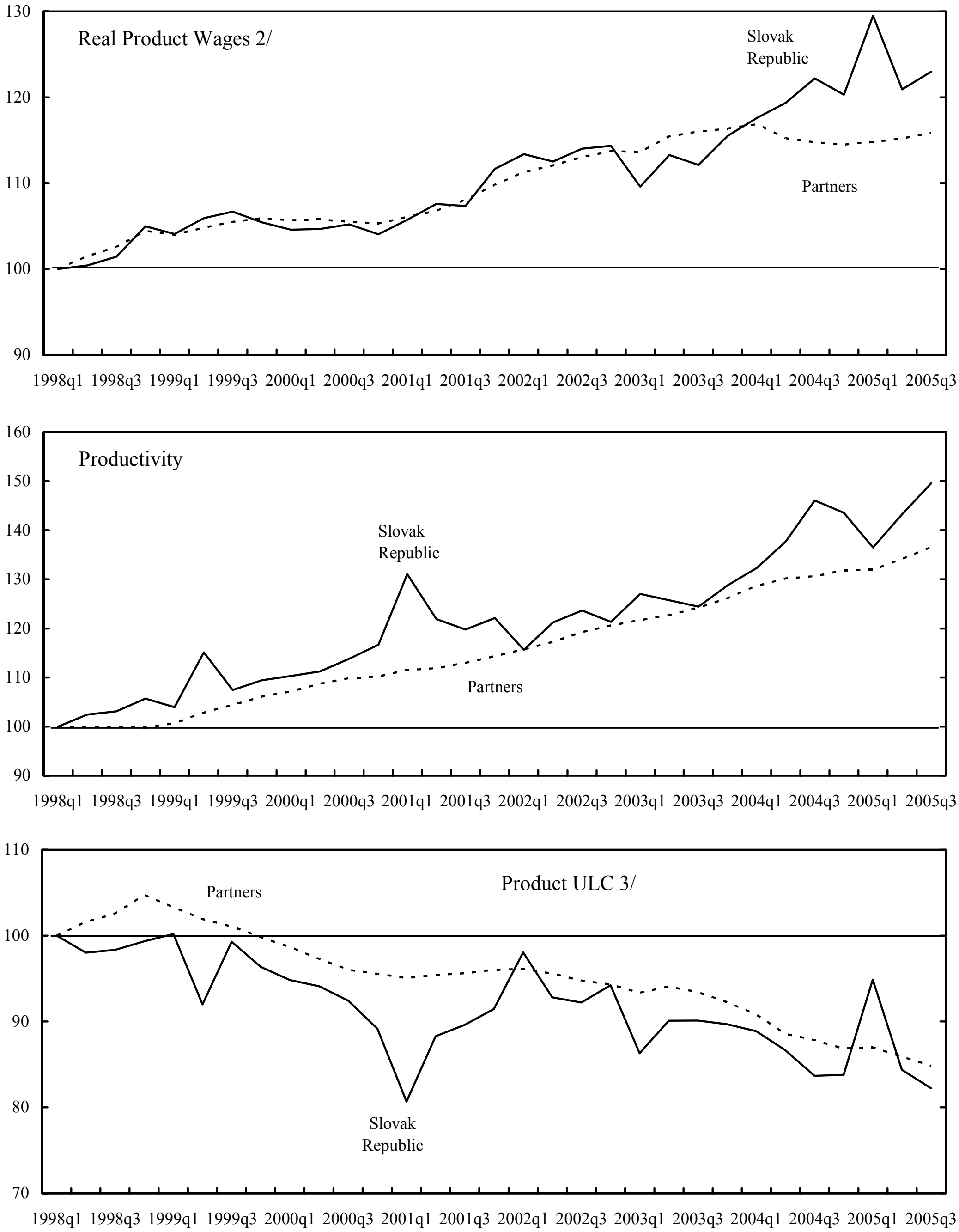
Sources: Statistical Office of the Slovak Republic, and European Central Bank.

Figure 7. Slovak Republic: Exchange Rate Indicators, 1998-2005
(1998q1=100) 1/



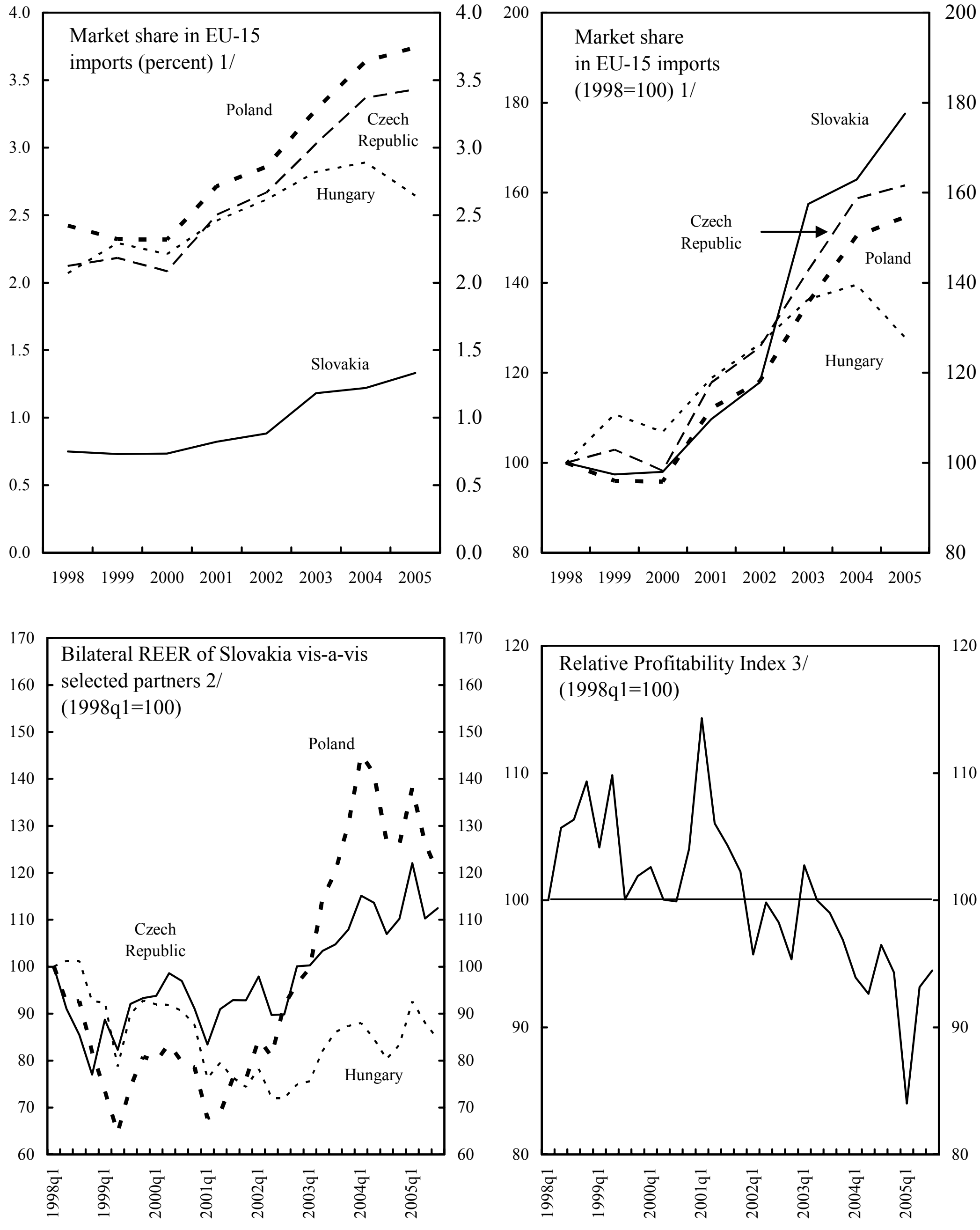
Sources: Eurostat; Intrenationa Financial Statistics; and IMF staff calculations.
1/ Trade weights based on 1999-2001 data for exports of goods. Partner countries comprise: Austria, Czech Republic, France, Germany, Hungary, Italy, Netherlands, Poland, United Kingdom, and United States.
2/ Unit labor costs in trading partner countries relative to those in Slovakia, adjusted for manufacturing producer price inflation–a rough indicator of developments in relative profitability. An increase represents gain in competitiveness, vis-a-vis trading partners, assuming similar capital-labor ratios.

Figure 8. Slovak Republic: Wages, Productivity, and Product ULC in Manufacturing, 1998-2005
(1998q1=100) 1/



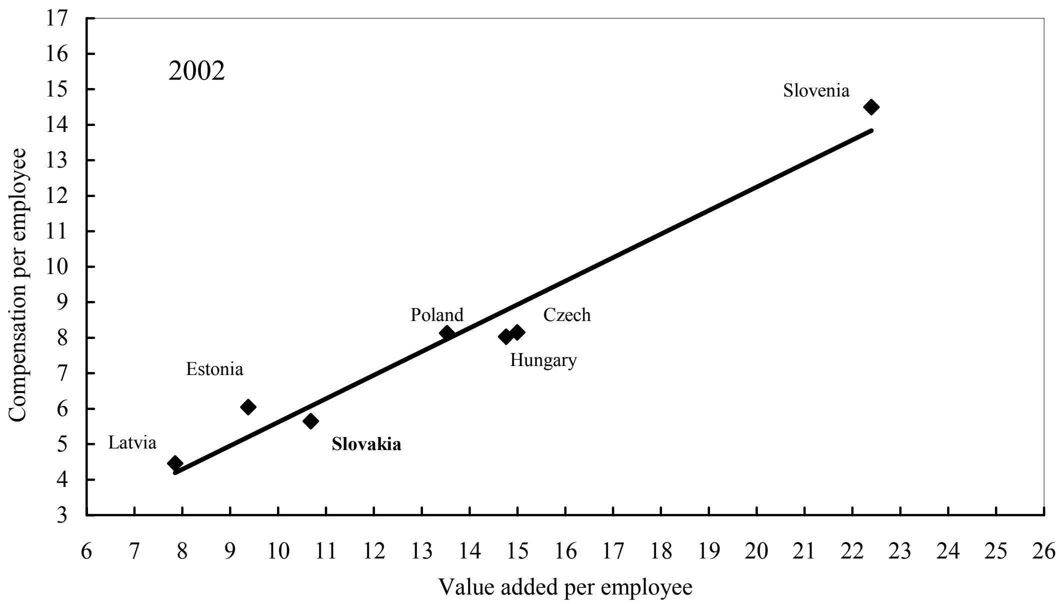
Sources: Statistical Office of the Slovak Republic; and IMF staff calculations.
1/ Trade weights based on 1999-2001 data for exports of goods. Partner countries comprise: Austria, Czech Republic, France, Germany, Hungary, Italy, Netherlands, Poland, United Kingdom, and United States.
2/ Defined as the ratio of nominal wages to producer price index.
3/ Defined as the ratio of real product wages to productivity.

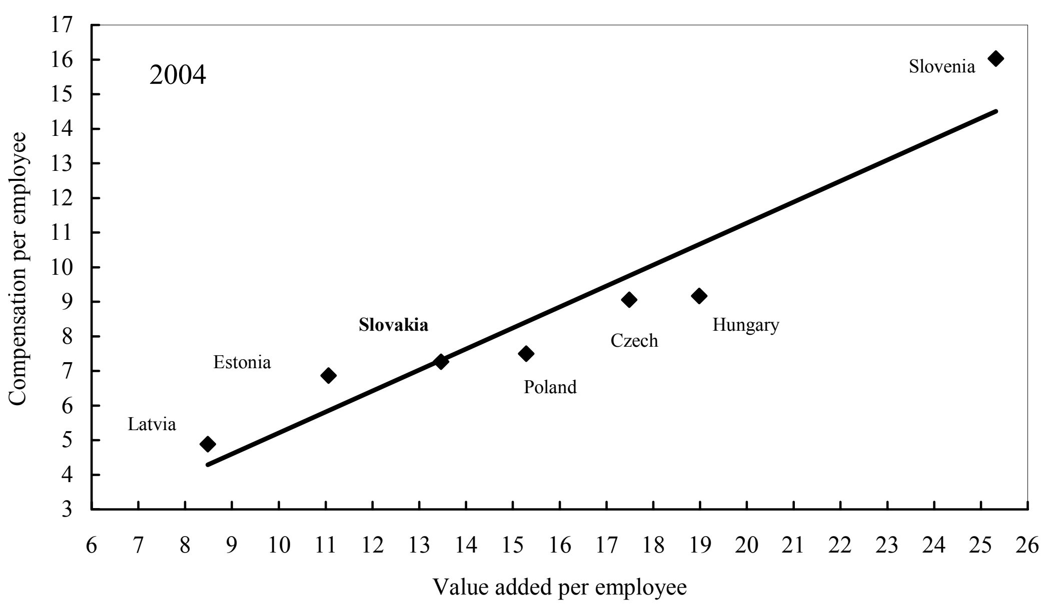
Figure 9. Competitiveness Indicators and Export Market Shares of Slovak Republic and Selected New EU-Member States, 1998-2005



Source: Eurostat; national authorities; and IMF staff calculations.
1/ Figure for 2005 refers to the first three quarters.
2/ ULC-based. An increase represents loss of competitiveness for Slovakia.
3/ Unit labor costs in Poland, Hungary, and Czech Republic relative to those in Slovakia, adjusted for manufacturing producer price inflation—a rough indicator of developments in relative profitability. An increase represents gain in competitiveness.

Figure 10. Productivity and Labor Costs in the Manufacturing Sector in Selected New EU-Member States, 2002-04
(In thousand euros, at current prices)





Sources: European Commission, Directorate General for Economic and Financial Affairs, AMECO database; and IMF staff calculations.

Table 1. Slovak Republic: Selected Economic Indicators, 2000-06

	2000	2001	2002	2003	2004	2005 Estimate	2006 Staff Proj.
	(Percent change, period average)						
Real sector							
Real GDP	2.0	3.8	4.6	4.5	5.5	6.0	6.3
Output gap (in percent of potential GDP)	-1.0	-0.8	-0.3	-0.5	-0.4	-0.2	0.0
Gross industrial output (constant prices)	-1.5	3.8	-1.3	9.1	11.5	4.7	...
Consumer prices (HICP)							
Period average	14.1	7.2	3.5	8.4	7.5	2.8	3.6
End of period	8.4	6.7	3.2	9.4	5.8	3.9	2.8
Wages							
Nominal wages	6.4	8.3	9.3	6.3	10.2	9.3	7.4
Real wages	-5.0	0.9	5.8	-2.1	2.5	6.6	4.0
Employment (LFS)	-1.4	1.0	0.2	1.8	0.3	2.0	1.0
Unemployment rate (annual average, in percent, ILO definition)	18.8	19.3	18.6	17.5	18.1	16.4	15.9
	(In percent of GDP)						
Public finance (ESA-95 basis)							
General government balance	-12.3	-6.0	-7.8	-3.7	-4.0	-3.1	-2.0
Structural general government balance	-7.0	-6.2	-5.5	-3.6	-3.8	-3.0	-1.9
General government debt	49.9	48.7	43.8	43.1	42.6	36.8	35.8
	(Percent change, end of period, unless otherwise indicated)						
Money and credit							
Broad money	15.4	11.8	3.4	5.6	5.8	1.9	…
Credit to enterprises and households 1/	7.8	7.5	14.8	14.8	10.9	24.7	…
Interest rates (in percent, end-of-period)							
NBS policy rate (two-week repo rate)	8.00	7.75	6.50	6.00	4.00	3.00	
Lending rate (short-term, national methodology)	10.7	8.8	7.5	7.2	7.5	6.1	…
Deposit rate (one month)	6.2	5.9	4.5	4.6	3.0	2.5	…
	(In billions of US dollars, unless otherwise indicated)						
Balance of payments							
Merchandise exports	11.9	12.6	14.4	21.8	27.8	31.9	36.6
Merchandise imports	12.8	14.8	16.5	22.5	29.2	-34.3	-39.0
Current account balance	-0.7	-1.8	-1.9	-0.3	-1.4	-2.4	-3.2
(in percent of GDP)	(-3.5)	(-8.4)	(-8.0)	(-0.9)	(-3.5)	(-7.2)	(-6.4)
Official reserves, end-period	4.1	4.2	9.2	12.1	14.9	15.5	18.8
(in months of imports of goods and nonfactor services)	(3.4)	(3.0)	(5.9)	(5.7)	(5.5)	(4.9)	(5.2)
(in percent of broad money)	(31.8)	(29.9)	(52.4)	(53.9)	(54.1)	(61.8)	(65.2)
Gross external debt, end-period	10.8	11.0	13.1	18.1	23.7	25.3	28.8
(in percent of GDP)	(54.9)	(52.9)	(50.0)	(50.8)	(53.6)	(56.2)	(56.6)
Short-term debt (in percent of GDP, original maturity basis)	12.3	14.7	16.2	21.9	23.5	30.0	33.0
Short-term debt (in percent of GDP, remaining maturity basis)	20.7	21.1	26.6	31.5	32.2	36.7	38.4
Official reserves to short-term debt (percent, remaining maturity basis)	100.2	95.2	132.1	108.4	104.4	93.6	95.9
Exchange rate							
Slovak koruna per U.S. dollar							
Period average	46.2	48.4	45.3	36.8	32.3	31.0	…
End of period	47.4	48.5	40.0	32.9	28.5	31.9	…
Slovak koruna per Euro							
Period average	42.6	43.3	42.7	41.5	40.1	38.6	…
End of period	44.0	42.8	41.7	41.2	38.8	37.8	…
Nominal effective exchange rate (percent change, period average) 2/	2.3	-3.5	-0.6	5.4	4.0	1.6	…
Real effective exchange rate (percent change, period average) 2/							
CPI-based	11.1	0.2	0.7	12.9	9.2	2.2	…
ULC-based 3/	7.2	-3.6	10.0	8.5	5.4	6.7	…
Memorandum items:							
GDP (current prices, Sk billions)	934	1,010	1,099	1,201	1,325	1,440	1,577

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

1/ Adjusted for bank restructuring. Figure for 2005 shows the change from December 2004 to November 2005.
2/ Partner countries comprise Austria, Czech Republic, France, Germany, Hungary, Italy, Netherlands, Poland, United Kingdom, and United States.
3/ Figure for 2005 is for the period January through September.

Table 2. Slovak Republic: Macroeconomic Framework, 2000-08

	2000	2001	2002	2003	2004	2005 Estimate	2006	2007	2008
							Staff Projections.		
					(In percent of nominal GDP)				
Consumption	76.3	78.2	77.8	76.4	76.3	75.7	74.6	73.1	72.4
Nongovernment	56.5	58.0	57.7	56.4	57.4	57.3	56.6	55.7	55.3
Government	19.8	20.1	20.1	19.9	18.9	18.4	18.0	17.5	17.1
Gross capital formation	26.1	30.0	29.3	25.1	26.6	28.5	29.3	30.0	30.2
Nongovernment	23.0	26.9	25.8	22.6	24.2	25.9	27.4	28.5	28.9
Government	3.1	3.1	3.5	2.5	2.5	2.6	1.9	1.5	1.3
Fixed investment	25.9	28.8	27.6	25.7	24.7	26.1	26.3	26.2	26.2
Foreign saving 1/	3.6	8.6	8.2	1.1	3.5	7.2	6.4	5.5	4.9
Gross national saving	22.5	21.4	21.2	24.0	23.2	21.3	22.9	24.5	25.3
Nongovernment	31.7	24.2	23.3	25.3	24.6	23.7	25.8	26.6	27.8
Of which : Households	6.2	4.1	4.0	3.7	3.4	3.3	3.3	3.2	3.2
Government	-9.2	-2.9	-2.2	-1.3	-1.5	-2.3	-2.8	-2.1	-2.5
Households' gross saving (percent of disposable income)	10.1	6.6	6.6	6.2	5.8	5.6	5.6	5.6	5.6
General government balance (ESA-95 basis) 2/	-12.3	-6.0	-7.8	-3.7	-4.0	-3.1	-2.0	-0.2	-0.1
					(Percentage change in real term)				
GDP	2.0	3.8	4.6	4.5	5.5	6.0	6.3	6.7	5.7
Households' disposable income	-0.9	1.1	5.5	-1.2	3.0	5.7	5.0	5.0	5.0
Domestic demand	0.1	7.4	4.6	-2.0	6.5	6.4	5.2	4.8	4.6
Consumption	-0.2	4.7	5.3	0.3	2.9	4.7	4.8	4.4	4.5
Nongovernment	-0.9	4.9	5.5	-0.8	3.5	5.9	5.0	5.0	5.0
Government	1.6	4.6	4.9	2.7	1.2	1.7	4.2	2.9	3.0
Gross capital formation	1.0	15.2	2.6	-8.1	16.9	10.9	6.2	5.7	5.0
Fixed investment	-7.2	13.9	-0.6	-1.5	2.5	12.0	7.2	6.5	5.6
Change in stocks (contribution to GDP growth) 3/	2.3	0.4	0.9	-1.9	3.6	0.1	0.0	0.0	0.0
Exports of goods and non-factor services	13.7	6.3	5.6	22.5	11.4	9.7	13.0	20.0	8.4
Imports of goods and non-factor services	10.5	11.0	5.5	13.6	12.7	10.2	11.9	18.5	7.7
					(Percentage change)				
Memorandum item:									
Inflation (HICP, period average)	14.1	7.2	3.5	8.4	7.5	2.8	3.6	2.5	2.5
Inflation (HICP, end of period)	8.4	6.7	3.2	9.4	5.8	3.9	2.8	2.5	2.5
GDP deflator	8.5	4.2	4.0	4.7	4.6	2.5	3.0	2.0	1.9
Employment	-1.4	1.0	0.2	1.8	0.3	2.0	1.0	1.0	1.0
Nominal wages	6.4	8.3	9.3	6.3	10.2	9.3	7.4	6.8	5.9
Real wages	-5.0	0.9	5.8	-2.1	2.5	6.6	4.0	4.3	3.4
Productivity	3.9	3.2	5.2	2.6	5.9	4.0	5.3	5.7	4.7
Unit labor costs	2.5	5.1	4.1	3.7	4.3	5.3	2.1	1.1	1.2
Unemployment rate (percent, annual average)	18.8	19.3	18.6	17.5	18.1	16.4	15.9	15.3	14.9
Gross domestic product (Sk billion, current prices)	934	1,010	1,099	1,201	1,325	1,440	1,577	1,716	1,847

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

1/ Negative of current account balance. For historical periods, foreign saving implied by national accounts data differs from the current account deficit reported in BOP statistics. The discrepancy is mainly due to different exchange rates employed in the calculations.

2/ Adjustment scenario.

3/ Includes the statistical discrepancy.

Table 3. Slovak Republic: Balance of Payments, 2000-05

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

	2000	2001	2002	2003	2004	2005 Est.
Current account balance	-700	-1,756	-1,939	-280	-1,427	-3,346
Trade balance	-904	-2,135	-2,131	-641	-1,456	-2,387
Exports, f.o.b.	11,872	12,631	14,365	21,838	27,754	31,905
Imports, f.o.b.	-12,777	-14,766	-16,497	-22,479	-29,210	-34,292
Services balance	439	480	456	237	268	445
Receipts	2,247	2,490	2,786	3,286	3,725	4,244
Payments	-1,807	-2,010	-2,330	-3,050	-3,458	-3,798
Income balance	-353	-313	-456	-120	-408	-1,574
Receipts	269	322	343	908	928	1,731
Payments	-622	-634	-800	-1,028	-1,336	-3,305
Of which: Interest	-187	-267	-634	-536	-353	-530
Current transfers	118	212	193	245	169	170
Official	-3	-9	-12	-13	58	330
Private	121	221	205	258	111	-160
Capital and financial account balance	1,511	1,647	5,175	1,763	3,015	5,558
Capital transfers	92	78	107	101	137	469
Direct foreign investment	2,096	1,137	3,963	647	1,137	1,958
Of which: Privatization	1,000	699	3,352	240	87	0
Portfolio investment	819	-217	554	-543	883	80
Other investment	-159	-14	274	194	-78	135
Credits received (net)	-429	-173	-247	-533	-239	-984
Disbursements	1,254	1,482	1,082	2,193	3,189	2,845
Amortization	-1,683	-1,654	-1,329	-2,725	-3,429	-3,829
Short-term capital	-908	835	524	1,897	1,176	3,901
Errors and omissions	-32	252	409	10	238	0
Overall balance	779	143	3,645	1,493	1826	2212
Financing	-779	-143	-3,645	-1,493	-1826	-2212
Gross reserves (negative indicates increase)	-652	-143	-3,645	-2,954	-2763	-568
Of which: exchange rate valuation	...	...	...	-1,460	-937	1644
Use of IMF credit	-127	0	0	0	0	0
Memorandum items:						
Current account balance (in percent of GDP)	-3.5	-8.4	-8.0	-0.9	-3.5	-7.2
Trade balance (in percent of GDP)	-4.5	-10.2	-8.8	-2.0	-3.5	-5.1
Merchandise export volume (percent change)	15.4	6.1	5.5	28.4	13.8	10.7
Merchandise import volume (percent change)	12.9	11.6	5.2	14.2	16.2	10.6
Terms of trade (percent change)	0.6	-3.2	1.5	-0.8	-0.1	-2.2
Gross official reserves (US$ million)	4,077	4,189	9,196	12,149	14,912	15,480
In months of imports of goods and services	3.4	3.0	5.9	5.7	5.5	4.9
Total external debt	10,804	11,042	13,107	18,090	23,764	25,317
(in percent of GDP)	54.9	52.9	50.0	50.8	53.6	56.2
Short-term external debt (original maturity basis)	2,415	3,073	4,237	7,782	10,448	13,497
(in percent of GDP)	12.3	14.7	16.2	21.9	23.5	29.9
Short-term external debt (remaining maturity basis)	4,069	4,402	6,962	11,211	14,277	16,530
(in percent of GDP)	20.7	21.1	26.6	31.5	32.2	36.7
Reserves/short-term debt (percent, remaining maturity basis)	100.2	95.2	132.1	108.4	104.4	93.6
Reserves/broad money (percent)	31.8	29.9	52.4	53.9	54.1	61.8
External debt service/Exports of goods and services (percent)	14.1	12.7	11.4	13.0	12.0	12.1

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

Table 4. Slovak Republic: Fiscal Operations of the Consolidated General Government (ESA-95 basis), 2004-08 1/

(In millions of koruny)

	2004	2005		2006		2007		2008	
	Actual	Budget	Estimates	Budget	Staff Proj.	Budget	Staff Proj.	Budget	Staff Proj.
Total revenue	468,451	521,467	533,290	564,520	569,690	612,225	617,752	643,665	650,366
Tax revenue	238,640	244,525	267,478	268,803	283,574	288,000	302,896	307,923	322,304
Personal income tax	37,388	33,366	39,048	40,184	41,509	44,383	46,117	49,206	50,791
Wage tax	30,612	29,966	33,953	34,845	36,093	38,675	40,100	43,104	44,164
Self-employment tax	6,776	3,400	5,095	5,339	5,416	5,708	6,017	6,102	6,627
Corporate profit tax	32,618	30,000	36,333	38,308	39,780	41,990	43,293	45,554	46,617
Withholding tax on capital income	5,675	6,400	3,812	4,470	4,470	4,646	4,646	4,806	4,806
VAT	103,787	118,200	123,424	121,417	132,165	129,509	140,353	138,527	148,633
Excises	44,148	45,800	50,711	51,290	52,516	54,128	55,142	56,273	57,899
Other taxes	15,024	10,759	14,150	13,134	13,134	13,344	13,344	13,557	13,557
Social contributions	169,071	189,871	185,606	201,737	200,562	214,041	215,700	225,999	228,808
Grants and transfers	9,826	30,928	18,323	35,012	26,586	51,707	40,680	52,442	41,954
Of which : from European Union (EU)	7,585	30,928	18,323	34,185	25,759	51,707	40,680	52,442	41,954
Other revenue	50,914	56,143	61,883	58,968	58,968	58,477	58,477	57,301	57,301
Of which : interest	7,630	5,321	5,121	4,566	4,566	4,149	4,149	3,630	3,630
Total expenditure	521,045	569,072	577,373	608,930	600,501	638,735	621,469	665,986	651,334
Current expenditure	466,683	512,938	513,022	545,451	544,304	573,915	565,277	599,691	592,710
Gross wages	91,511	99,139	101,093	109,564	109,564	114,443	114,443	120,105	120,105
Wages	69,339	73,930	75,404	81,783	81,783	85,370	85,370	89,561	89,561
Employer social security contributions	22,172	25,209	25,689	27,781	27,781	29,073	29,073	30,544	30,544
Goods and services	68,512	75,926	79,559	82,612	82,612	83,151	83,151	84,565	84,565
Subsidies and transfers	276,872	304,756	306,393	323,615	322,468	344,662	336,024	360,693	353,712
Agricultural subsidies	10,288	13,498	13,498	14,732	14,732	16,000	16,000	17,000	17,000
Transport subsidies	9,150	10,265	10,401	11,027	11,027	11,227	11,227	11,428	11,428
Health insurance companies	62,137	68,378	66,878	71,727	71,727	77,033	77,033	81,182	81,182
Sickness benefits	4,859	5,580	5,580	5,343	5,343	5,657	5,657	5,968	5,968
Old-age and disability pensions	99,890	106,218	109,968	116,139	118,578	121,673	125,684	128,759	134,456
Active labor market policies	3,573	4,701	4,701	4,729	4,729	4,720	4,720	5,286	5,286
Unemployment benefits	3,987	2,928	2,928	3,740	3,740	4,035	4,035	4,112	4,112
State benefits and social assistance	27,649	33,071	31,740	32,498	32,498	33,020	33,020	33,169	33,169
Social security contributions on behalf of certain groups	22,723	26,154	25,984	28,326	28,326	30,369	30,369	32,219	32,219
Transfers to the EU	8,037	13,189	12,882	14,105	14,105	15,380	15,380	15,185	15,185
Other subsidies and transfers	24,579	20,774	21,833	21,249	17,662	25,548	12,899	26,385	13,707
Interest	29,788	33,117	25,977	29,660	29,660	31,659	31,659	34,328	34,328
Capital spending	54,362	56,134	64,351	63,479	56,197	64,820	56,192	66,295	58,624
Capital assets	32,756	36,517	37,650	29,892	29,892	25,238	25,238	23,787	23,787
Capital transfers 2/	21,606	19,617	26,701	33,587	26,305	39,582	30,954	42,508	34,837
Net lending/borrowing (+/-)	**-52,594**	**-47,605**	**-44,083**	**-44,410**	**-30,810**	**-26,510**	**-3,717**	**-22,321**	**-968**
Of which : primary balance 3/	-30,436	-19,809	-11,978	-19,316	-5,716	1,000	23,793	8,377	29,730
Memorandum items:									
Second pension pillar costs	0	5,596	11,208	20,200	20,200	22,936	22,936	25,409	25,409
Fiscal deficit including second pension pillar costs	-52,594	-53,201	-55,291	-64,610	-51,010	-49,446	-26,653	-47,730	-26,377
Nominal GDP	1,325,486	1,407,382	1,439,901	1,531,400	1,576,509	1,648,200	1,715,736	1,767,700	1,847,469

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

1/ Staff projections assume that receipts from EU budget and execution of EU-earmarked spending and co-financing will be 75 percent of the budgeted level in 2006 and 2007, and 80 percent in 2008. The staff projections also assume a permanent cut, relative to the budget, in expenditure on subsidies and transfers in 2007 equivalent to 0.5 percent of GDP.

2/ In 2004, includes forgiveness of domestic debt claims on the health sector falling due, equivalent to 0.8 percent of GDP. In 2005, the estimated outturn includes forgiveness of external debt claims on Afghanistan and Sudan, equivalent to 0.8 percent of GDP, not envisaged in the budget.

3/ In 2005, excludes forgiveness of external debt claims on Afghanistan and Sudan, equivalent to 0.8 percent of GDP, not envisaged in the budget.

Table 4. Slovak Republic: Fiscal Operations of the Consolidated General Government (ESA-95 basis), 2004-08 (Continued) 1/

(In percent of GDP)

	2004	2005		2006		2007		2008	
	Actual	Budget	Estimates	Budget	Staff Proj.	Budget	Staff Proj.	Budget	Staff Proj.
Total revenue	35.3	37.1	37.0	36.9	36.1	37.1	36.0	36.4	35.2
Tax revenue	18.0	17.4	18.6	17.6	18.0	17.5	17.7	17.4	17.4
Personal income tax	2.8	2.4	2.7	2.6	2.6	2.7	2.7	2.8	2.7
Wage tax	2.3	2.1	2.4	2.3	2.3	2.3	2.3	2.4	2.4
Self-employment tax	0.5	0.2	0.4	0.3	0.3	0.3	0.4	0.3	0.4
Corporate profit tax	2.5	2.1	2.5	2.5	2.5	2.5	2.5	2.6	2.5
Withholding tax on capital income	0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3
VAT	7.8	8.4	8.6	7.9	8.4	7.9	8.2	7.8	8.0
Excises	3.3	3.3	3.5	3.3	3.3	3.3	3.2	3.2	3.1
Other taxes	1.1	0.8	1.0	0.9	0.8	0.8	0.8	0.8	0.7
Social contributions	12.8	13.5	12.9	13.2	12.7	13.0	12.6	12.8	12.4
Grants and transfers	0.7	2.2	1.3	2.3	1.7	3.1	2.4	3.0	2.3
Of which : from European Union (EU)	0.6	2.2	1.3	2.2	1.6	3.1	2.4	3.0	2.3
Other revenue	3.8	4.0	4.3	3.9	3.7	3.5	3.4	3.2	3.1
Of which : interest	0.6	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2
Total expenditure	39.3	40.4	40.1	39.8	38.1	38.8	36.2	37.7	35.3
Current expenditure	35.2	36.4	35.6	35.6	34.5	34.8	32.9	33.9	32.1
Gross wages	6.9	7.0	7.0	7.2	6.9	6.9	6.7	6.8	6.5
Wages	5.2	5.3	5.2	5.3	5.2	5.2	5.0	5.1	4.8
Employer social security contributions	1.7	1.8	1.8	1.8	1.8	1.8	1.7	1.7	1.7
Goods and services	5.2	5.4	5.5	5.4	5.2	5.0	4.8	4.8	4.6
Subsidies and transfers	20.9	21.7	21.3	21.1	20.5	20.9	19.6	20.4	19.1
Agricultural subsidies	0.8	1.0	0.9	1.0	0.9	1.0	0.9	1.0	0.9
Transport subsidies	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.6	0.6
Health insurance companies	4.7	4.9	4.6	4.7	4.5	4.7	4.5	4.6	4.4
Sickness benefits	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Old-age and disability pensions	7.5	7.5	7.6	7.6	7.5	7.4	7.3	7.3	7.3
Active labor market policies	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Unemployment benefits	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
State benefits and social assistance	2.1	2.3	2.2	2.1	2.1	2.0	1.9	1.9	1.8
Social security contributions on behalf of certain groups	1.7	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.7
Transfers to the EU	0.6	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.8
Other subsidies and transfers	1.9	1.5	1.5	1.4	1.1	1.6	0.8	1.5	0.7
Interest	2.2	2.4	1.8	1.9	1.9	1.9	1.8	1.9	1.9
Capital spending	4.1	4.0	4.5	4.1	3.6	3.9	3.3	3.8	3.2
Capital assets	2.5	2.6	2.6	2.0	1.9	1.5	1.5	1.3	1.3
Capital transfers 2/	1.6	1.4	1.9	2.2	1.7	2.4	1.8	2.4	1.9
Net lending/borrowing (+/-)	**-4.0**	**-3.4**	**-3.1**	**-2.9**	**-2.0**	**-1.6**	**-0.2**	**-1.3**	**-0.1**
Of which : primary balance 3/	-2.3	-1.4	-0.8	-1.3	-0.4	0.1	1.4	0.5	1.6
Public debt	42.6	...	36.8	...	35.8	...	32.9	...	31.8
Memorandum items:									
Second pension pillar costs	0.0	0.4	0.8	1.3	1.3	1.4	1.3	1.4	1.4
Fiscal deficit including second pension pillar costs	-4.0	-3.8	-3.8	-4.2	-3.2	-3.0	-1.6	-2.7	-1.4
Cyclically adjusted primary fiscal balance	-2.2	-1.4	-0.8	-1.2	-0.4	-0.1	1.2	0.3	1.5
Net transfers from the EU	0.0	1.3	0.4	1.3	0.7	2.2	1.5	2.1	1.4
Fiscal impulse including the impact of net transfers from the EU 4/	0.4	0.4	-1.0	1.4	0.0	-0.2	-0.8	-0.5	-0.3

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

1/ Staff projections assume that receipts from EU budget and execution of EU-earmarked spending and co-financing will be 75 percent of the budgeted level in 2006 and 2007, and 80 percent in 2008. The staff projections also assume a permanent cut, relative to the budget, in expenditure on subsidies and transfers in 2007 equivalent to 0.5 percent of GDP.

2/ In 2004, includes forgiveness of domestic debt claims on the health sector falling due, equivalent to 0.8 percent of GDP. In 2005, the estimated outturn includes forgiveness of external debt claims on Afghanistan and Sudan, equivalent to 0.8 percent of GDP, not envisaged in the budget.

3/ In 2005, excludes forgiveness of external debt claims on Afghanistan and Sudan, equivalent to 0.8 percent of GDP, not envisaged in the budget.

4/ Change in cyclically adjusted primary balance plus the change in net transfers from the EU.

Table 5. Slovak Republic: Monetary Survey, 2000-05
(End of period)

	2000	2001	2002	2003	2004	2005 Nov
			(In billions of koruny)			
Net foreign assets	93.2	92.0	228.5	189.5	169.5	144.5
Assets	274.1	291.0	417.4	447.9	484.0	550.8
Liabilities	180.9	199.0	188.9	258.4	314.5	406.3
Net domestic assets	514.7	587.9	474.4	553.0	615.9	656.6
Net credit to government 1/	199.9	355.8	262.5	306.5	354.4	350.0
Credit to enterprises and households	395.4	320.8	326.1	372.6	401.3	499.6
In domestic currency	344.9	267.3	271.8	304.0	318.2	392.8
In foreign currency	50.5	53.5	54.3	68.6	83.1	106.8
Other items, net	-80.6	-88.7	-114.2	-126.1	-139.8	-193.0
Broad Money	607.9	679.9	702.9	742.5	785.4	801.1
Koruna broad money	513.6	574.8	596.2	650.5	697.5	712.7
Currency	67.0	81.0	84.2	91.8	100.5	114.9
Deposits	446.6	493.8	512.0	558.7	597.0	597.8
Foreign currency deposits	94.3	105.1	106.7	92.0	87.9	88.4
Memorandum items:						
Broad money (percent change)	15.4	11.8	3.4	5.6	5.8	4.5
Koruna broad money (percent change)	14.0	11.9	3.7	9.1	7.2	6.8
M2/GDP (percent)	65.1	67.3	64.0	61.8	59.3	55.7
Net credit to government (in percent of GDP)	21.4	35.2	23.9	25.5	26.7	24.3
Credit to private sector (in percent of GDP)	42.3	31.8	32.9	31.0	30.3	34.7
of which: In domestic currency	36.9	26.5	28.0	25.3	24.0	27.3
In foreign currency	5.4	5.3	4.9	5.7	6.3	7.4
Credit to private sector (percent change) 2/	7.4	7.1	14.3	14.3	7.7	24.2
Credit to enterprises (percent change) 2/	5.0	4.9	13.4	8.5	-1.0	16.9
Credit to households (percent change)	22.0	18.5	18.1	38.8	37.1	42.7
Share of foreign currency loans in credit to enterprises (percent)	22.7	22.9	20.5	23.8	29.1	31.2

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

1/ Includes accumulated interest payments on restructuring bonds.

2/ Adjusted for bank restructuring and reclassification of loans.

Table 6. Slovak Republic: Vulnerability Indicators, 2000-05

(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005 *Latest month available*	
Financial indicators							
Public sector debt 1/	49.9	48.7	43.8	43.1	42.6	36.8	Dec
Broad money (percent change, 12-month basis)	15.4	11.8	3.4	5.6	5.8	1.9	Dec
Private sector credit (percent change, 12-month basis)	7.8	7.5	14.8	14.8	10.9	24.2	Nov
Of which: credit to households (percent change, 12-month basis)	22.0	18.5	18.1	38.8	37.1	42.7	
BRIBOR (six months, end-of-period, in percent) 2/							
Nominal	7.8	7.7	5.7	5.7	3.5	3.2	Dec
Real	-0.5	1.0	2.4	-3.4	-2.2	-0.6	Dec
External indicators							
Merchandise exports (percent change, 12-month basis in US$)	16.1	6.4	13.7	52.0	27.1	15.0	Dec
Merchandise imports (percent change, 12-month basis in US$)	12.9	15.6	11.7	36.3	29.9	17.4	Dec
Terms of trade (percent change, 12-month basis)	0.6	-2.7	1.0	0.0	-0.5	-2.0	Jan-Sep
Current account balance	-3.5	-8.4	-8.0	-0.9	-3.5	-4.6	Jan-Sep
Capital and financial account balance	7.5	8.2	21.4	5.4	7.8	9.2	Jan-Sep
Capital transfers	0.5	0.4	0.4	0.3	0.3	0.0	
Portfolio investment, net	4.0	-1.0	2.3	-1.7	2.1	-0.6	
Medium- and long-term credits and short-term credits	-7.4	3.5	2.3	4.2	2.3	7.2	
Direct investment, net	10.4	5.4	16.3	2.0	3.2	3.0	
Net foreign assets (NFA) of commercial banks (in US$ billions)	1.0	1.0	0.3	-1.1	-2.3	-5.5	Dec
Gross official reserves (in US$ billions)	4.1	4.2	9.2	12.1	14.9	15.5	Dec
Net international reserves (NIR) (in US$ billions)	3.8	3.9	8.8	11.1	14.8	15.3	Dec
Central bank short-term foreign liabilities (in US$ billions) 3/	0.0	0.0	0.0	0.9	0.0	0.0	Dec
Central bank foreign currency exposure (in US$ billions)	1.2	1.4	6.1	8.0	10.4	12.3	Dec
Short-term foreign assets of commercial banks (in US$ billions)	1.5	1.2	1.0	0.9	0.8	0.8	Dec
Short-term foreign liabilities of commercial banks (in US$ billions)	0.3	0.6	1.0	2.3	3.9	6.8	Dec
Foreign currency exposure of commercial banks (in US$ billions)	1.0	1.0	0.3	-1.1	-2.3	-5.5	Dec
Official reserves in months of imports of goods and services	3.4	3.0	5.9	5.7	5.5	4.9	Dec
Reserve money to gross official reserves (percent)	58.8	56.0	31.4	28.6	23.1	29.8	Dec
Broad money to gross official reserves (percent)	314.7	334.9	190.9	185.7	184.8	161.9	Dec
Total short-term external debt to gross official reserves (percent) 4/	98.0	105.1	75.7	92.3	95.8	106.8	Dec
Total external debt	54.9	52.9	50.0	50.8	53.6	59.1	Sep
Of which: public sector debt	17.2	16.5	14.3	14.8	15.5	14.5	
Total external debt to exports of goods and services (percent)	76.5	73.0	76.4	72.0	75.3	71.5	Sep
Total external debt service payments to exports of goods and services (percent)	13.2	12.7	11.4	13.0	12.0	12.1	Jan-Dec
External interest payments to exports of goods and services (percent)	1.3	1.8	3.7	2.1	1.1	1.3	
External amortization payments to exports of goods and services (percent)	11.9	10.9	7.7	10.8	10.9	8.7	
Exchange rate (per US$, period average)	46.2	48.4	45.3	36.7	32.3	30.8	Jan-Dec
Real effective exchange rate (CPI-based, period average)	11.1	0.2	0.7	12.9	9.2	2.2	Jan-Dec
Real effective exchange rate (ULC-based, period average)	7.2	-3.6	10.0	8.5	5.4	6.7	Jan-Sep
Financial market indicators (end-year)							
Stock market index	91.9	120.8	140.0	177.6	326.6	413.3	Dec
Foreign currency debt rating (Moody's)	Ba1	Baa3	A3	A3	A2	A2	Dec

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

1/ General government. Number in the 2005 column is the estimated end-year debt.
2/ Bratislava Interbank Offering Rate.
3/ Includes short-term liabilities of the government.
4/ Includes medium- and long-term debt due next year.

Table 7. Slovak Republic: Medium-term Balance of Payments, 2004-10

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

	2004	2005	2006	2007	2008	2009	2010
		Est.	Staff Projections				
Current account balance	-1,427	-3,346	-3,237	-3,152	-3,108	-2,793	-2,534
Trade balance	-1,456	-2,387	-2,436	-2,247	-2,119	-1,815	-1,443
Exports, f.o.b.	27,754	31,905	36,602	44,293	47,941	52,222	57,010
Imports, f.o.b.	-29,210	-34,292	-39,038	-46,540	-50,060	-54,038	-58,453
Services balance	268	445	452	443	469	492	510
Receipts	3,725	4,244	4,506	4,865	5,131	5,388	5,657
Payments	-3,458	-3,798	-4,054	-4,422	-4,662	-4,896	-5,147
Income balance	-408	-1,574	-1,697	-1,777	-1,913	-1,935	-2,071
Receipts	928	1,731	1,953	2,136	2,375	2,644	2,973
Payments	-1,336	-3,305	-3,650	-3,913	-4,287	-4,579	-5,044
Current transfers	169	170	443	430	454	465	470
Capital and financial account balance	3,015	5,558	6,508	6,550	5,779	5,012	4,965
Capital transfers	137	469	1,049	866	878	913	964
Direct foreign investment	1,137	1,958	3,417	2,816	2,266	2,453	2,663
Portfolio investment	883	80	331	302	339	346	356
Other investment	-78	135	128	131	133	136	140
Credits received (net)	-239	-984	109	470	547	531	551
Disbursements	3,189	2,845	3,142	3,202	3,380	3,006	3,026
Amortization	-3,429	-3,829	-3,033	-2,732	-2,833	-2,475	-2,475
Short-term capital	1,176	3,901	1,474	1,964	1,616	633	291
Errors and omissions	238	0	0	0	0	0	0
Overall balance	1826	2212	3270	3398	2671	2219	2431
Financing	-1826	-2212	-3270	-3398	-2671	-2219	-2431
Gross reserves (negative indicates increase)	-2763	-568	-3270	-3398	-2671	-2219	-2431
Of which: exchange rate valuation	-937	1644	0	0	0	0	0
Memorandum items:							
Current account balance (in percent of GDP)	-3.5	-7.2	-6.4	-5.5	-4.9	-3.9	-3.2
Trade balance (in percent of GDP)	-3.5	-5.1	-4.8	-3.9	-3.3	-2.6	-1.8
Merchandise export volume (percent change)	13.8	10.7	14.0	21.4	8.7	8.6	8.5
Merchandise import volume (percent change)	16.2	10.6	11.5	19.5	7.9	7.6	7.5
Terms of trade (percent change)	-0.1	-2.2	-1.4	-0.1	-0.1	-0.1	-0.1
Gross official reserves (US$ million)	14,912	15,480	18,750	22,148	24,819	27,038	29,468
In months of imports of goods and services	5.5	4.9	5.2	5.2	5.4	5.5	5.6
Total external debt	23,764	25,317	28,836	31,855	34,603	36,458	37,993
(in percent of GDP)	53.6	56.2	56.5	55.5	54.2	51.4	48.1
Short-term external debt (original maturity basis)	10,448	13,497	16,822	19,286	21,402	22,535	23,326
(in percent of GDP)	23.5	29.9	33.0	33.6	33.5	31.8	29.6
Short-term external debt (remaining maturity basis)	14,277	16,530	19,554	22,118	23,877	25,010	25,801
(in percent of GDP)	32.2	36.7	38.3	38.6	37.4	35.3	32.7
Reserves/short-term debt (percent, remaining maturity basis)	104.4	93.6	95.9	100.1	103.9	108.1	114.2
External debt service/Exports of goods and services (percent)	12.0	12.1	9.3	7.2	7.1	6.3	6.0

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

Table 8. Slovak Republic: Banking Sector Soundness Indicators, 2001-05

(In percent; end of period)

	2001	2002	2003	2004	2004 September	2005 September
Capital adequacy						
Regulatory capital to risk-weighted assets	19.6	21.3	22.4	18.6	20.4	15.9
Regulatory Tier 1 capital to risk-weighted assets	15.9	18.5	21.6	18.9	20.5	16.4
Capital to assets	7.1	7.7	8.9	7.7	8.1	7.2
Nonperforming loans net of provisions to capital 1/	12.7	6.0	4.2	3.1	3.5	5.6
Asset quality						
Nonperforming loans to gross loans	11.1	7.9	3.7	2.6	2.8	2.0
Large exposures to capital	...	...	174.0	198.8	...	252.7
Earnings and profitability						
Net interest margin to gross income	...	76.6	80.7	73.3	73.1	68.4
Net interest margin to average interest-bearing assets	2.3	2.7	2.9	2.8	2.1	1.6
Non-interest expenses to average assets	...	2.4	2.6	2.5	1.9	1.6
Return on assets (after tax)	1.0	1.2	1.2	1.2	1.0	0.9
Return on equity (after tax)	16.3	13.9	12.5	14.1	11.5	12.4
Liquidity						
Liquid assets to total assets 2/	21.7	28.9	16.8	13.3	14.0	15.4
Liquid assets to short-term liabilities 2/	61.5	81.3	55.9	40.3	40.3	43.0
Foreign exchange risk						
Net open position in foreign exchange to capital	-41.0	-77.0	-53.0	-40.0	-47.0	-30.0
Foreign currency-denominated loans to total loans	17.2	17.1	20.7	22.8	23.5	24.8
Foreign currency-denominated liabilites to total liabilities	17.3	15.6	19.0	19.3	17.7	24.0
Memorandum items:						
Ownership of banking sector (percent of equity capital)						
Foreign	56.3	83.2	88.1	88.9	...	88.8
Domestic	40.3	12.4	11.9	11.2	...	11.2
State	...	...	6.5	4.8	...	4.8
Other domestic entities	...	...	5.4	6.3	...	6.4
Concentration						
Share of the three largest banks in total assets of banking sector	54.5	55.5	54.0	53.0	...	49.0

Source: National Bank of Slovakia.

1/ Nonperforming loans are defined as loans that are 90 days or more past due.
2/ Liquid assets include cash, sight deposits in other banks, T-bills and NBS bills.

Slovak Republic: Fund Relations

(As of February 27, 2006)

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

II. **General Resources Account**:

	SDR Million	%Quota
Quota	357.50	100.00
Fund Holdings of Currency	357.50	100.00
Reserve Position	0.00	0.00

III. **SDR Department**:

	SDR Million	%Allocation
Holdings	0.90	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 (Sk). Slovak Republic joined the ERM2 on November 28, 2005 at the central parity of Sk 38.455 per euro. Since ERM2 entry, the koruna has appreciated and the exchange rate stood at Sk 37.270 per euro on February 27, 2006. The exchange rate regime is currently classified as pegged exchange rate within horizontal band. Slovak Republic aims to adopt the euro in January 2009.

The Slovak Republic has accepted the obligations of Article VIII, sections 2, 3, and 4, and maintains no restrictions on the making of payments and transfers for current international transactions, except for those imposed in compliance with applicable UN Security Council resolutions. All such restrictions have been notified to the Fund pursuant to Decision No. 144 (52/51).

VIII. **Article IV Consultation**:

The last consultation with the Slovak Republic was concluded on February 11, 2005 (IMF Country Report No. 05/71). The chairman's summing up of the discussion was circulated as SUR05/15.

IX. **FSAP Participation and ROSCs**:

An FSAP was concluded with the completion of the 2002 Article IV consultation on August 7, 2002 on the basis of missions that took place in February 2002 and April 2002. The FSSA report was published (IMF Country Report No. 02/198).The report on the Fiscal ROSC was issued in August 2002 (IMF Country Report No. 02/189) and updates were issued in August 2003 (IMF Country Report No. 03/236) and in March 2005 (IMF Country Report No. 05/73). The report on the Data ROSC was issued in May 2005 (IMF Country Report No. 05/161).

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

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

Slovak Republic: Technical Assistance, 2000–2005[20]

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

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

SLOVAK REPUBLIC: STATISTICAL ISSUES

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

2. With regard to timeliness and public access, the authorities in general follow a free and open data publication policy. Data are promptly released to news services, and are also published regularly in various monthly and quarterly statistical publications, and on the Internet[21] according to a pre-announced schedule. Data on core surveillance variables are provided regularly to the Fund, and with minimal lags: a week or less for foreign exchange reserves; a day for monthly state budget implementation data; 10 days to a month for consumer prices, reserve money, broad money, and interest rates; two months for foreign trade data; and about three months for other fiscal, balance of payments, and national accounts data. However, the 2004 Data ROSC mission reported some difficulties in fully reconciling the balance of payments with the national accounts, monetary, and government finance statistics.

Real Sector and Prices

3. Significant progress has been made in the elaboration of the 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. An important outstanding issue is the compilation of reliable price deflators for imports and exports that would enable better decomposition into volume and price changes. The unit value trade price indices—on which the national accounts trade price deflators are based—are published with long delays and are not appropriately adjusted for quality changes; the statistical authorities are aware of these issues and improvements are pending.

[21] Data are available on the website of the Statistical Office of the Slovak Republic (www.statistics.sk), the National Bank of Slovakia (NBS) (www.nbs.sk), and the Ministry of Finance (MoF) (www.finance.gov.sk).

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

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

Fiscal Sector

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

7. The MOF has converted its fiscal accounts to ESA95 standards. The MOF compiles Government Finance Statistics according to the *Government Finance Statistics Manual 2001* (*GFSM 2001*) analytical framework; data are available and disseminated on a cash basis for 2000–02, and on an accrual basis for 2003.

External Sector

8. The Slovak Republic provides monthly balance of payments in a timely manner. The balance of payment statements are presented in two formats, an analytical presentation and the standard presentation. Banks are now reporting their arbitrage transactions accurately. Improvements have also been made in reporting nonresidents' claims and liabilities in domestic currency. The balance of payments is compiled and disseminated quarterly on a cumulative basis during the year; however, dissemination on a cumulative basis does not follow best practice. Weekly reports of information on gross international reserves are timely. Moreover, the NBS revised in 2002 its methodology for reporting foreign exchange reserves in line with IMF guidelines and STA technical recommendations to include the valuation of gold at market prices and to change 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." Remaining problem areas include: (i) the measurement of inward portfolio investment; (ii) the need for more detailed and timely information on publicly guaranteed external debt; (iii) more timely reporting of information on external debt, including short-term debt; (iv) the recording of most interest payments on a cash basis; and (v) the need to improve data compilation on the composition of exports.

Monetary Sector

9. 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 memorandum 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: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(as of February 21, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memorandum Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	02.02.2006	02.02.2006	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	31.12.2005	31.01.2006	M	M	M		
Reserve/Base Money	31.12.2005	31.01.2006	M	M	M	LO, LO, O, LO	O, O, O, O, O
Broad Money	31.12.2005	31.01.2006	M	M	M		
Central Bank Balance Sheet	10.01.2006	24.01.2006	10 Day	10 Day	10 Day		
Consolidated Balance Sheet of the Banking System	31.12.2005	31.01.2006	M	M	M		
Interest Rates[2]	1/2006	02.02.2006	M	M	M		
Consumer Price Index	1/2006	2/2006	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	31.12.2004	25.03.2005	A	A	A	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	31.01.2006	02.02.2006	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	30.09.2005	15.11.2005	Q	Q	Q		
External Current Account Balance	11/2005	31.01.2006	M	M	M	O, O, LO, LO	O, O, O, O, O
Exports and Imports of Goods and Services	11/2005	31.01.2006	M	M	M		
GDP/GNP	Q3/2005	8.12.2005	Q	Q	Q	O, O, LO, LO	LO, O, LO, O, LO
Gross External Debt	10/2005	31.01.2006	M	M	M		

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

SLOVAK REPUBLIC: DEBT SUSTAINABILITY ANALYSIS

41. External and fiscal debt sustainability assessments were conducted applying standardized sensitivity tests to the staff's baseline scenario.

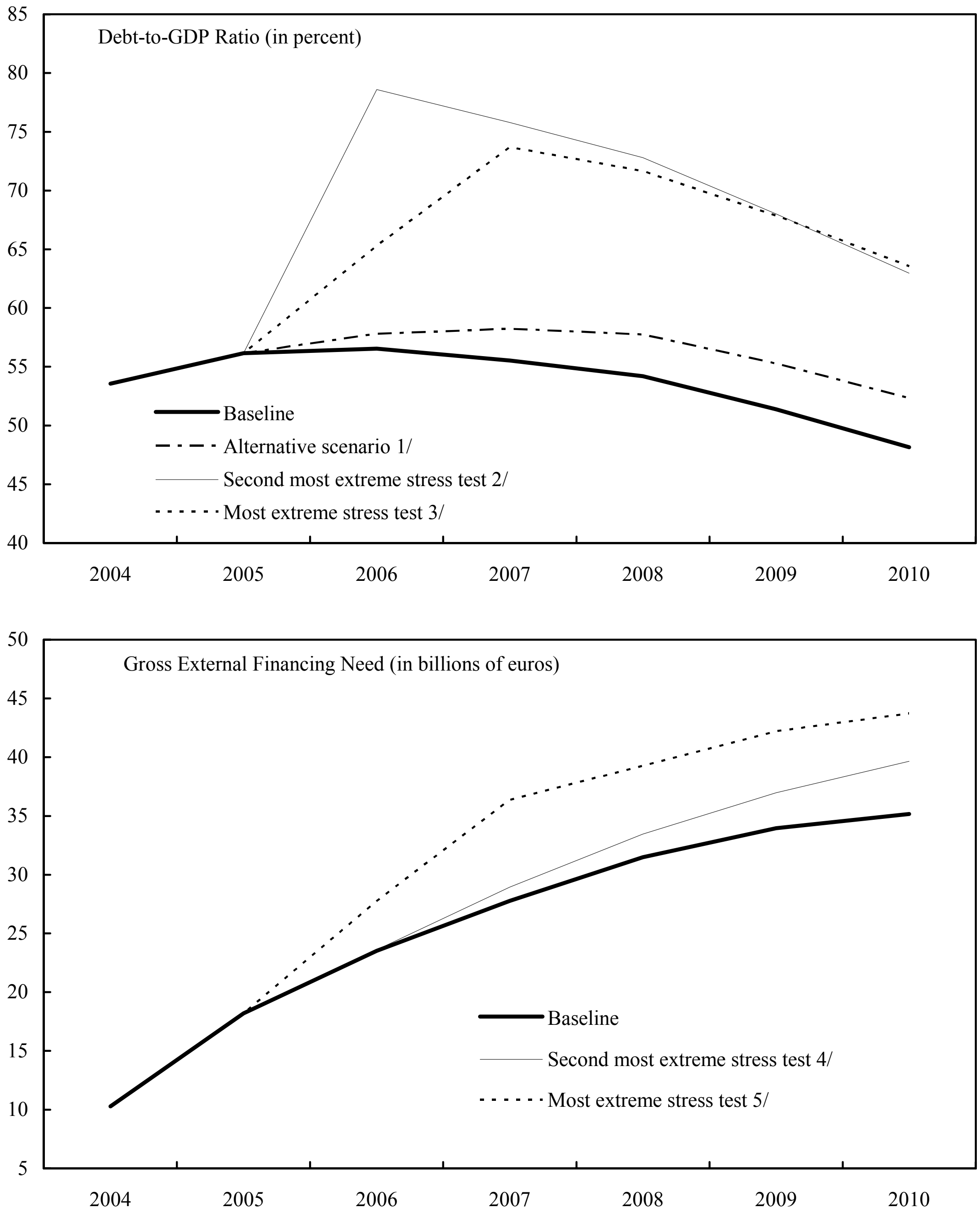
A. External Sustainability

42. Stress testing of external debt dynamics suggests that external debt sustainability is not seriously at risk, although the external debt ratio surges temporarily under a sizable depreciation of the currency or a significant current account balance deterioration. Staff's baseline scenario assumes rising exports, driven by automobile production, and strong FDI inflows throughout the period. Under this scenario, the external debt stock falls to 48 percent of GDP due to a gradual improvement in current account balance (Table 1. A-3 and Figure 1. A-3). Dynamics of external debt ratio are resilient to shocks to nominal interest rate, real GDP growth, and terms-of-trade as the debt ratio falls to the range of 50-55 percent by 2010. A combination of these shocks together with worsening of the overall external environment and one-time 30 percent nominal depreciation in 2006 raise the external debt ratio temporarily to the range of 70-79 percent in 2006-07. However, even under these adverse conditions, the debt ratio starts declining in 2007-08 and falls to the range of 60-63 percent by 2010.

B. Fiscal Sustainability

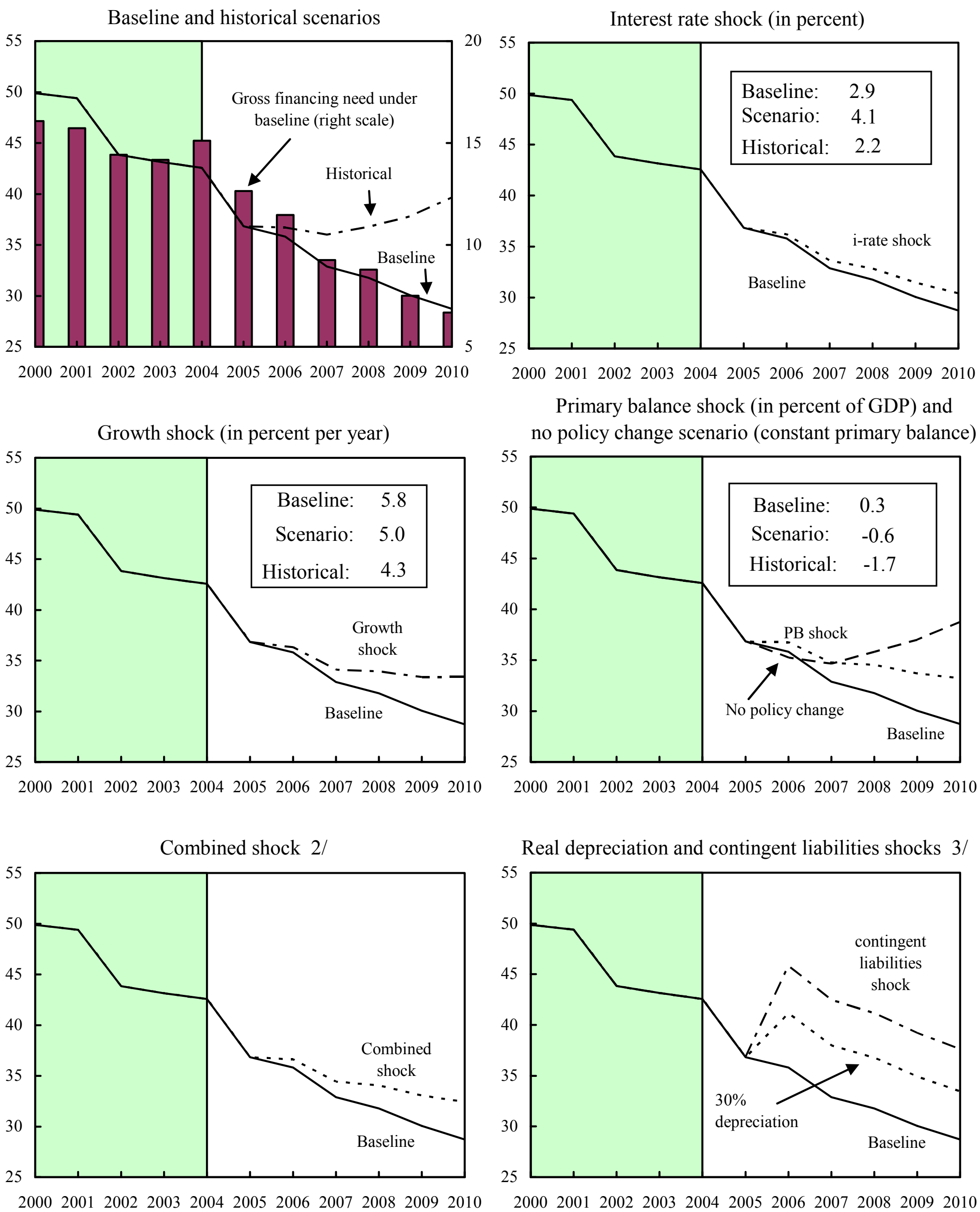
43. Stress testing of public debt dynamics suggests that fiscal sustainability is not at risk over the medium-term. Staff's baseline scenario assumes forceful fiscal consolidation efforts throughout the period and completion of privatization by 2007. Under this scenario, the public debt ratio steadily falls to about 29 percent by 2010 (Table 2. A-3). Dynamics of public debt ratio are resilient to shocks to nominal interest rate, economic growth, and primary balance as the debt ratio remains below 40 percent throughout the period (Figure 2. A-3). Under a no policy change scenario, the debt ratio starts increasing marginally after the completion of privatization in 2007, but it remains below 40 percent throughout the period. One-time 30 percent real depreciation and 10 percent of GDP shock to contingent liabilities in 2006 raise the debt ratio temporarily to the range of 42-47 percent in 2006. However, even under these adverse conditions, the debt ratio starts declining in 2007 and falls to below 40 percent by 2009, well below the Maastricht public debt ratio ceiling of 60 percent.

Figure 1. A-3. Slovak Republic: Debt Ratio and Gross External Financing Need, 2004-10



Source: IMF staff calculations.
1/ Reduction in real GDP growth to 4 percent throughout the projection period
2/ Combination of shocks to nominal interest rate, real GDP growth, current account, and the exchange rate.
3/ A depreciation of 30 percent in 2006.
4/ Non-interest current account at historical average minus two standard deviations in 2006 and 2007.
5/ Key variables at their historical averages.

Figure 2. A-3. Slovak Republic: Public Debt Sustainability: Bound Tests 1/
(In percent of GDP)



Source: IMF staff calculations.

1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1. A-3. Slovak Republic: External Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	Estimate 2005			Projections 2006	2007	2008	2009	2010	
									I. Baseline Projections					**Debt-stabilizing non-interest current account 6/**
1 **External debt**	54.9	52.9	50.0	50.8	53.6	56.2			**56.5**	**55.5**	**54.2**	**51.4**	**48.1**	**-6.6**
2 Change in external debt	0.6	-2.0	-2.9	0.8	2.7	2.6			0.4	-1.0	-1.3	-2.8	-3.3	
3 Identified external debt-creating flows (4+8+9)	-13.3	-1.3	-13.3	-6.7	-5.3	-2.8			-6.6	-5.4	-4.0	-4.7	-5.2	
4 Current account deficit, excluding interest payments	0.8	6.0	5.5	-1.2	2.1	5.3			4.5	3.5	2.9	2.4	1.6	
5 Deficit in balance of goods and services	2.3	7.9	6.9	1.2	2.9	4.2			4.0	3.2	2.6	1.9	1.2	
6 Exports	69.7	72.4	70.6	76.8	76.5	78.0			82.6	87.8	85.2	83.2	81.3	
7 Imports	72.0	80.3	77.5	78.0	79.4	82.2			86.5	91.1	87.8	85.1	82.5	
8 Net nondebt creating capital inflows (negative)	-10.1	-6.3	-16.3	-2.1	-2.5	-4.2			-6.9	-5.0	-3.6	-3.5	-3.5	
9 Automatic debt dynamics 1/	-4.1	-1.0	-2.4	-3.3	-4.8	-3.9			-4.3	-3.9	-3.2	-3.5	-3.3	
10 Contribution from nominal interest rate	2.6	2.4	2.5	2.1	1.4	1.9			2.0	2.1	2.1	1.7	1.7	
11 Contribution from real GDP growth	-1.0	-2.0	-2.2	-2.0	-2.4	-2.9			-3.2	-3.4	-2.8	-2.4	-2.4	
12 Contribution from price and exchange rate changes 2/	-5.8	-1.4	-2.7	-3.4	-3.8	-2.9			-3.1	-2.6	-2.5	-2.8	-2.6	
13 Residual, incl. change in gross foreign assets (2-3)	13.9	-0.8	10.4	7.5	8.0	5.4			7.0	4.4	2.7	1.9	1.9	
External debt-to-exports ratio (in percent)	78.8	73.0	70.9	66.2	70.0	72.0			68.5	63.2	63.6	61.8	59.2	
Gross external financing need (in billions of euros) 3/	5.5	6.5	6.9	7.7	11.9	18.2			23.5	27.8	31.5	34.0	35.2	
in percent of GDP	24.9	28.0	26.8	26.6	36.0	48.9			56.0	58.9	60.2	58.5	54.5	
Key macroeconomic assumptions							10-Year Historical Average	10-Year Standard Deviation						Projected Average
Real GDP growth (in percent)	2.0	3.8	4.6	4.5	5.5	6.0	4.3	1.5	6.3	6.7	5.7	5.0	5.1	5.8
Exchange rate appreciation (Euro value of local currency, change in percent)	3.5	-1.7	1.4	2.9	3.6	3.5	-0.5	4.2	3.1	3.1	3.1	3.1	3.1	3.2
GDP deflator in euros (change in percent)	12.3	2.4	5.5	7.7	8.4	6.1	5.4	4.7	6.2	5.2	5.1	5.7	5.7	5.6
Nominal external interest rate (in percent)	5.5	4.6	5.3	4.7	3.2	4.0	4.9	0.7	4.0	4.2	4.2	3.4	3.6	3.9
Growth of exports (Euro terms, in percent)	32.6	10.5	7.6	22.3	14.0	14.6	13.3	9.9	19.6	19.3	7.6	8.3	8.6	13.0
Growth of imports (Euro terms, in percent)	27.9	18.7	6.4	13.2	16.4	16.4	14.8	10.8	19.0	18.0	7.0	7.5	7.8	12.6
Current account balance, excluding interest payments	-0.8	-6.0	-5.5	1.2	-2.1	-5.3	-3.5	4.0	-4.5	-3.5	-2.9	-2.4	-1.6	-3.4
Net nondebt creating capital inflows	10.1	6.3	16.3	2.1	2.5	4.2	4.4	5.2	6.9	5.0	3.6	3.5	3.5	4.5
									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 2006-10 4/						**56.2**			**60.1**	**61.2**	**60.6**	**59.1**	**57.8**	**-6.9**
A2. Reduction in real GDP growth (relative to baseline) 5/						**56.2**			**57.8**	**58.2**	**57.8**	**55.3**	**52.4**	**-6.6**
B. Bound tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2006 and 2007.						**56.2**			**57.7**	**57.8**	**56.3**	**53.4**	**50.0**	**-6.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007.						**56.2**			**59.2**	**60.9**	**59.1**	**55.8**	**52.1**	**-7.2**
B3. Change in euro GDP deflator is at historical average minus two standard deviations in 2006 and 2007.						**56.2**			**61.5**	**65.0**	**62.9**	**59.2**	**55.1**	**-7.8**
B4. Non-interest current account is at historical average minus two standard deviations in 2006 and 2007.						**56.2**			**63.6**	**70.2**	**68.0**	**64.3**	**60.2**	**-7.3**
B5. Combination of B1-B4 using one standard deviation shocks.						**56.2**			**65.3**	**73.7**	**71.7**	**67.9**	**63.6**	**-8.2**
B6. One time 30 percent nominal depreciation in 2006.						**56.2**			**78.6**	**75.8**	**72.8**	**68.0**	**63.0**	**-9.2**

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 2006-10.
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 at their levels of the last projection year.

Table 2. A-3. Slovak Republic: Public Sector Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

		Actual					Estimate	Projections					
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing primary balance 10/
1	**Baseline: Public sector debt 1/**	49.9	49.4	43.8	43.1	42.6	**36.8**	**35.8**	**32.9**	**31.8**	**30.1**	**28.8**	**-0.9**
	o/w foreign-currency denominated	15.2	17.9	13.8	11.6	11.2	10.0	10.9	10.6	10.5	10.7	10.8	
2	Change in public sector debt	2.7	-0.5	-5.5	-0.7	-0.6	-5.7	-1.0	-2.9	-1.1	-1.7	-1.3	
3	Identified debt-creating flows (4+7+12)	1.7	13.1	-15.7	-2.8	-1.8	1.0	-3.0	-3.2	-1.2	-1.8	-2.2	
4	Primary deficit 2/	4.7	3.5	2.0	1.2	1.7	2.0	1.4	-0.3	-0.4	-1.0	-1.3	
5	Revenue and grants	38.6	36.7	39.3	36.1	35.3	36.3	34.8	34.7	33.8	34.2	33.6	
6	Primary (noninterest) expenditure	43.3	40.2	41.3	37.3	37.1	38.3	36.2	34.4	33.4	33.2	32.4	
7	Automatic debt dynamics 3/	-0.3	-0.3	-3.3	-3.6	-3.3	-0.3	-1.8	-1.4	-0.7	-0.8	-0.9	
8	Contribution from interest rate/growth differential 4/	-1.7	-0.6	-0.3	-1.2	-1.8	-1.6	-1.3	-1.1	-0.5	-0.8	-0.9	
9	Of which contribution from real interest rate	-0.9	1.1	1.8	0.6	0.4	0.8	0.8	1.1	1.2	0.7	0.5	
10	Of which contribution from real GDP growth	-0.9	-1.7	-2.1	-1.8	-2.2	-2.4	-2.1	-2.2	-1.7	-1.5	-1.5	
11	Contribution from exchange rate depreciation 5/	1.5	0.3	-3.0	-2.4	-1.5	1.3	-0.5	-0.4	-0.2	0.0	0.0	
12	Other identified debt-creating flows	-2.7	9.9	-14.4	-0.4	-0.2	-0.8	-2.6	-1.5	-0.1	-0.1	-0.1	
13	Privatization receipts (negative)	-4.3	-3.6	-14.7	-1.0	-0.2	0.0	-2.2	-1.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	1.7	0.8	0.3	0.6	0.0	-0.8	-0.4	-0.5	-0.1	-0.1	-0.1	
15	Other (specify, e.g. bank recapitalization)	0.0	12.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 6/	1.0	-13.6	10.1	2.1	1.2	-6.7	2.0	0.3	0.1	0.2	0.9	
	Public sector debt-to-revenue ratio 1/	129.1	134.5	111.7	119.4	120.4	101.6	102.8	94.8	93.9	88.0	85.5	
	Gross financing need 7/	16.1	15.7	14.4	14.2	15.1	12.6	11.5	9.3	8.8	7.5	6.7	
	in billions of U.S. dollars	3.2	3.3	3.5	4.6	6.2	5.9	5.8	5.3	5.6	5.2	5.0	
	Scenario with key variables at their historical averages 8/						**36.8**	**36.7**	**36.0**	**36.8**	**37.8**	**39.7**	**-0.9**
	Scenario with no policy change (constant primary balance) in 2005-2010						**36.8**	**35.2**	**34.7**	**35.8**	**37.1**	**38.8**	**-1.3**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	2.0	3.8	4.6	4.5	5.5	6.0	6.3	6.7	5.7	5.0	5.2	
	Average nominal interest rate on public debt (in percent) 9/	6.6	6.8	8.2	6.3	5.7	4.6	5.6	5.6	6.1	5.1	4.5	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.9	2.6	4.2	1.7	1.2	2.1	2.6	3.6	4.2	2.6	2.0	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-10.8	-2.2	21.1	21.6	15.5	-10.7	4.8	3.4	1.9	0.0	0.0	
	Inflation rate (GDP deflator, in percent)	8.5	4.2	4.0	4.7	4.6	2.5	3.0	2.0	1.9	2.5	2.5	
	Growth of real primary spending (deflated by GDP deflator, in percent)	5.7	-3.6	7.4	-5.5	4.7	9.5	0.5	1.3	2.7	4.5	2.6	
	Primary deficit 2/	4.7	3.5	2.0	1.2	1.7	2.0	1.4	-0.3	-0.4	-1.0	-1.3	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Does not take into account the interest revenues and includes second pillar pension costs introduced in 2005.
3/ 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).
4/ 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.
5/ The exchange rate contribution is derived from the numerator in footnote 2 as $\alpha\varepsilon(1+r)$.
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/32
FOR IMMEDIATE RELEASE
March 22, 2006

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

IMF Executive Board Concludes 2005 Article IV Consultation with the Slovak Republic

On March 20, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Slovak Republic.[1]

Background

Economic performance in 2005 continued to be strong. Real GDP growth accelerated to 6 percent, as domestic demand growth maintained momentum and the contribution of net foreign demand improved. Private consumption strengthened appreciably, fueled by large increases in real wages and employment, and rapid credit growth. Fixed investment also picked up markedly though inventory accumulation was smaller. Exports continued to grow in the double-digits. However, because of a deterioration of the terms-of-trade due to rising oil prices and higher reinvested earnings on foreign investment, the external current account deficit doubled to 7¼ percent. Competitiveness remained adequate. Much of the external deficit was covered by inflows of foreign direct investment. However, external liabilities increased, as banks resorted to external finance to fund their lending.

The strength of the economy was visible in labor market conditions. Real wage growth is estimated to have accelerated to about 6½ percent in 2005, from 2½ percent in 2004 and large increases were recorded in both self-employment and wage-employment. Thus, the economy-wide unemployment rate declined by 2 percentage points to about 15½ percent in September 2005, with considerable regional variation in the level and trend.

[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.

Inflation declined further in 2005. Headline consumer price inflation (HICP basis) fell by 1.9 percentage points to 3.9 percent at end-December—at the upper end of the NBS's target range of 3–4 percent. Koruna appreciation, increased competition at the retail level subsequent to EU membership, and lower increases in regulated utility prices moderated inflationary pressures. Higher gasoline prices (which are not regulated) restrained the progress with disinflation.

The general government deficit in 2005, estimated at 3.1 percent of GDP, was better than envisaged in the budget and implied a substantial withdrawal of stimulus. Collections in most tax categories and non-tax revenues surpassed expectations. In addition, interest payments came in lower than expected, and, with receipts from the EU budget at 60 percent of the envisaged level, co-financing of projects was below budgeted amounts. These gains were partly offset by forgiveness of certain foreign debt claims not envisaged in the budget.

In January 2005, the NBS adopted a hybrid monetary framework of "inflation targeting under ERM2 conditions." It announced explicit end-year inflation targets for 2005–08. At the same time, it intervened in the foreign exchange market in both directions on several occasions to influence the exchange rate. Slovakia entered ERM2 on November 28, 2005. The central parity was set at Sk 38.455 per euro, equal to the then-prevailing market rate. The koruna appreciated in the immediate aftermath and strengthened further in January 2006, in step with other currencies in the region, to nearly 3 percent above the central parity. Following a cut in February 2005, NBS kept its policy interest rate unchanged at 3 percent until February 2006, when the rate was increased by 50 basis points to 3½ percent.

Economic growth is projected by the staff to strengthen further and reach 6¾ percent in 2007, with the commencement of production at two new automobile plants in 2006–07 and the associated pick up in exports. The current account deficit is projected to narrow progressively to about 5 percent of GDP over the medium-term. Fundamental improvements in the economy and continued positive sentiment of investors toward Slovakia are likely to result in some appreciation of the koruna. The NBS expects inflation to fall to 2¾ at end-2006, and has announced a target of below 2 percent for end-2007. The 2006-08 budget framework envisages the general government deficit declining progressively to about 1¼ percent of GDP.

Executive Board Assessment

Executive Directors congratulated the authorities for Slovakia's recent early entry into ERM2. Sound macroeconomic management and a wide range of important structural reforms over the past few years have positioned Slovakia well for euro adoption, but challenges lie ahead, in particular, to reduce the still-high rate of, and wide regional disparities in, unemployment, and to bring down inflation in a manner that does not undermine exchange rate stability and competitiveness. Directors considered that, while agreeing on the benefits of meeting early the Maastricht criteria and adopting the euro, it is equally important to secure continued strong economic performance in the monetary union through a strengthening of fiscal policy and enhanced structural flexibility.

Directors observed that the authorities' inflation targets for 2006–08 are ambitious, especially viewed against the structural influences stemming from the process of catching up economically with other Euro area states. Some Directors expressed concern that the tight fiscal policy that might be needed to defend the inflation target would have negative effects on the real sector, and saw no obvious gain in targeting an inflation rate lower than that needed for euro adoption. Directors cautioned that higher energy prices, strong economic growth, and rising unit labor costs in the nontradable sector are risks for inflationary pressures. They welcomed the National Bank of Slovakia's (NBS) readiness to increase its key policy interest rate to counter second-round effects from these factors, as demonstrated by their recent step in this direction. Directors urged the authorities to improve policy communication on adjustments of regulated prices to reinforce the role of the NBS's inflation targets in anchoring inflation expectations.

Directors noted that, consistent with the favorable growth and external outlook and continued inflows of foreign direct investment, some exchange rate appreciation could occur in the period ahead, and that this would help with disinflation. However, they stressed the importance of safeguarding competitiveness, noting that while Slovakia's prevailing level of competitiveness is adequate, its initial cushion has diminished. Directors cautioned that significant appreciation under ERM2 would erode competitiveness and risk producing an excessively strong conversion rate, with potentially serious long-term consequences. They observed that Slovakia needs to be sufficiently competitive within the monetary union to facilitate a significant reduction in unemployment over time.

Directors recommended orienting fiscal policy not only toward meeting the Maastricht deficit criterion, but also toward supporting the inflation goal while containing koruna appreciation. Most Directors encouraged the authorities to attain a tighter fiscal stance than envisaged in the 2006–08 budget framework. This could be achieved by saving any revenues collected above the targeted amount, as appears likely, and by durably restraining expenditure beyond that anticipated in the budget framework. At the same time, some Directors cautioned against seeking budgetary savings by not implementing EU-funded public investment projects, as these are designed to produce long-term gains through increased convergence with the Euro area. Directors observed that maintaining a tight fiscal stance will require continued steadfast political commitment to further fiscal consolidation and the support of all levels of government. With regard to the latter, more binding expenditure ceilings and a stronger fiscal framework for local governments, consistent with the national fiscal consolidation strategy, would be advisable.

Directors highlighted that wage moderation would be important to bring inflation down and maintain competitiveness. They welcomed the authorities' efforts to encourage the social partners to adopt forward-looking adjustment of wages to inflation. They encouraged the authorities to signal the need for wage moderation by restraining wage increases in the public sector. A slower pace of minimum wage increases and greater enterprise-level wage bargaining will also help moderate overall wage growth and enhance wage flexibility.

Directors noted that Slovakia's banking system is generally sound, but that rapid household credit growth calls for vigilance. Directors commended the NBS's initiatives to improve data collection, monitor risk management practices of banks more closely, and regularly interact with home supervisors of foreign-owned banks. They welcomed the NBS's intention to extend the risk-based supervision approach to non-bank financial institutions. They encouraged the authorities to enhance the supervision of rapidly growing pension funds and to continue tackling the money laundering risk in all areas of the financial sector. They supported the authorities' request for an Financial Sector Assessment Program (FSAP) update.

Directors observed that structural reform efforts, as well as buoyant economic growth, have resulted in a strong pick-up in employment, but the unemployment rate remains high.
The recently adopted rules on investment incentives according to regional criteria and project profile should help reduce unemployment in less economically advanced regions. Directors welcomed the authorities' consideration of measures to improve access to capital for start-up companies and to introduce an earned income tax credit for low-income workers, with a view to enhancing employment growth and further increasing incentives to work.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the 2005 Article IV Consultation with the Slovak Republic is also available.

Slovak Republic: Selected Economic and Financial Indicators, 2000-06

	2000	2001	2002	2003	2004	2005 Estimate	2006 Staff Proj.
	(Percent change, period average)						
Real sector							
Real GDP	2.0	3.8	4.6	4.5	5.5	6.0	6.3
Output gap (in percent of potential GDP)	-1.0	-0.8	-0.3	-0.5	-0.4	-0.2	0.0
Gross industrial output (constant prices)	-1.5	3.8	-1.3	9.1	11.5	4.7	...
Consumer prices (HICP)							
Period average	14.1	7.2	3.5	8.4	7.5	2.8	3.6
End of period	8.4	6.7	3.2	9.4	5.8	3.9	2.8
Wages							
Nominal wages	6.4	8.3	9.3	6.3	10.2	9.3	7.4
Real wages	-5.0	0.9	5.8	-2.1	2.5	6.6	4.0
Employment (LFS)	-1.4	1.0	0.2	1.8	0.3	2.0	1.0
Unemployment rate (annual average, in percent, ILO definition)	18.8	19.3	18.6	17.5	18.1	16.4	15.9
	(In percent of GDP)						
Public finance (ESA-95 basis)							
General government balance	-12.3	-6.0	-7.8	-3.7	-4.0	-3.1	-2.0
Structural general government balance	-7.0	-6.2	-5.5	-3.6	-3.8	-3.0	-1.9
General government debt	49.9	48.7	43.8	43.1	42.6	36.8	35.8
	(Percent change, end of period, unless otherwise indicated)						
Money and credit							
Broad money	15.4	11.8	3.4	5.6	5.8	1.9	…
Credit to enterprises and households 1/	7.8	7.5	14.8	14.8	10.9	24.7	…
Interest rates (in percent, end-of-period)							
NBS policy rate (two-week repo rate)	8.00	7.75	6.50	6.00	4.00	3.00	
Lending rate (short-term, national methodology)	10.7	8.8	7.5	7.2	7.5	6.1	…
Deposit rate (one month)	6.2	5.9	4.5	4.6	3.0	2.5	…
	(In billions of US dollars, unless otherwise indicated)						
Balance of payments							
Merchandise exports	11.9	12.6	14.4	21.8	27.8	31.9	36.6
Merchandise imports	12.8	14.8	16.5	22.5	29.2	-34.3	-39.0
Current account balance	-0.7	-1.8	-1.9	-0.3	-1.4	-2.4	-3.2
(in percent of GDP)	(-3.5)	(-8.4)	(-8.0)	(-0.9)	(-3.5)	(-7.2)	(-6.4)
Official reserves, end-period	4.1	4.2	9.2	12.1	14.9	15.5	18.8
(in months of imports of goods and nonfactor services)	(3.4)	(3.0)	(5.9)	(5.7)	(5.5)	(4.9)	(5.2)
(in percent of broad money)	(31.8)	(29.9)	(52.4)	(53.9)	(54.1)	(61.8)	(65.2)
Gross external debt, end-period	10.8	11.0	13.1	18.1	23.7	25.3	28.8
(in percent of GDP)	(54.9)	(52.9)	(50.0)	(50.8)	(53.6)	(56.2)	(56.6)
Short-term debt (in percent of GDP, original maturity basis)	12.3	14.7	16.2	21.9	23.5	30.0	33.0
Short-term debt (in percent of GDP, remaining maturity basis)	20.7	21.1	26.6	31.5	32.2	36.7	38.4
Official reserves to short-term debt (percent, remaining maturity basis)	100.2	95.2	132.1	108.4	104.4	93.6	95.9
Exchange rate							
Slovak koruna per U.S. dollar							
Period average	46.2	48.4	45.3	36.8	32.3	31.0	…
End of period	47.4	48.5	40.0	32.9	28.5	31.9	…
Slovak koruna per Euro							
Period average	42.6	43.3	42.7	41.5	40.1	38.6	…
End of period	44.0	42.8	41.7	41.2	38.8	37.8	…
Nominal effective exchange rate (percent change, period average) 2/	2.3	-3.5	-0.6	5.4	4.0	1.6	…
Real effective exchange rate (percent change, period average) 2/							
CPI-based	11.1	0.2	0.7	12.9	9.2	2.2	…
ULC-based 3/	7.2	-3.6	10.0	8.5	5.4	6.7	…
Memorandum items:							
GDP (current prices, Sk billions)	934	1,010	1,099	1,201	1,325	1,440	1,577

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

1/ Adjusted for bank restructuring. Figure for 2005 shows the change from December 2004 to November 2005.
2/ Partner countries comprise Austria, Czech Republic, France, Germany, Hungary, Italy, Netherlands, Poland, United Kingdom, and United States.
3/ Figure for 2005 is for the period January through September.