INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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IMF Concludes 2004 Article IV Consultation with the Slovak Republic

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

Background

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

Economic activity was entirely export-driven in 2003; real GDP increased by 4½ percent despite a contraction in domestic demand. But activity broadened to the domestic sector in 2004, supported by accommodating macroeconomic policies, and real GDP grew by an estimated 5¼ percent. The external current account deficit widened in 2004 to an estimated 3 percent of GDP, still well within sustainable bounds. Despite the strong economic performance, however, employment gains have been uneven across sectors, and unemployment remains high at 17¾ percent.

[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. This PIN summarizes the views of the Executive Board as expressed during the [February, 11, 2005] Executive Board discussion based on the staff report.

Headline inflation remained high (5.9 percent at end-2004, against 9.3 percent at end-2003), driven by administered price and indirect tax increases, but should fall in 2005 as these one-off effects wane. Core inflation was low, at 1½ percent at end-2004, below the end-2003 outcome of 2.7 percent owing largely to falling food prices. For end-2005, the National Bank of Slovakia (NBS) targets ranges of 3.5±0.5 percent for headline inflation and expects core inflation to fall within the range 1.1-3.4 percent.

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

Following a sharp contraction in 2003, the fiscal deficit widened slightly in 2004 to an estimated 3.8 percent of GDP (ESA95 basis). This reflected a small reduction in revenues as a share of GDP following the 2004 tax reform, only partly offset by lower spending on wages, benefits and interest. Taking into account net transfers from the EU, the fiscal impulse was about 1 percent of GDP in 2004.

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

Executive Board Assessment

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

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

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

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

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

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

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

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

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

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

Slovak Republic: Selected Economic Indicators

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

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

1/ Calculated for trade partners of Austria, Czech Republic, France, Germany, Hungary, Italy, and Poland.
2/ Includes deposits of Sk 61.4 billion in privatization receipts at the pension fund account at the NBS in 2002.
3/ Adjusted for bank restructuring.
4/ Excludes domestic currency denominated debt.
5/ Short-term debt is defined to include medium- and long-term debt due in the subsequent year.
6/ Short-term debt is defined to exclude medium- and long-term debt due in the subsequent year.

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.