IMF Country Reports 13/262

Slovak Republic
2013 Article IV Consultation

INTERNATIONAL MONETARY FUND

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IMF Country Report No. 13/262

SLOVAK REPUBLIC

2013 ARTICLE IV CONSULTATION

August 2013

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 2013 Article IV consultation with the Slovak Republic, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 4, 2013, with the officials of the Slovak Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 16, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Press Release** summarizing the views of the Executive Board.

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
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SLOVAK REPUBLIC

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

July 16, 2013

KEY ISSUES

Context. Slovakia recovered strongly following the global crisis, and remains among the more robust European economies with positive growth, moderate public and private debt, a dynamic export sector, external surpluses, and a sound financial system. Weakness among trading partners and a further decline in already anemic domestic demand are causing the economy to lose momentum, and a key challenge is to balance the substantial further fiscal consolidation that is necessary with concerns about slowing growth. Given very high unemployment, laying the foundations for stronger job-rich growth is key for the medium term. External factors, particularly challenges in Europe, are among the most important risks.

Strengthening growth and creating jobs. Slovakia's integration into international supply chains has yielded great benefits, but has not been enough to address high unemployment and may also amplify risks from trade shocks. Boosting growth and employment depends on further improvements to the business environment, effective active labor market policies, better educational quality, and regional integration. Over the medium term, promoting new sources of growth and export diversification would help lessen external vulnerabilities.

Fiscal policy. Fiscal consolidation has continued, although some sources of revenue or savings have been temporary. The 2013 fiscal deficit target is achievable, but automatic stabilizers should be allowed to operate if risks to growth materialize. Going forward, sizeable additional fiscal adjustment is needed to avoid economically harmful effects from crossing key debt thresholds and to meet EU commitments. High-quality measures will be important to ensure the durability of consolidation efforts and to improve the structure of the budget.

Financial sector policies. Slovakia's banking sector is sound, liquid, and well-capitalized, but credit to the corporate sector has declined, reflecting weak demand. Banking supervision has been prudent but it could usefully be enhanced with a more developed framework for early intervention and more effective resolution mechanisms.

Approved By
Ajai Chopra and Mark Flanagan

The mission took place in Bratislava from May 22 to June 4, 2013. The team comprised Messrs. John (head), Giustiniani (both EUR) and Ogata (FAD), and Ms. Zhao (EUR), and was assisted at headquarters by Messrs. Winnekens and Augustinyak and Mmes. de Moraes Rego and Adu. Mr. Jakoby (Senior Advisor to the Executive Director) accompanied the mission and Mr. Prader (Executive Director) attended the concluding meeting.

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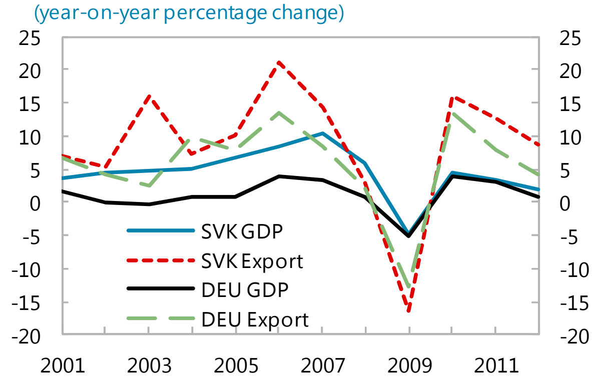
RECENT DEVELOPMENTS AND OUTLOOK

Vibrant export growth powered a strong post-crisis recovery. Growth remains positive, but the Slovak economy has gradually lost momentum with the external environment faltering and domestic demand contracting. Slovakia has nonetheless stayed on track in its fiscal consolidation efforts while enjoying moderate public and private debt levels. It has seen decelerating inflation, registered record trade and current account surpluses, and maintained a sound banking system, all in the context of a stable political landscape. Reducing very high unemployment, however, is a key challenge while external weakness, particularly stemming from Europe, remains a central risk.

A. Losing Momentum After Strong Post-Crisis Recovery

1. **While still one of the strongest performers in the euro area, the Slovak economy has lost momentum** (Figure 1 and Table 1). With average growth of 3.2 percent over the past three years, the Slovak Republic outpaced most EU economies. However, Slovakia's export-driven economy has progressively lost steam with growth declining to 2 percent in 2012, reflecting spillovers from the rest of the euro area, and especially Germany's slowdown. Nonetheless, net exports remained the key driver of growth as a number of large-scale projects in the auto industry came online, boosting industrial production and exports. By contrast, domestic demand contracted sharply. Private consumption continued on its downward trend due to rising unemployment and stagnant real wages. Gross investment plunged by more than 10 percent, reflecting not only a strong base effect—due to the large projects carried out in 2011—but also growing economic uncertainty and a sizeable decline in inventories.

Export and GDP Growth Rates in Slovakia and Germany
(year-on-year percentage change)



Sources: Haver and IMF staff calculations.

2. **Inflation decelerated**. During 2012, weak domestic demand and lower fuel prices prompted a gradual deceleration of headline inflation to 3.4 percent from 4.1 percent in 2011. The decline accelerated in the first months of 2013 with headline and core inflation down to 1.6 and 1.7 percent as of June, narrowing the differential with average euro area inflation to around ½ percentage point from almost 2 percentage points at end-2011.

3. **Troubling labor market conditions deteriorated further** (Figure 2). Despite still positive growth, unemployment continued rising, reaching 14.4 percent at end-2012. The trend edged up towards the end the year with anecdotal reports of firms accelerating layoffs in anticipation of the stricter provisions of the new Labor Code, which entered into force in January 2013. Labor market conditions stabilized in the first months of 2013.

4. **The government outperformed the 2012 deficit target**. The 2012 general government deficit came in at 4.3 percent of GDP, below the 4.6 percent target under the Excessive Deficit Procedure (EDP) (Figure 3 and Tables 2–3). Gross public debt reached 52 percent of GDP, due in part to contributions of 2 percent of GDP to euro area firewalls (the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)) and some pre-funding. While public debt is manageable, scenario analysis suggests some vulnerability, especially to growth shocks (Table A1 and Figure A1).

5. **Sovereign financing conditions improved substantially in early 2013 and have remained largely stable despite broader market volatility beginning in May**. With the new government's strong commitment to comply with EDP targets, the ECB's statement on Outright Monetary Transactions to safeguard the euro area, and broader improvements in market sentiment, Slovakia's CDS and bond spreads narrowed to historical lows and maturities have been extended. The share of non-resident holdings of government bonds increased to 47 percent in 2012 as part of efforts to diversify the investor base, including by tapping foreign-currency markets. While yields rose slightly in May and June 2013 as market volatility increased, they remain low (about 2.6 percent for Slovakia's 10-year bond with spreads relative to Germany around 100 basis points).

6. **External competitiveness remained strong in export-oriented manufacturing**. Substantial foreign direct investment (FDI), particularly in the auto sector, contributed to 15 percent annual average export growth over the past decade and rising market shares. Booming exports, along with weak domestic demand, led to sizeable trade and current account surpluses (Figure 4 and Table 4). These developments as well as productivity and inflation outpacing manufacturing wage increases point to competitiveness having been preserved, and the real effective exchange rate (REER) based on unit labor costs in the manufacturing sector shows a substantial competitiveness improvement (Figure 5). The CGER methodology provides a mixed picture of the REER with the macroeconomic balance and the external sustainability approaches indicating undervaluation while the equilibrium real exchange rate approach suggests some overvaluation, perhaps capturing trend appreciation in the CPI-based REER as real convergence takes place. Supplemental analysis supports staff's view that the REER is somewhat undervalued, reflecting restrained wage growth amidst productivity increases (Box 1).

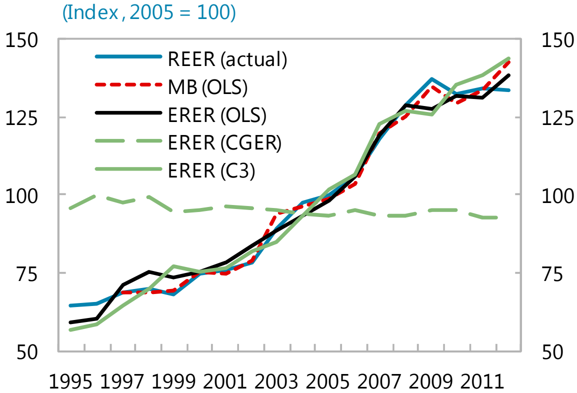
7. **The external position remains stable**. Slovakia's net international investment position (NIIP) has improved somewhat to negative 62 percent of GDP, a level similar to other countries in the region. Slovakia's external debt has edged down to about 74 percent of GDP and is projected to fall even under stress scenarios (Table A2 and Figure A2). The improvement in the NIIP and external debt indicators was mostly due to a reduction in liabilities of the National Bank of Slovakia (NBS) and commercial banks. Large portfolio inflows in 2012 reflected an increase in foreigners' holdings of government debt and a decrease in foreign debt holdings by the NBS and other financial institutions.

Box 1. Slovak Republic: Assessing Slovakia's Real Effective Exchange Rate

The standard CGER methodology provides a mixed assessment of Slovakia' real effective exchange rate (REER). While the external sustainability (ES) and macroeconomic balance (MB) approaches point to an undervaluation of Slovakia's REER of about 9 and 16 percent in 2012, the equilibrium real exchange rate (ERER) approach suggests an overvaluation of more than 40 percent. The ES and MB results indicate that actual current account surpluses are larger than fundamental determinants of savings and investment would suggest, and hence a REER appreciation would be needed to close that gap and stabilize Slovakia's net foreign asset position. On the other hand, Slovakia's experience of having inflation above peers, reflecting the convergence process, may explain the ERER result which is based on deviations from the long-run equilibrium value. However, this wide range of the results may also reflect the fact that CGER estimates are based on a large sample of countries and hence specific characteristics of individual economies may not be fully factored in.

A more tailored analysis suggests that Slovakia's REER is broadly in line with fundamentals, even marginally undervalued. As an alternative, the MB and ERER equations were estimated for Slovakia alone and for a more homogeneous group of Central and Eastern European countries (Czech Republic, Slovak Republic and Hungary). The results point to an undervaluation of Slovakia's REER ranging between 3½ and 16 percent in 2012. This conclusion is also consistent with the analysis carried out by the NBS. A closer look at CGER estimates show that the resulting long-run equilibrium exchange rates appear to be nearly constant over time. While this feature might be plausible for more advanced economies, it seems unlikely to be accurate for emerging or fast-changing economies such as Slovakia.

Slovak Republic: Exchange Rate Assessments
(Index, 2005 = 100)



Sources: WEO and IMF staff calculations.

8. **Bank lending slowed.** Reflecting some tightening in credit standards, corporate lending contracted while household borrowing, mainly housing loans, continued at a steady pace (Figure 6). Nonperforming loans are low and well-provisioned. Reflecting the difficult operating environment and increased taxation, bank profits declined. Banks continued to enjoy stable domestic deposit funding and robust capitalization (Table 5).

B. Outlook and Risks

9. **The near-term outlook has become less favorable**. Growth is projected to slow to 0.6 percent in 2013 due to a weakening external environment and large fiscal consolidation efforts coupled with high unemployment and modest wage increases, which will be a drag on domestic demand, and in turn will further dampen underlying inflation. Net exports are expected to continue to contribute positively to growth, albeit to a lesser extent, with the current account remaining in surplus. In an unchanged policies scenario, staff forecasts output to strengthen in 2014 to 2.3 percent, as the external environment gradually improves and domestic confidence recovers, with positive effects on investment and employment, and hence on private consumption. Growth should

pick up to 3–3½ percent in the medium term (potential growth is estimated at 3 percent), with unemployment falling to around 11 percent by the end of the forecast period.

Slovak Republic: Real Growth Projections
(in percent)

	2013	2014	2015	2016
IMF 1/	0.6	2.3	2.8	3.2
NBS (June 2013)	0.6	2.3	3.3	
MoF (June 2013)	0.5	2.2		
EC (May 2013)	1.0	2.8		
OECD (May 2013)	0.8	2.0		
EBRD (May 2013)	1.0	2.0		
Consensus (May 2013)	0.9	2.3		

1/ No policy changes scenario.

10. Risks are primarily to the downside (Annex I, Risk Assessment Matrix). Prolonged high unemployment could depress economic activity, which would push debt ratios up, and hamper fiscal consolidation. Over the longer term, there is a risk that a generation of workers is not well-integrated into the labor force, potentially compounding future demographic challenges. The euro area crisis and the potential for prolonged weakness in Europe could delay the expected pick-up in Slovakia, particularly through the export channel (where the global outlook for the important automobile sector is already uncertain), while risks from financial linkages appear limited.

Authorities' views

11. The authorities broadly shared staff views. The authorities' latest forecasts are similar to staff projections, and they concurred on the importance of risks emanating from the euro area, including from inaction on reform priorities. On the domestic front, the authorities were slightly more optimistic than staff regarding labor market prospects, which would provide modest support to domestic demand and revenue.

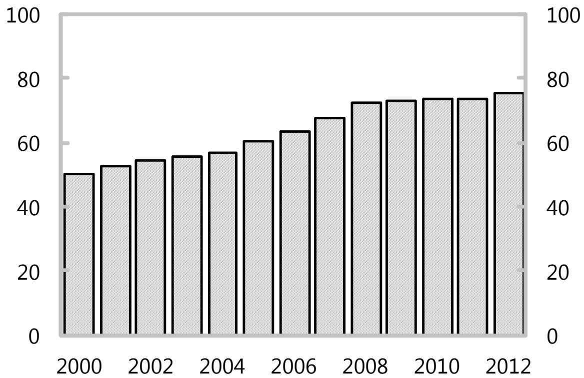
REVIVING STRONG GROWTH

Export-led growth has served Slovakia well by fostering a rapid catching-up with European income levels, but convergence progress has slowed, employment creation has been limited, and regional disparities have widened. The weak domestic labor market has also been a factor in holding back domestic demand, even while the high productivity export sector generates current account surpluses. A range of structural reforms would help maintain competitiveness and promote more enduring, inclusive, and job-rich growth. This would help to strengthen domestic demand and preserve competitiveness, consistent with maintaining external balance in the Slovak economy.

12. Slovakia's growth model has been based on dynamic export sectors. Growth has depended heavily on FDI and foreign demand: exports of goods and services almost doubled from roughly 55 percent to 95 percent of GDP between 1995 and 2012. Over time, Slovakia has improved its comparative advantage in knowledge-intensive manufacturing as part of global supply chains. But it remains specialized in more downstream stages of production in a few sectors (automobiles and electronics, in particular), raising risks from external shocks (Box 2). Commercial and investment links with Germany have been crucial—about 20 percent of Slovakia's exports go to Germany

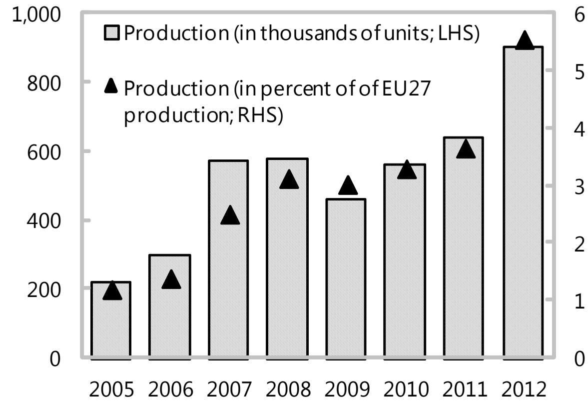
although about a quarter is re-exported, underscoring the importance of other destinations in the EU, as well as regions such as Asia.[1]

Per-capita GDP in percent of EU average
(in purchasing-power standard)



Sources: Eurostat; and IMF staff calculations.

Motor Vehicle Production



Source: International Organization of Motor Vehicle Manufacturers.

Box 2. Slovak Republic: Integration into Global Supply Chains 1/

In the last two decades, Slovakia has become extensively integrated into the global economy and global supply chains (GSCs). The degree of openness of the economy, as measured by the sum of exports and imports of goods as a percent of GDP, has grown steadily from around 100 percent at the end of the 1990s to 170 percent in 2012. This expansion was supported by significant inflows of foreign direct investment and went hand-in-hand with growing participation of the Slovak economy in GSCs. The share of foreign inputs and domestically produced inputs used in other countries' exports, which is a measure of a country's participation in GSCs, increased from 50 percent in 1995 to 63 percent before the large trade collapse in 2008. Slovakia ranks second among OECD economies in terms of being most integrated into GSCs and its foreign trade has become more concentrated in terms of products and trade partners.[2/]

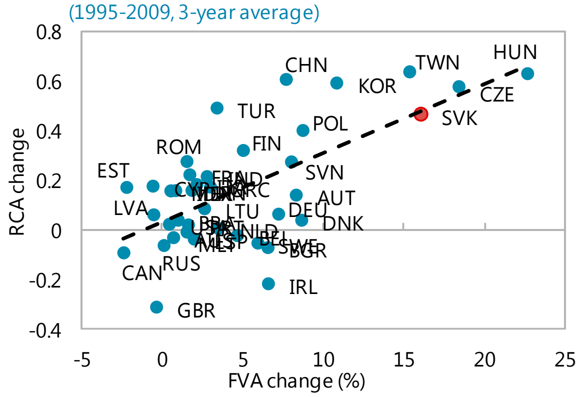
Participation in GSCs has significantly changed Slovakia's export structure. Empirical evidence shows that changes in a country's revealed comparative advantages (RCA)—measured in terms of domestic value added (DVA)—in knowledge-intensive manufacturing sectors are positively correlated with changes in the foreign value added (FVA) shares in GDP. In other words, with participation in GSCs, countries' exports seem to shift toward more knowledge-intensive sectors. For example, in the early 1990s, Slovakia showed no RCA in the transportation and electronic sectors, which started emerging only in 2007. A similar pattern can be detected for countries such as the Czech Republic and Hungary, which are also extensively involved in GSCs. Currently, exports of vehicles and electronic products account for 38 percent of Slovakia's total exports.

Slovakia's business cycle has become much more synchronized with Germany's. Germany is the largest trade partner for Slovakia with the share of FVA from Germany in Slovakia's exports having increased from 5 percent in 1995 to 9 percent in 2008. As a result, Slovakia's exports and GDP developments have become

[1] In addition to Box 3, further detail is provided in the forthcoming *German-Central European Supply Chain—Cluster Report* (www.imf.org).

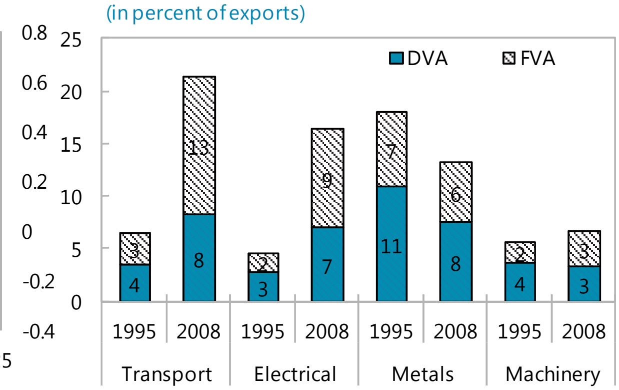
Box 2. Slovak Republic: Integration into Global Supply Chains (concluded)

RCA Change in Knowledge-Intensive Manufacturing
(1995-2009, 3-year average)



Sources: World Input-Output Tables and IMF staff calculations.

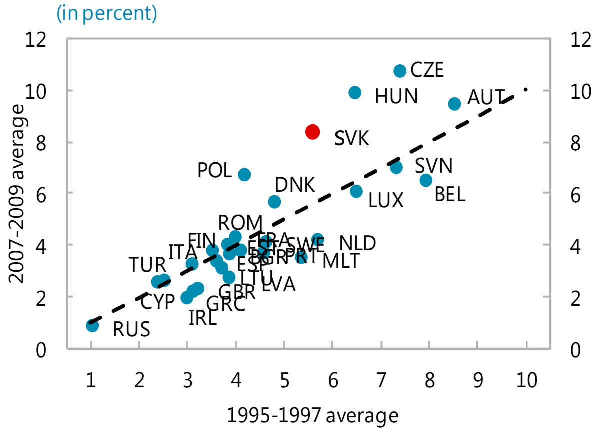
The Four Largest Export Sectors in Slovakia
(in percent of exports)



Sources: World Input-Output Tables and IMF staff calculations.

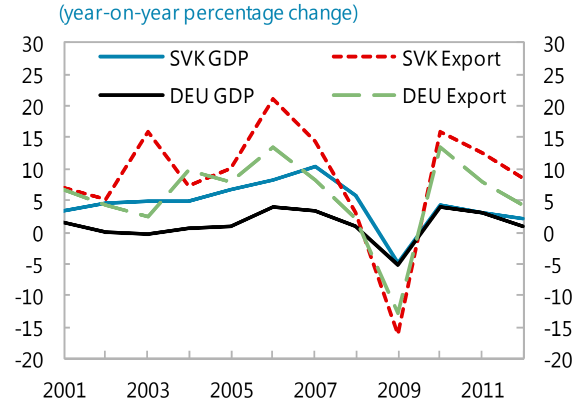
strongly correlated with Germany's, although Slovakia shows a more volatile pattern. Moreover, about one-fourth of Slovakia's exports to Germany are re-exported to third countries, meaning trade shocks affecting Germany could be passed on to Slovakia. Value-added figures show that Slovakia's exports to countries outside of Europe, including the U.S. and China, have grown from 18 to 27 percent of exports between 1995 and 2009.

The Share of German Value Added in Total Exports
(in percent)



Sources: World Input-Output Tables and IMF staff calculations.

Export and GDP Growth Rates in Slovakia and Germany
(year-on-year percentage change)



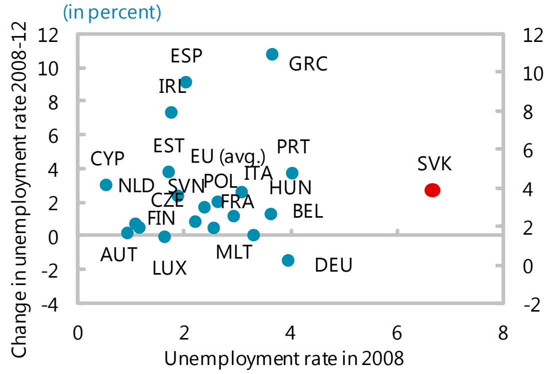
Sources: Haver and IMF staff calculations.

Participation in GSCs offers significant opportunities but poses risks as well. Research shows that the vulnerability of individual countries to global shocks is heavily influenced by their participation and position in GSCs (OECD, 2012). Specialization in more downstream stages of GSCs and in a few specific industries makes Slovakia vulnerable to global market conditions. Although Germany will continue to play a crucial role, going forward, with a view to mitigating those risks, Slovakia might seek to gradually diversify its production and trade partners, including by encouraging FDI from other countries. To this end, improving the business environment, including by seeking ways to increase public sector efficiency, is a key priority, while improving labor market efficiency (both in terms of flexibility and mobility) would help the economy adjust more rapidly to external shocks.

1/ This box draws from *The German-Central European Supply Chain—Cluster Report*.
2/ OECD (2012) "Mapping Global Value Chains," TAD/TC/WP/RD(2012)9, December.

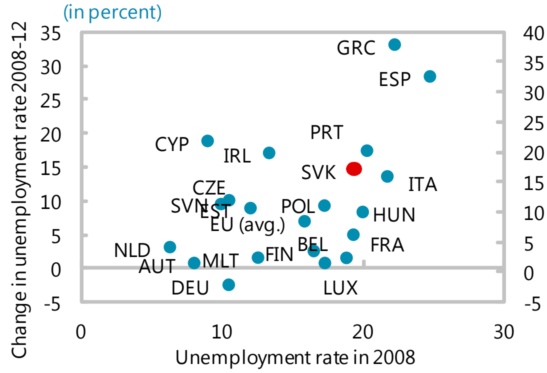
13. Unemployment has remained high since the global crisis (Box 3). After falling for a number of years and reaching single digits in 2008, unemployment rose sharply after the crisis with only a modest improvement in 2010–11 when growth averaged 3.8 percent. The dynamic export industries are mainly capital intensive and firms' investments have aimed at improving productivity at the expense of employment. Long-term unemployment has been a feature of the Slovak economy for some time and the recent crisis has exacerbated the problem. Also, between 2008 and 2012, youth unemployment nearly doubled. More than one-third of young people are unemployed, risking a lost generation and heightened demographic challenges.

Long-term Unemployment Rate
(in percent)



Sources: Eurostat and Haver.

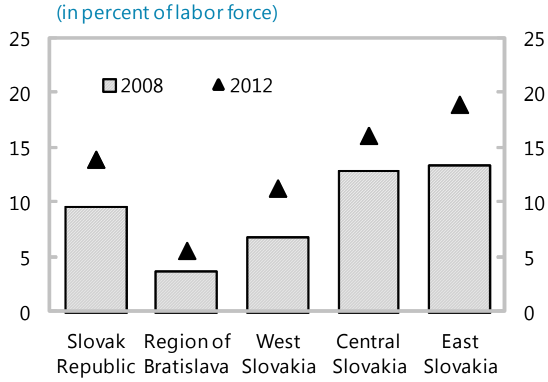
Youth Unemployment Rate
(in percent)



Sources: Eurostat and Haver.

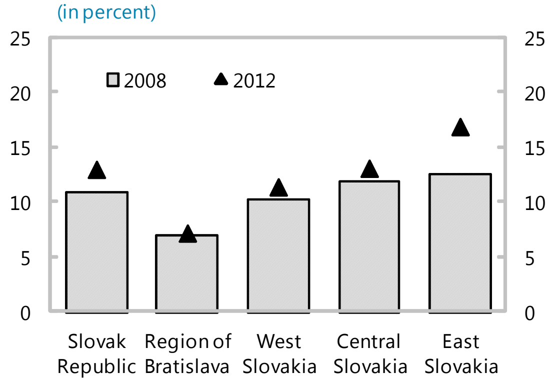
14. Regional imbalances have widened. Slovakia suffers one of the highest regional disparities among advanced economies, with unemployment concentrated in the eastern and poorer regions. Labor mobility is limited reflecting skill mismatches, infrastructure gaps, and an inadequate rental housing market.

Unemployment by Region
(in percent of labor force)



Source: Statistical Office of the Slovak Republic.

Population at Risk of Poverty
(in percent)

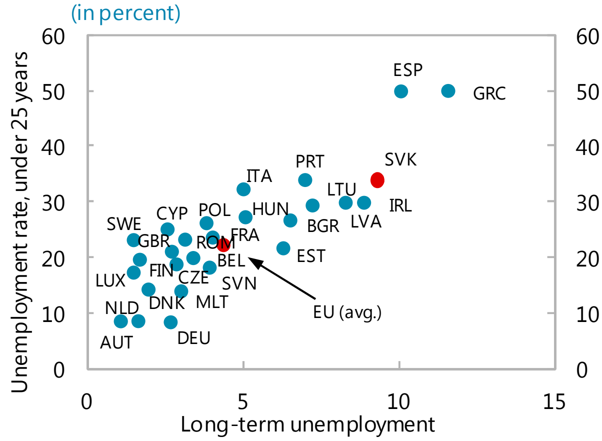


Source: Statistical Office of the Slovak Republic.

Box 3. Slovak Republic: Unemployment and the Labor Market

Slovakia suffers from high unemployment, especially youth and long-term. Despite the economic rebound in the aftermath of the 2008-09 global financial crisis, unemployment has continued to rise, reaching more than 14 percent, the sixth highest unemployment rate in the EU. Furthermore, Slovakia does not compare favorably with other European countries in terms of long-term and youth unemployment, and regional disparities are among the highest.

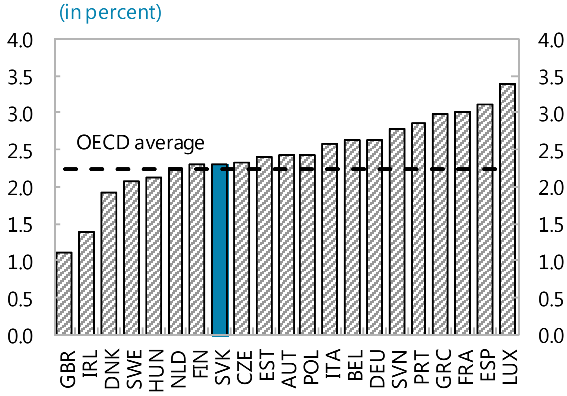
Long-Term and Youth Unemployment, 2011-12
(in percent)



Sources: Eurostat and Haver.

However, reported institutional features do not seem to explain such poor performance of the labor market. Slovakia's employment protection legislation, even after the recent unwinding of some 2011 reforms, appears broadly in line with peers, although continuous revisions, reflecting changes in the political scene, might have created some uncertainty. Slovakia's unemployment benefits appear to be limited in terms of both net replacement rates and duration, even when compared with other countries in the region. In the current context of insufficient labor demand, the greater risk might be that restrictive unemployment benefits contribute to increasing poverty without promoting job-searching.

Strictness of Employment Protection
(in percent)

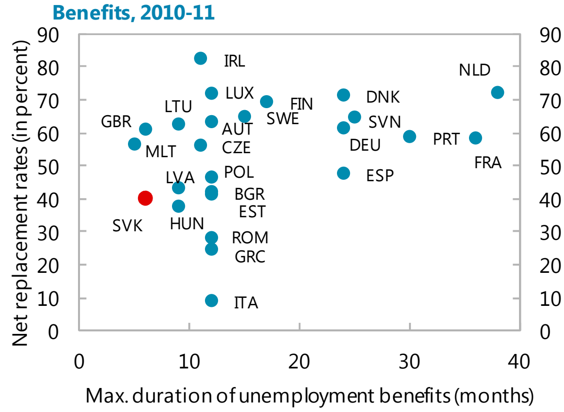


Source: OECD.

By contrast, Slovakia's spending on active labor market policies (ALMPs) is among the lowest in the EU. In 2010, it amounted to just 0.3 percent of GDP, less than half of the EU average (about 0.8 percent of GDP). Slovakia also seems to have lost ground compared to other central European countries on ALMP outlays, which are largely financed by the European Social Fund (ESF). Empirical evidence has shown the positive impact of ALMP spending to decrease the duration of unemployment (European Commission, 2012).

In addition, the composition of ALMP spending could be more effective. Start-up incentives and temporary activation works account for about one-third of Slovakia's ALMP spending. Start-up incentives have wide eligibility criteria, are not means-tested, and are not adequately monitored, raising the risk of misuse of scarce resources.

Net Replacement Rates and Duration of Employment Benefits, 2010-11

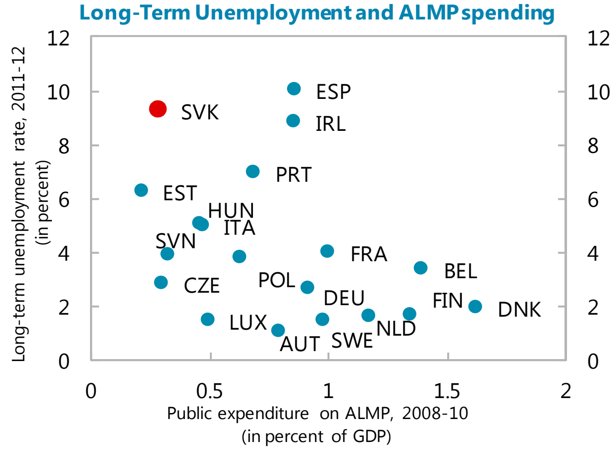


Sources: EU and OECD.

Box 3. Slovak Republic: Unemployment and the Labor Market (concluded)

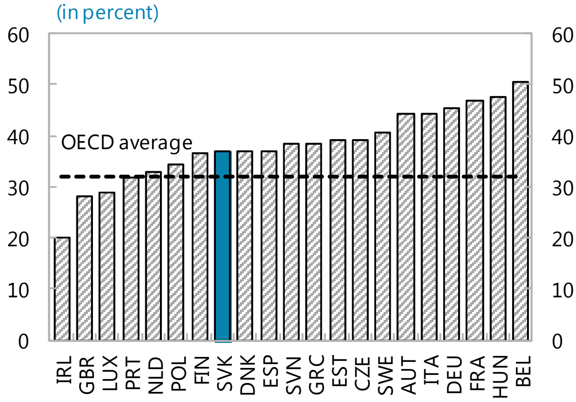
The temporary activation program, which covers small municipal work projects and contributions for voluntary service, is not likely to provide participants, mainly young people, with the skills and work experiences needed to successfully integrate into the job market. In addition, direct job creation induces lock-in effects by reducing the incentive to exit public employment schemes through job search and training (Klein, 2012). Training programs account for only 3 percent of Slovakia's ALMP expenditure. Moreover, spending on public employment services, which in principle constitute the cornerstone of ALMPs, has not adapted sufficiently to the increasing challenges and demands associated with rising and persistent unemployment rates. The number of staff is limited (and decreasing due to fiscal consolidation measures) as is the range of services offered. More broadly, access to ESF-financed ALMP spending can be hampered by complicated administrative procedures, which seem to favor insiders (N. Duell and L. Kurekova, 2012).

Long-Term Unemployment and ALMP spending



Sources: Eurostat; OECD; and Haver.

Average Tax Wedge, 2012
(in percent)



Source: OECD.

Labor taxation is relatively high for low–paid jobs. The average tax wedge for a single person earning 67 percent of the average wage is 5 percentage points higher than the OECD average, although it does not compare unfavorably with other EU countries. Nonetheless, taxation might contribute to lower employment of low-productivity workers, who actually represent the largest share in Slovakia's unemployment pool.

International experience may provide valuable guidance. In addition to the importance of strong overall recovery, the Danish experience provides an example of how sound institutions and active policies can improve labor market performance (Andersen and others, 2011). The so-called "flexicurity" model combines flexible employment protection, mainly by easing hiring and lay-off procedures and costs for employers, with a solid social safety net, which is backed by an extensive and effective system of activation policies, ranging from short counseling and assessment programs to job training and wage-subsidized jobs.

Andersen, M., N. Bosch, A. Deelen and R. Euwals, 2011, "The Danish Flexicurity Model in the Great Recession," Vox, April.
Duell, N. and L. Kurekova, 2012, "Implementing the Benefit in Material Need in the Slovak Republic," The World Bank, mimeo.
European Commission, 2012, "Employment and Social Developments in Europe 2012," Directorate-General for Employment, Social Affairs and Inclusion, Brussels.
Klein, C., 2013,"Investing Efficiently in Education and Active Labour Market Policies in Slovakia," OECD Economics Department, Working Paper No. 1017, January.

Policy issues

15. **Shortcomings in employment services, education and training; labor taxes; and impediments to mobility stand out as possible factors contributing to high unemployment**. Employment protection legislation is not restrictive when compared with peers and unemployment benefits are low, but frequent changes to the Labor Code could create uncertainty (e.g., reforms to reduce restrictions in 2011 were partially reversed in 2012). An even more flexible labor market (e.g., lowering disincentives to bring on new employees) might be appropriate given youth and long-term unemployment levels that are well above peers. Wages do not appear high and compare favorably with productivity. On the other hand, labor taxation is relatively high for low-paid jobs, limiting employment opportunities for less productive workers who represent the largest share of the unemployed. Further, three key mechanisms seem not to work properly: (i) the transition from unemployment back to employment; (ii) the transition from school to work; and (iii) mobility across regions. These challenges are particularly acute for marginalized groups, whose labor potential is largely unrealized.

16. **Actions to address unemployment and improve the business environment could lay the foundation for stronger and more job-rich growth.** Over the medium term, actions in these areas could also have positive spillovers for moving up value chains and export diversification, which along with fiscal buffers, would help improve resiliency to trade shocks. To this end, it is crucial to**:**

- *Lower labor taxes*. When fiscal space allows, reducing the labor tax wedge could encourage hiring, especially for low-productivity workers.

- *Strengthen active labor market policies (ALMPs).* The issue is not only to bring overall ALMP expenditure more in line with other European countries but to improve the composition and the cost-efficiency of current spending. Priorities should include promoting employability through tailored activation incentives and services, increasing the share of spending allocated to training, and reforming and strengthening public employment services as part of a comprehensive strategy to improve labor market institutions and policies.

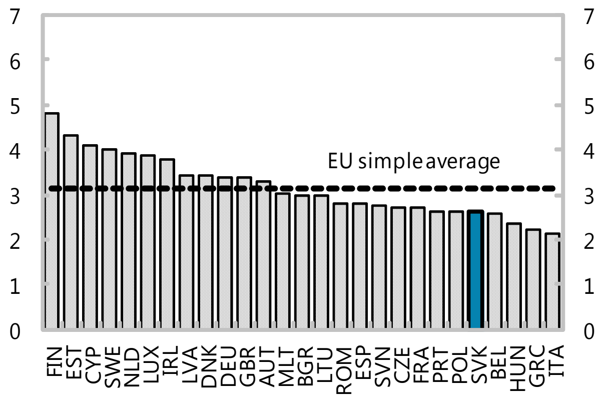
- *Improve the quality of education and training*. Employers cited the need to match educational curriculums and vocational training more closely to job requirements, and to combine practical experience with training. The demand for high-skilled labor is also likely to increase if Slovakia's production possibility frontier were to expand towards new and more sophisticated goods or if there is progress in moving upstream in existing supply chains. The recently approved act on vocational education and training is a step in the right direction.

- *Enhance mobility*. Regional integration and labor mobility would benefit from infrastructure improvements (e.g., highway links to the east) and easing of rental housing regulations, thereby unlocking additional pools of labor and parts of the country for business opportunities.

- *Strengthen the business climate*. Slovakia's regulatory burden compares unfavorably with other EU countries, and competitor countries which were lagging behind have been catching up. The

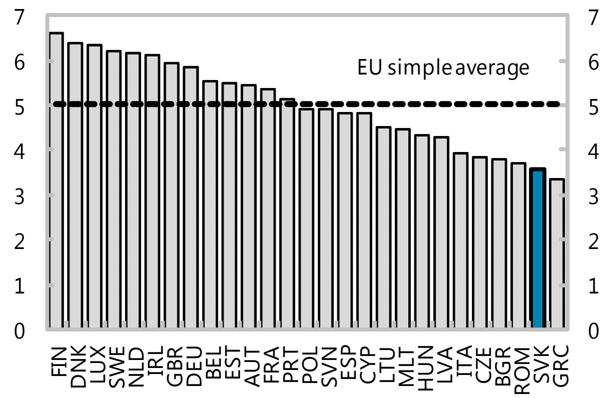
efficient provision of "backbone" services (e.g., starting a business, investor protection, and infrastructure) could help safeguard competitiveness while also being a catalyst for growth and export diversification. Improvements in public sector efficiency and the legal environment should be a priority and could encourage entrepreneurship and innovation while limiting opportunities for dishonest behaviors (Transparency International ranks Slovakia below the majority of European countries surveyed in its Corruption Perceptions Index).

Burden of Government Regulation
(1 = burdensome; 7 = not burdensome)



Source: World Economic Forum, 2012-13.

Irregular Payments and Bribes
(1 = very common; 7 = never occurs)



Source: World Economic Forum, 2012-13.

Authorities' views

17. The authorities reiterated their commitment to reduce unemployment, improve education and training, and enhance the business environment. Steps have been taken to reform ALMPs by eliminating less effective programs and focusing resources on better services for disadvantaged job seekers. While fiscal adjustment needs limit the scope to reduce the tax burden on low-income employees, a labor cost subsidy for newly created jobs for disadvantaged job seekers (youth, long-term, and unemployed workers over 50) has been introduced. Vocational education and training and education amendments are being implemented to link curriculums more closely to employer needs, pilot a "dual-system" approach so that students gain practical experience directly in firms, and improve education for marginalized groups. Although it is early to assess recent changes to the Labor Code, the authorities did not consider them likely to have adversely affected employment. The government has embarked on a major reform to streamline public administration procedures and improve service efficiency for both citizens and businesses. Also, in collaboration with the European Investment Fund, the government has set up a €100 million fund to provide bank guarantees as well as venture capital to innovative small- and medium-sized enterprises.

ENSURING HIGH-QUALITY FISCAL CONSOLIDATION

The government over-performed on its 2012 deficit target and, despite a weaker economic environment, achievement of the 2013 target of 2.9 percent of GDP looks within reach, which could allow exit from the EU's EDP. Given some reliance on temporary measures in the past, substantial additional adjustment is needed in 2014 and subsequent years so that Slovakia can avoid hitting debt brakes under its fiscal responsibility act (FRA) that would trigger overly abrupt fiscal adjustment, and to comply with EU commitments. The emphasis should be on implementing high-quality permanent measures.

Background

18. **The fiscal consolidation target was more than met in 2012 despite challenges from weaker growth**.[2] The progressive slowing of the economy and falling domestic demand affected revenue, especially VAT and corporate income tax receipts, compounding persistent inefficiencies in VAT collection. Wage bill overruns and higher-than-budgeted assumption of past hospital debts put additional pressure on the budget. These adverse developments were offset by a combination of revenue measures adopted during the year—e.g., a broadening of the base for the bank levy, a special levy on regulated enterprises, a shift in pension contributions from the second to the first pillar, and allowing people to move out of the second pillar—as well as lower-than-budgeted use of EU Funds, lower investment, and some savings on social insurance outlays. A positive contribution also came from local governments, which for the first time in five years recorded a small surplus, reflecting a significant curtailment in capital expenditure.

19. **The authorities are determined to meet their 2013 deficit target of 2.9 percent of GDP to allow for EDP exit on schedule.** To this end, the 2013 budget implemented numerous revenue measures, including an increase in the corporate income tax rate from 19 to 23 percent, the introduction of a new 25 percent bracket for personal income above €3,246, an adjustment in the tax regime for self-employed and short-term work agreements, and changes to the assessment base for social contributions. Expenditure savings are mainly concentrated on the wage bill, which is planned to be reduced by 6 percent compared to the 2012 outturn, as well as on public investment and other spending, including by local governments. Owing to weaker-than-expected revenue developments in the first months of the year, the government took steps including use of budget reserves and cuts to health care, capital, and ministry budgets. It also expects to realize higher dividend income.

20. **Public debt is approaching more restrictive debt brake thresholds under the FRA**. General government gross debt reached 52 percent of GDP at end-2012. However, debt developments reflected not only Slovakia's borrowing due to its deficit, but also its EFSF and ESM

[2] Additional detail on Slovakia's fiscal performance and plans can be found in its 2013 Stability Program (http://ec.europa.eu/europe2020/pdf/nd/sp2013_slovakia_en.pdf).

contributions to support other euro area members totaling about 2 percent of GDP, and the decision to take advantage of favorable market conditions to pre-finance a significant portion of 2013 borrowing needs. General government cash balances currently amount to about 5 percent of GDP or roughly half of 2013 gross funding needs. If gross debt (the indicator used in the FRA) reaches 55 percent of GDP, which could happen as early as this year, 3 percent cuts in many spending lines would be required in the following year. Crossing the 57 percent threshold would force the government to submit a balanced budget, which would imply sharp adjustment with significant growth impact when output is still below potential.

Slovak Republic: Fiscal Responsibility Act

Debt level 1/ (in percent of GDP)		Action
until 2017	from 2027 onwards	
50% - 53%	40% - 43%	The Ministry of Finance addresses a letter to the Parliament explaining the reasons for breaching the debt threshold and indicating measures for its reduction.
53% - 55%	43% - 45%	The government submits to the Parliament a proposal of measures for debt reduction and the wages of government members are frozen to the previous fiscal year level.
55% - 57%	45% - 47%	The Ministry of Finance reduces current year state budget expenditure by 3 percent (with specified exemptions such as interest payments, EU funds, co-financing and EU budget contributions) while restrictions apply to the release of funds from the reserves of the government and the Prime Minister. If the debt level exceeds this threshold for consecutive years, the reduction happens only in the first year. In addition, the government should submit to the parliament a general government budget for the subsequent year that does not increase the nominal expenditure level (with previously mentioned specified exemptions); it applies to local governments as well.
57% - 60%	47% - 50%	The government should submit to the Parliament a balanced (or in surplus) general government budget; it applies also to local governments.
> 60%	> 50%	The government asks the parliament for a vote of confidence.

1/ Starting in 2018, the debt ceiling will be gradually reduced by one percentage point of GDP each year to reach 50 percent of GDP by 2027.

Policy issues

21. Staff forecast that the 2013 target is within reach, but automatic stabilizers should be allowed to operate if risks to growth materialize. Assuming growth of 0.6 percent and based on existing policies and policy intentions (including, if needed, readiness to accelerate 2014 measures that would have little macroeconomic impact such as the sale of strategic oil reserves), staff estimate that the budget deficit target of 2.9 percent of GDP can be met. There are risks to this scenario, including the possibility of still weaker growth or difficulties in achieving public sector wage reductions or savings from local governments, on which the state's influence is limited, and no buffers remain in the 2013 budget. If growth disappoints further or interest costs rise due to market volatility, automatic stabilizers should be allowed to operate to avoid extra drag on output when growth is weakest. In a scenario where the headline deficit exceeded 2.9 percent of GDP due to weaker growth, the structural adjustment would still be significant at just over 1 percent of GDP.

22. Sizeable consolidation efforts in 2014 and beyond are needed to avoid debt rising above a domestic debt threshold and to comply with EU commitments. Under an unchanged-policies scenario, the general government deficit is projected to widen to 3.8 percent of GDP

in 2014, mainly reflecting the unwinding of temporary measures. This scenario factors in a return of the VAT rate to 19 percent as envisaged by law once the deficit falls below 3 percent of GDP and assumes significant expenditure containment in line with the government's plans (e.g., a sustained public wage bill freeze). The deficit will then stabilize around 3½ percent of GDP in the outer years.

Slovak Republic: General Government Balance, 2014-2018

(in percent of GDP)

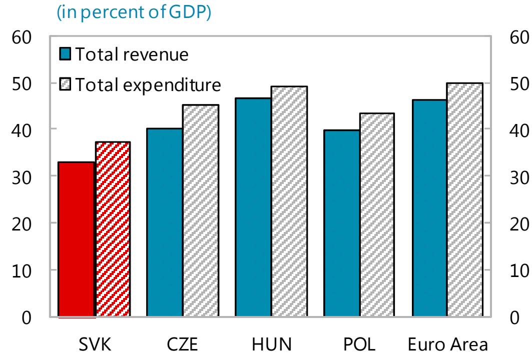
	2014		2015		2016		2017		2018	
	Baseline	Active	Baseline	Active	Baseline	Active	Baseline	Active	Baseline	Active
Total revenue	32.9	33.9	32.5	33.8	32.4	34.3	32.4	34.8	32.4	35.0
Total expenditure	36.6	36.5	35.9	35.8	35.8	35.6	35.8	35.6	35.8	35.5
Primary balance	-1.7	-0.6	-1.3	0.1	-1.0	1.0	-0.9	1.6	-0.9	1.6
Overall balance 1/	-3.8	-2.6	-3.4	-2.0	-3.4	-1.3	-3.4	-0.7	-3.4	-0.5
Memorandum items:										
Total measures (cumulative) 2/	...	1.3	...	1.6	...	2.2	...	2.8	...	2.9
One-off measures	0.4	0.4	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance 3/	-3.4	-2.2	-3.0	-1.4	-3.0	-0.9	-3.2	-0.5	-3.4	-0.5
Structural adjustment	0.1	1.3	0.4	0.8	-0.1	0.5	-0.2	0.4	-0.1	0.0
Gross debt	57.5	56.5	58.6	56.3	59.1	55.0	59.6	53.1	60.0	51.0
Real GDP growth 4/	2.3	1.9	2.8	2.5	3.3	3.0	3.5	3.3	3.5	3.5

1/ The active scenario is consistent with Stability Pact targets.
2/ It is assumed that two-thirds of measures are revenue-enhancing and one-third are expenditure savings.
3/ In percent of potential output.
4/ Consistent with estimates of the authorities in their latest Stability Program, the effect on growth from fiscal measures assumes a multiplier of about 0.3 in the year they are enacted and about half that effect in the subsequent year. This reflects the high degree of openness, lack of binding financing constraints, and relatively greater reliance on revenue measures which are estimated to have a smaller impact on growth.

As a result, gross government debt would climb over the 57 percent of GDP debt brake that would mandate a sharp move to balance the budget. To avoid this risk and comply with EU rules, which require Slovakia to implement an annual structural adjustment of at least 0.5 percent of GDP until the medium-term objective (MTO) of a structural deficit of 0.5 percent of GDP is achieved, staff estimate that a little over 2 percent of GDP in additional permanent fiscal adjustment measures will be required over 2014–16 with about 1 percent thereafter. This would imply more moderate growth over the forecast period (the text table provides an illustrative scenario), but would keep debt below the threshold at which the government would be required to introduce a balanced budget.

Government Revenue and Expenditure, 2012

(in percent of GDP)



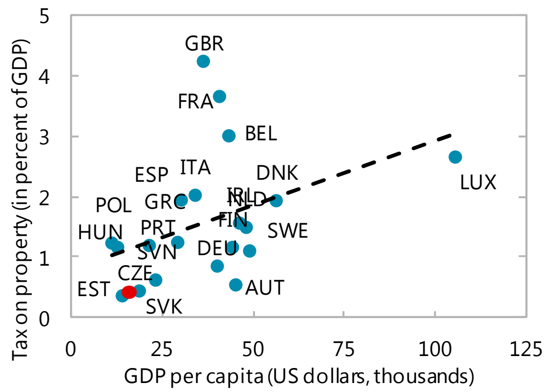
Sources: IMF Fiscal Monitor and IMF staff estimates.

23. The authorities should focus on high-quality measures to achieve medium-term fiscal consolidation. With revenue and spending well below peers, there is scope for improving revenue collection without jeopardizing competitiveness. This, along with more efficient spending would help safeguard (or even boost) growth-enhancing expenditure, such as education, ALMPs, and infrastructure investment. Since the design of high-quality measures may require time, some further reliance on temporary measures is likely in 2014. There might be scope for savings on benefits and to

realize partial early gains from actions to improve tax collection and spending efficiency described below.

- *Improving tax collection*. Lifting Slovakia's VAT efficiency (currently among the lowest in the EU) could generate more than 1 percent of GDP in additional revenues (Box 4 and Annex III). Furthermore, the completion of the merger of the tax and customs administrations as well as the integration of tax and social contribution collections could reduce administrative costs and help combat tax evasion and fraud. Given consolidation needs, the current VAT rate (20 percent) also should be maintained.

Taxes on Property

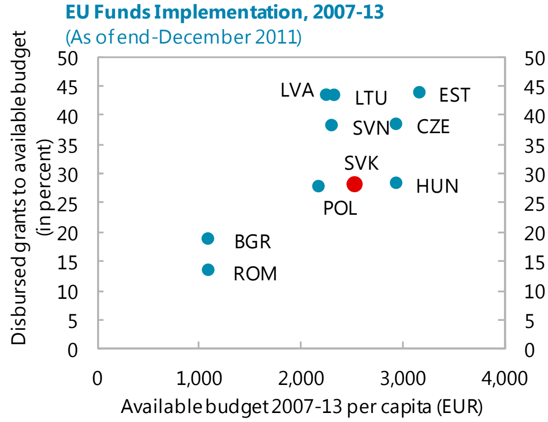


Source: OECD.

- *Market value-based real estate tax*. International evidence suggests that recurrent taxes on immovable property (and residential property in particular) may be less distortive than other taxes in their effect on long-term growth. In Slovakia, raising the current taxation of real estate, which is low compared to other European countries, and basing the tax on market value might raise an additional 0.5 percent of GDP.

- *Strengthening expenditure efficiency*. Compared with peers, Slovakia's health spending relative to outcomes is inefficient, suggesting scope for better care at no additional cost or possibly budgetary savings. Consideration of health reforms—the government is planning to create a unitary (government) health insurance system—should prioritize achievement of greater efficiency and savings. More broadly, evidence suggests that Slovakia has significant scope to improve public administration efficiency, which would support more effective use of EU funds, among other benefits.

EU Funds Implementation, 2007-13
(As of end-December 2011)



Source: KPMG.

- *Enhancing recent pension reforms*. Comprehensive pension reforms in 2012 linked the retirement age with demographic trends, changed pension indexation, and capped the accrual of pension benefits for higher earners. While these changes should significantly improve long-term sustainability of the pension system (the estimated public pension deficit in 2060 has been reduced from a little under 9 percent of GDP to slightly below 5 percent of GDP, which remains above the EU average of 3 percent of GDP), further steps would still be needed to ensure first pillar sustainability. Reducing the replacement rate could unduly increase the risk of old age poverty. Consistent with longer life expectancy, shortening the transition period to a higher retirement age and possibly increasing the retirement age could be more viable options; Slovakia's current retirement age of 62 for men (women's

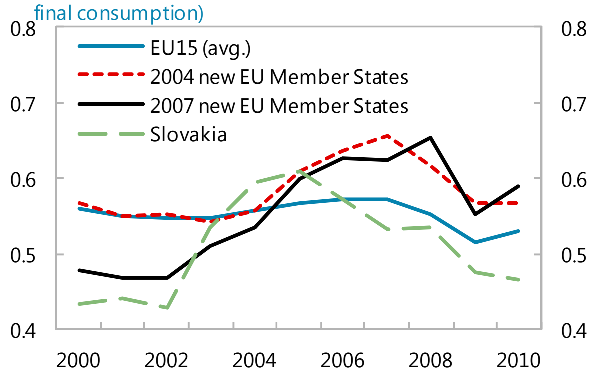
pensions are being adjusted to this age) is lower than most European countries and would rise slowly (roughly by one year every seven years) based on the link to demographic trends.

Box 4. Slovak Republic: Improving Tax Collection

Improving VAT efficiency, which is low and worsening, stands out as a key priority. C-efficiency—the ratio between actual VAT revenue and the proceeds that would be obtained by applying the standard VAT rate to final consumption—is below 0.5 and compares unfavorably with other EU countries as well as other regions. More importantly, the trend is rapidly deteriorating. While Slovakia's VAT performance has followed a pattern commonly observed in the new EU members—relatively low C-efficiency in the years leading up to EU accession, much higher C-efficiency immediately following EU membership, and steep decline in the recent crisis—its decline started earlier and is getting much worse. These developments suggest that factors specific to Slovakia are at play.

VAT C-efficiency

(ratio of VAT revenue to the product of the standard rate and final consumption)



Sources: WEO; OECD; Eurostat; Haver; DxTime; country authorities; and IMF staff calculations.

To improve low VAT efficiency, the underlying causes need to be identified. C-efficiency by itself is a simple metric summarizing the extent to which a country's VAT system departs from the application of a uniform VAT to all transactions under the assumption of full compliance. To understand precisely where improvements in the VAT might be expected, C-efficiency can be decomposed into a "policy gap," which captures the impact of rate differentiations and exemptions, and a "compliance gap," which measures the degree of non-conformity (ranging from minor errors to tax evasion). Preliminary analysis of a granular dataset on VAT tax returns and payments (see Annex III for details) suggests that the policy gap in Slovakia is relatively small and unlikely to provide much scope to generate additional revenue. On the other hand, over-claiming of VAT input credits rather than under-reporting of tax due seems the most important factor to explain the low VAT efficiency. Moreover, compliance risks appear concentrated in a few sectors. Staff will refine its VAT gap analysis and once completed, it should provide a clearer picture of VAT compliance conditions and help develop an effective compliance management strategy.

The government has also embarked on a comprehensive action plan to fight tax fraud. The action plan sets out 50 precise measures and a timeline for implementation. Acknowledging that to improve VAT compliance broader administrative and legal powers are needed, the government's strategy comprises not only tax measures but also amendments to business, criminal, and financial laws. The plan also envisages strengthening information gathering capabilities, which is crucial. However, full implementation of the plan will inevitably take time, not least because some measures are medium-term in nature and others require negotiation with other countries. The action plan would therefore benefit from a more risk-based prioritization of the envisaged measures through identification of businesses and activities with the highest compliance risk.

Box 4. Slovak Republic: Improving Tax Collection (concluded)

The action plan could address international aspects of VAT non-compliance more forcefully. The openness and deep integration of the Slovak economy into the world economy may have a bearing on VAT non-compliance. Pure fraud through fictitious import-export transactions aside, artificial reduction of the VAT base could be achieved through abusive intra-group transactions that shift companies' profits out of the Slovak jurisdiction. Therefore, the revenue authorities should be equipped with countermeasures not only against specific VAT non-compliance but also against undue profit shifting. For example, a controlled foreign corporation regime to tax artificially shifted profit could be introduced and transfer pricing rules to counter abusive intra-group transactions could be applied more widely, assisted by active use of advance pricing agreements. In addition, although there is little link with VAT issues, the corporate capitalization rule could be strengthened, for instance through limiting abusive deductions of interest payments to foreign parents since cross-border intra-group interest payments typically pose the highest risks.

24. **Effective fiscal institutions can help underpin sound fiscal policies.** Establishment of the Council for Budget Responsibility and adoption of the FRA (at the level of the constitution) signal the authorities' strong commitment to fiscal discipline. This is appropriate for a country in a monetary union and increasingly exposed to global trade shocks as integration into global supply chains deepens. The FRA's reliance on gross debt figures published independently by Eurostat helps reinforces the credibility of the FRA. On the other hand, gross debt does not adjust for factors such as recent intergovernmental lending in the context of the crisis in Europe and the accumulation of precautionary cash balances (pre-funding). As experience under the FRA is gained over time and expenditure ceilings are elaborated, a proper balance should be sought between upholding strong credibility and ensuring sufficient flexibility. This means maintaining the firm commitment to fiscal discipline and perhaps enhancing it by covering public entities, and potentially considering a net debt target if published by Eurostat and a smoother multi-year adjustment path toward a balanced budget to avoid excessive impact on growth.

Authorities' views

25. **The authorities broadly agreed with staff analysis, reiterated their strong commitment to the 2013 deficit target, and stressed the importance of improving tax collections.** They reiterated their determination to meet the 2013 fiscal deficit target to allow for EDP exit, and to achieve the MTO. A memorandum of understanding signed with local governments should help control spending, and public wage bill savings were considered achievable. The authorities shared staff's concern that the sharp adjustment required by a balanced budget if debt crosses the 57 percent of GDP threshold could harm the economy, and stressed that debt would be expected to remain safely below the threshold if support to other euro area members and the cash balance were netted out. They concurred on the importance of enhancing VAT collection efficiency and reducing tax evasion, which are top priorities for the Finance Ministry. The government recently adopted a comprehensive action plan to combat tax fraud and welcomed IMF analysis to support improvements in VAT efficiency. The authorities argued that linking real estate taxation to the market value of property will require substantial preparation, but work is underway and scope for collecting additional revenue under the current real estate tax could be considered. The authorities

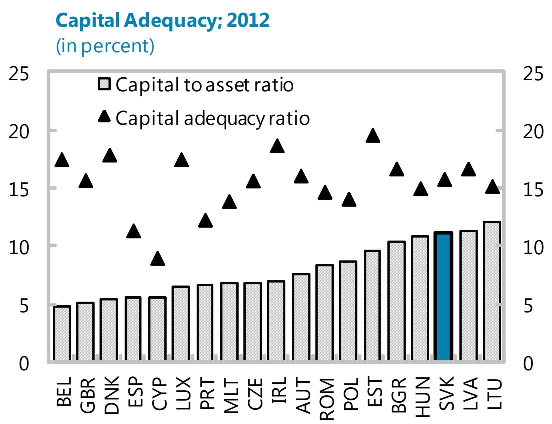
did not see raising the retirement age more rapidly than stipulated by the recent pension reform as desirable due to relatively low life expectancy and considered that a more accelerated transition would produce only small savings.

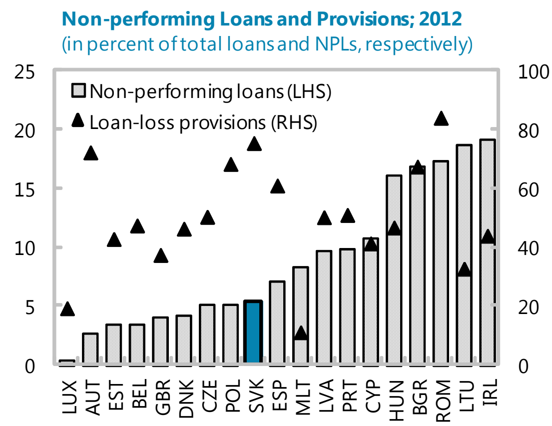
PRESERVING FINANCIAL STABILITY

The banking system remains sound, reflecting a traditional business model and prudent oversight. Bank profitability is under pressure due to a weak operating environment and a special levy on bank liabilities. With the Single Supervisory Mechanism (SSM), a significant portion of the Slovak banking sector will come under ECB direct supervision, underscoring the importance of close collaboration between the ECB and the NBS to maintain effective supervision.

Background

26. Slovak banks' soundness reflects a traditional retail-oriented business model with healthy capital and liquidity buffers. Foreign bank subsidiaries are key players in Slovakia, but the banking system's reliance on external funding is limited with lending mostly financed through domestic retail deposits. Ample liquidity allowed banks to repay about two-thirds of ECB LTROs in the first quarter of 2013. Bank capitalization is solid with a core Tier I capital ratio of 14.7 percent in 2012, up more than 2 percentage points from 2011, reflecting in part the NBS's strict rules on profit distribution. Non-performing loans (NPLs) are relatively low (5.2 percent of total loans in 2012) and well-provisioned (loan loss allowances amount to about three-quarters of NPLs).





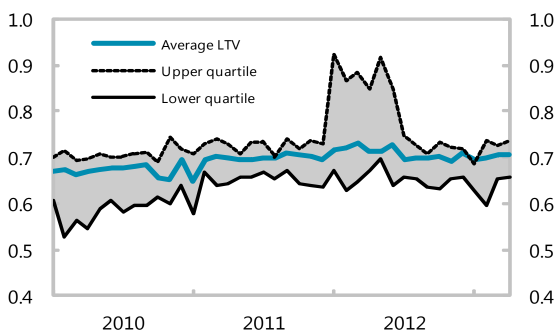
Sources: Global Financial Stability Report and National Bank of Slovakia.

27. Household lending continued to expand at a relatively rapid pace, while corporate credit declined. Although lending rates have broadly tracked easing in the ECB's monetary stance, lending to the corporate sector progressively slowed since 2011 before contracting in 2012, mainly reflecting weakening credit demand due the uncertain economic outlook. Competition for retail mortgages has intensified and while mortgage loans remained broadly flat, less stringently-regulated "other housing loans" have continued to grow. Nonetheless, risks related to household

lending seem low. Loan-to-value (LTV) ratios returned to more customary levels (around 70 percent) in the second half of 2012 after an increase earlier in the year, and the housing market remains depressed, with prices essentially flat for some time and about 20 percent below the 2008 peak.

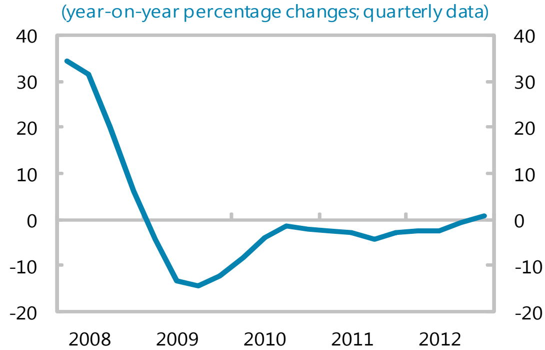
28. **The weak domestic economy and temporary levy dented banks' profits**. Lower lending volumes together with pressure on interest margins, driven by increased competition for deposits, curtailed gross income. Despite some improvements in cost efficiency and cost of risk, as measured by the share of gross income absorbed by administrative expenses and loan-loss provisioning respectively, banks' aggregate net profits declined by almost 30 percent. The current levy on bank liabilities (0.4 percent) to fund potential future resolution costs is relatively high in comparison to other jurisdictions, but will fall based on accumulated payments and asset coverage. In the first half of 2012, levy payments amounted to about 12 percent of the sector's pre-tax profits, but its impact varied across banks.

Banks' Loan-to-Value Ratio



Source: National Bank of Slovakia.

Housing Prices
(year-on-year percentage changes; quarterly data)

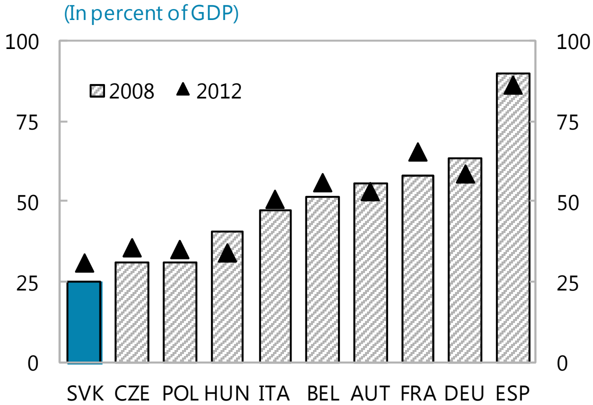


Source: National Bank of Slovakia.

Policy issues

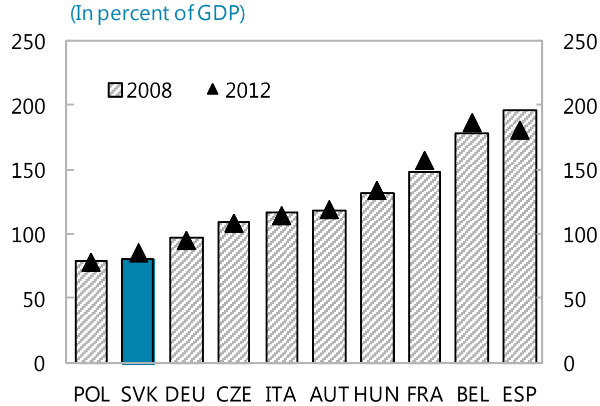
29. **Going forward, there is a risk that credit quality could deteriorate given economic conditions, with banks' profitability under further pressure**. Reflecting the weak economic outlook, bank lending to the corporate sector is expected to remain depressed while retail credit

Households' Debt
(In percent of GDP)



Source: Haver.

Nonfinancial Corporations' Debt
(In percent of GDP)



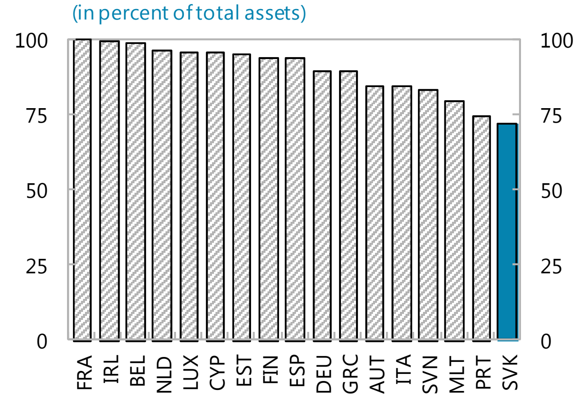
Source: Haver.

growth is likely to slow owing to high unemployment. Banks' NPLs may increase and the high borrower concentrations in the banks' corporate portfolios reinforce concerns, though limited private sector debt and low interest rates may be mitigating factors. As a result, banks' already falling profitability is likely to remain under pressure, though capital buffers are robust.

30. The effects of bank levies on lending and costs should be kept in mind, and proceeds might be more clearly allocated. There is a risk that additional burdens on banks may hamper the transmission of supportive monetary conditions to the real economy. The proceeds of the bank levy might finance a more well-defined fund dedicated to absorbing potential bank restructuring costs, and, to avoid creating a new institution, it could be managed by the NBS, or by the Deposit Protection Fund (DPF) under a modified mandate. A flexible approach could help accommodate potential changes in EU banking rules.

31. Establishment of the SSM and an effective banking union would strengthen the environment for banks in Slovakia. Although Slovak banks do not rely on parent funding, creation of the SSM is a key step in preserving financial stability and market integration in the euro area. About 70 percent of the Slovak banking system in terms of total assets will come under direct supervision of the ECB, underscoring the importance of good collaboration between the ECB and NBS. It will take time to put in place the effective cross-border resolution framework and solid pan-European deposit guarantee scheme needed for the SSM to function properly and the NBS also will retain direct supervisory responsibility for a number of banks. Given this, staff encouraged the authorities to enhance the current supervisory framework through a less discretionary system of early intervention and more effective resolution mechanisms: the legal powers of special administrators could be strengthened and the resolution toolkit broadened, for example by allowing purchase and assumption operations and the establishment of bridge banks. Consideration could also be given to gradually increasing the resources of the DPF. Any changes should take into account expected European directives and banking union developments.

Asset Coverage of the Banking Union
(in percent of total assets)



Sources: National Bank of Slovakia and Bruegel.

Authorities' views

32. The authorities saw little effect on lending from policy actions and emphasized their commitment to a prudent financial sector approach. The authorities considered credit developments primarily demand-driven, with little or no effect on lending from taxation and prudential regulation. On the bank levy, the authorities argued that the proceeds held as part of the government's cash balances are available if needed for resolution and that the levy rate will gradually decline with the accumulation of resources. They also observed that the small size of the

banking system has facilitated close supervision, but stand ready to implement amendments required by forthcoming EU directives. While supportive of the SSM, NBS officials stressed the importance of good cooperation and expressed concern if SSM encouraged the conversion of subsidiaries into branches, potentially lessening their scope for prudent supervision (a subsidiary of a large European bank converted to a branch last year).

STAFF APPRAISAL

33. **After a strong recovery in the wake of the global crisis, the Slovak economy is expected to continue growing, but at a significantly slower pace in 2013.** The Slovak Republic has been among Europe's most dynamic economies in recent years, largely due to sizeable foreign investment in the auto sector that led to rapidly rising exports, much faster growth than most others in the region, and limited vulnerabilities. Spillover risks are materializing, however, with weaker demand expected from trading partners, especially in Europe. This, coupled with still anemic domestic demand, has worsened the near-term outlook.

34. **Risks are tilted to the downside**. Domestic demand is expected to slowly recover but will remain restrained for some time due to ongoing fiscal adjustment as well as high unemployment. If prolonged, high unemployment risks negatively affecting growth, fiscal consolidation, and debt ratios, as well as long-term labor participation and productivity. If weakness in Europe is deeper or more drawn out than expected, this could reduce export demand and contribute to uncertainty holding back investment. Integration into international supply chains has brought great opportunities, but can also amplify risks from trade shocks, underscoring the importance over the medium term of new sources of growth and export diversification.

35. **Addressing very high unemployment—particularly youth and long-term unemployment—should be a top priority**. Efforts underway to strengthen education, training, and ALMPs including targeting to disadvantaged groups are welcome, but are still at an early stage. Public employment services should be strengthened and funding for ALMPs—which was increased in the 2013 budget—should be a priority even amidst budget consolidation. Effective use of EU Funds will be especially important in these areas. Steps to streamline administrative burdens for businesses are also welcome, and should be complemented by action to achieve a more stable, open, and predictable business climate with respect to labor regulations, the legal environment, procurement practices, and corruption.

36. **Slovakia has demonstrated its strong commitment to sustainable public finances but further progress is needed.** The fiscal deficit has come down substantially since 2009 and important structural reforms have been implemented, such as those that strengthen the pension fund’s finances, but other sources of revenue or savings have been temporary or have affected valuable projects such as those financed by EU Funds. Slovakia’s gross public debt, which includes contributions to support other euro area members and a healthy level of cash balances, remains manageable. However, to avoid economically harmful effects from debt rising above thresholds

under the FRA as well as to comply with EU targets, substantial additional adjustment measures will be needed for a number of years.

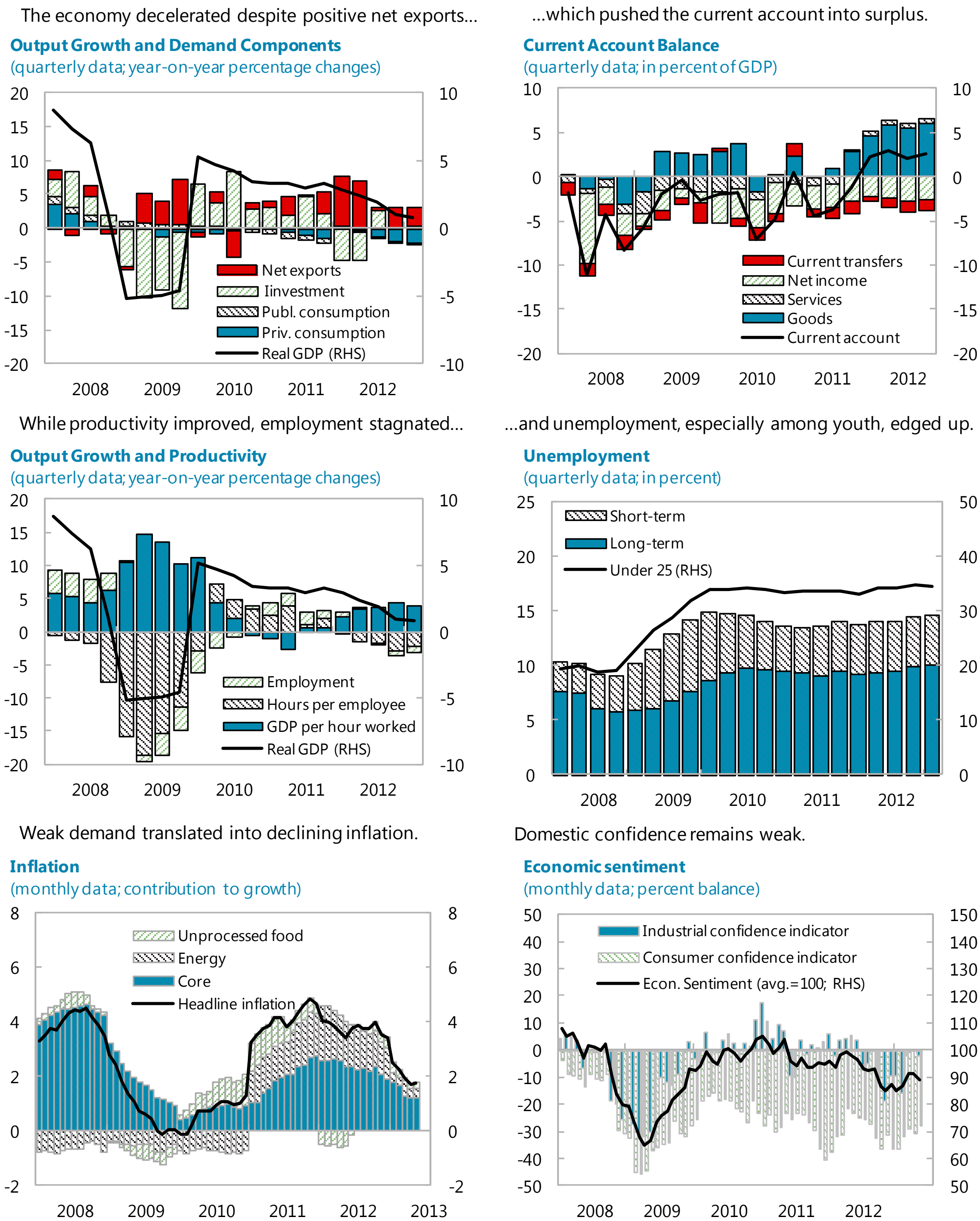
37. The 2013 fiscal deficit target is achievable, but automatic stabilizers should be allowed to operate if risks to growth materialize. Provisions in the 2013 budget, additional steps taken so far, and the government's readiness to take further measures that would have little macroeconomic impact suggest the 2013 target can be met. There are risks to this scenario, including the possibility of still weaker growth or difficulties controlling public wages and local government budgets. And should growth further disappoint, automatic stabilizers should be allowed to operate to avoid a further drag on output when growth is weakest.

38. Efforts should focus on identifying high quality fiscal measures for 2014 and over the medium term. Further fiscal consolidation is needed to ensure medium-term debt sustainability, and in light of EU rules and a domestic debt brake that would mandate an overly sharp move to balance the budget. In addition to maintaining the current VAT rate, adjustment efforts should focus on improving VAT collection efficiency and reducing tax evasion, introducing a property value-based real estate tax, and improving spending efficiency. Moving more quickly to a higher retirement age and potentially raising the overall age target would improve the long-term sustainability of the pension system.

39. A traditional banking model and prudent supervisory approach have contributed to a sound banking system. Slovakia's banking sector is liquid and well capitalized, with low and well-provisioned NPLs, although a weaker economic outlook could have effects on credit quality. Bank taxes have risen at a time when the operating environment is weak and credit to firms is declining, hitting profits. The levy should be lowered to be more in line with other countries in Europe and the proceeds allocated to a more well-defined special resolution fund. The size of the banking system has facilitated close supervision (and risks are low), but the current supervisory framework could be enhanced through a more well-specified intervention and resolution framework, in line with expected European directives and banking union developments.

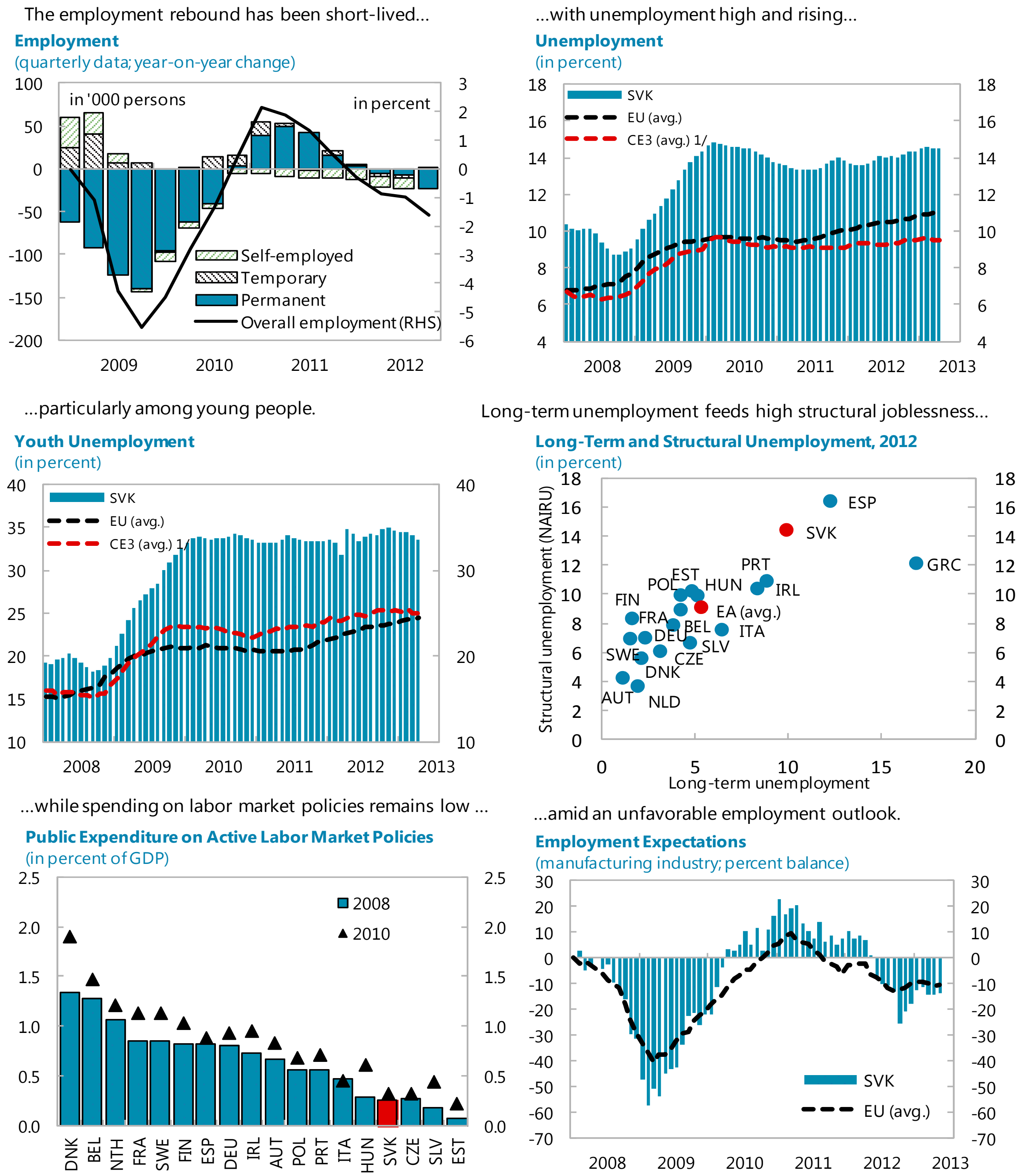
40. It is proposed that the next Article IV consultation with the Slovak Republic take place on the standard 12-month cycle.

Figure 1. Slovak Republic: Main Economic Developments



Sources: Eurostat and IMF staff calculations.

Figure 2. Slovak Republic: Labor Market Developments

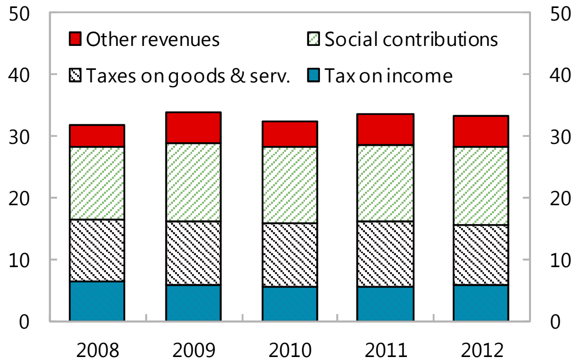


Sources: Eurostat; OECD; and IMF staff calculations.
1/ CE3 comprises Czech Republic, Hungary, and Poland.

Figure 3. Slovak Republic: Fiscal Developments

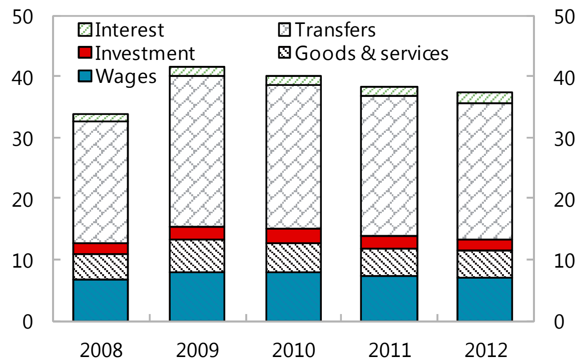
Revenue remained broadly constant as a share of GDP...

General Government Revenue
(in percent of GDP)



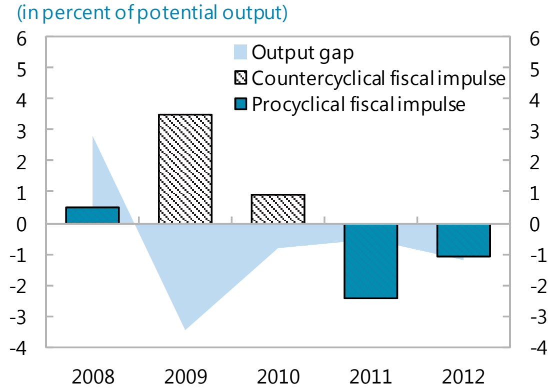
... whereas expenditure continued on a downward trend...

General Government Deficit
(in percent of GDP)



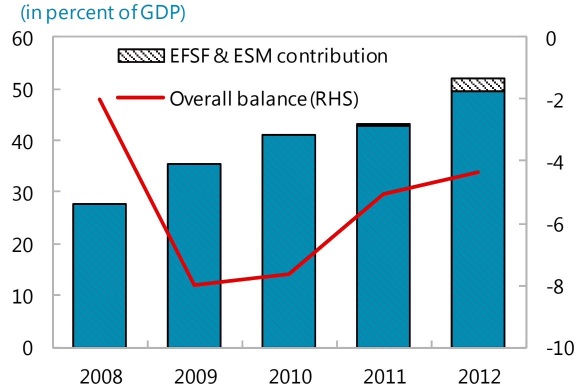
...the fiscal impulse remained procyclical...

Fiscal Impulse
(in percent of potential output)



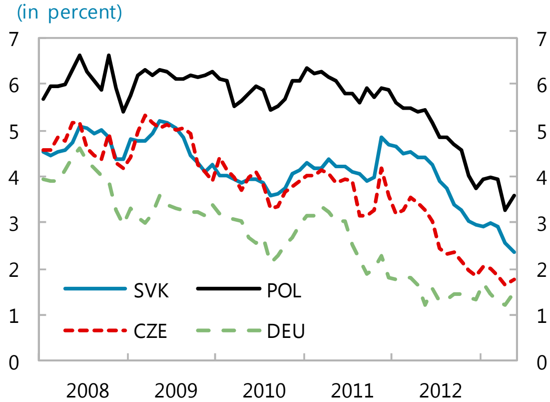
...while debt edged up also due to EU firewall contributions...

General Government Deficit and Gross Debt
(in percent of GDP)



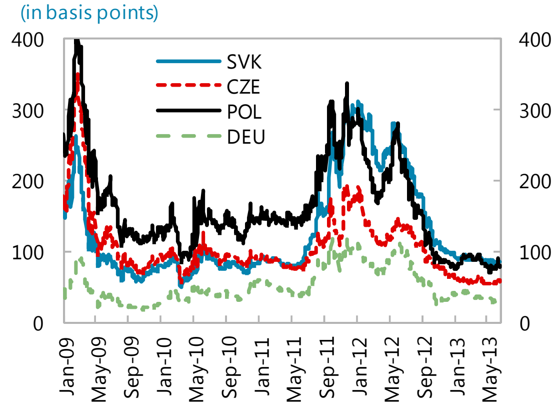
...but market sentiment has improved...

Government 10-Year Bond Yields
(in percent)



...and spreads have declined.

5-year CDS Spreads
(in basis points)

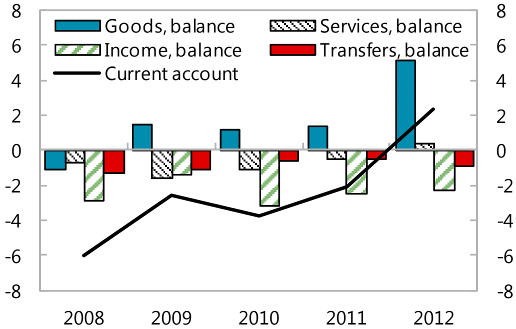


Sources: Eurostat; National Authorities; Bloomberg; and IMF staff calculations.

Figure 4. Slovak Republic: External Developments

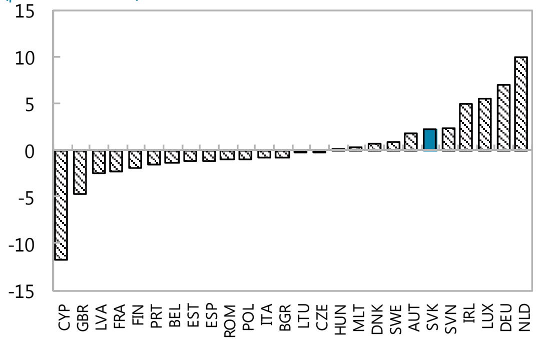
Goods exports shifted the current account into surplus...

Current Account in Slovakia
(percent of GDP)



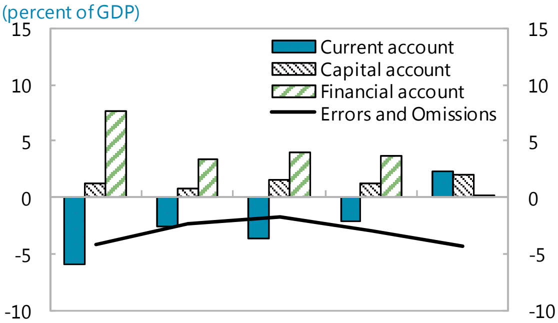
...placing Slovakia among Europe's stronger exporters.

Current Account in 2012
(percent of GDP)



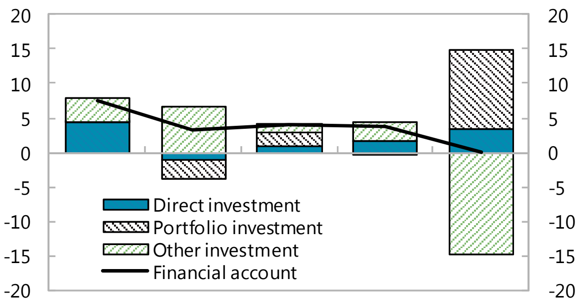
However, errors and omissions became larger...

Balance of Payments in Slovakia, 2008–12
(percent of GDP)



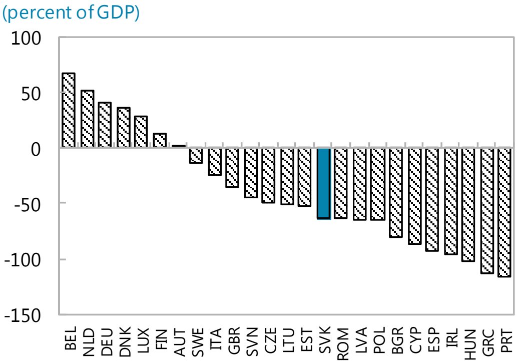
...and the financial account recorded large swings.

Financial Account in Slovakia, 2008–12
(percent of GDP)



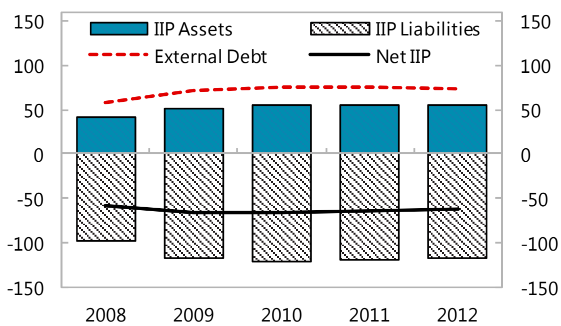
Although negative, the NIIP is relatively limited...

Net International Investment Positions, 2012
(percent of GDP)



...and has remained broadly stable, as has external debt.

Foreign Investment Position in Slovakia, 2008–12
(percent of GDP)



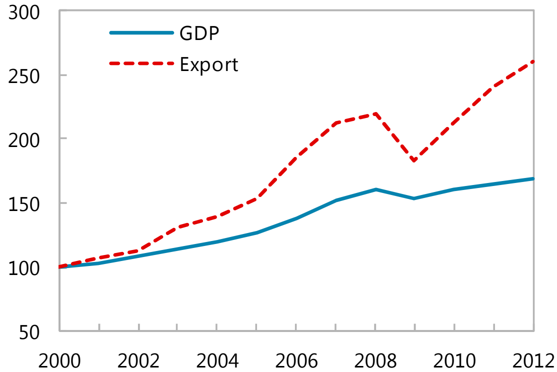
Sources: Eurostat and Haver.

Figure 5. Slovak Republic: Competitiveness Indicators

Exports recovered from crisis period...

Real GDP and Export Growth

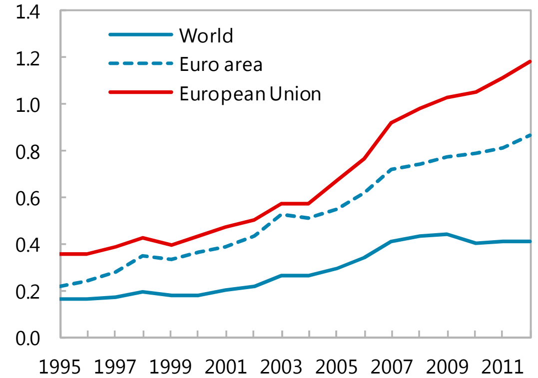
(2000=100)



...and market shares have continued to increase.

Slovak Export Shares

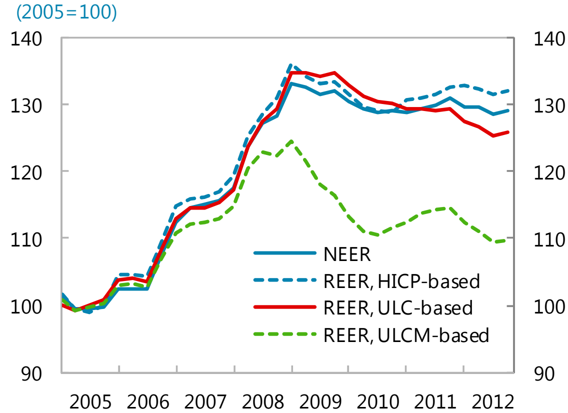
(percent of destination's total imports)



The real exchange rate has improved...

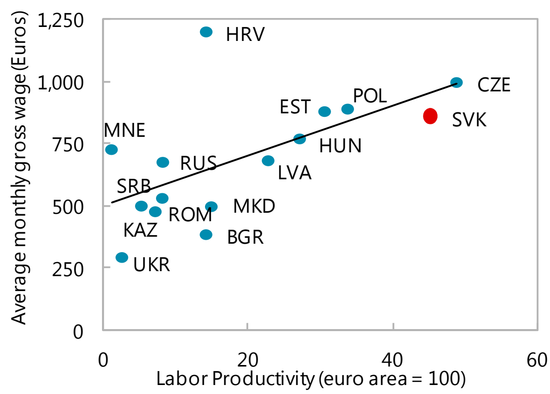
Nominal and Real Effective Exchange Rates

(2005=100)



...as wages remain low relative to productivity...

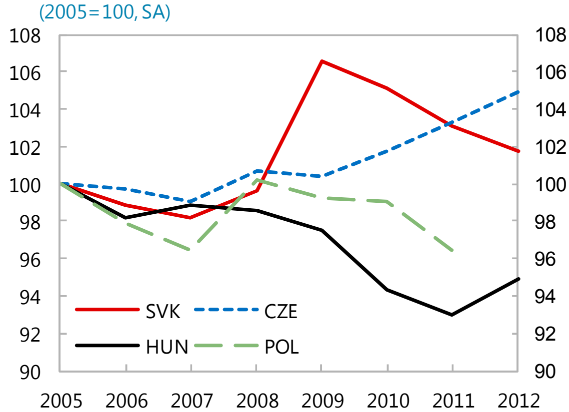
Labor Productivity and Wages, 2011



...and unit labor cost decreased...

Real Unit Labor Cost

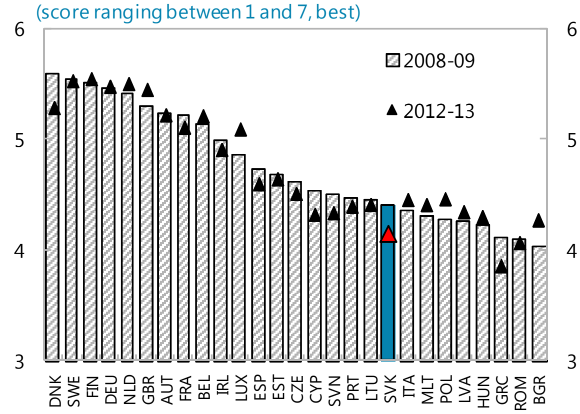
(2005=100, SA)



...while the business environment deteriorated somewhat.

Global Competitiveness Index

(score ranging between 1 and 7, best)

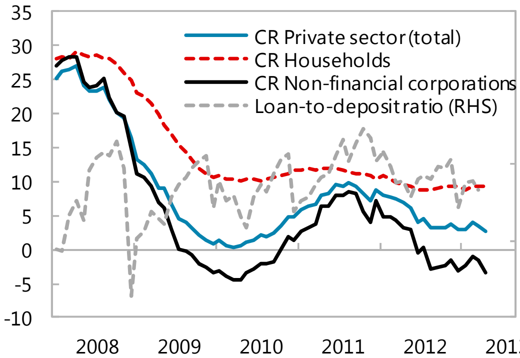


Sources: Eurostat; Haver; World Economic Forum; IMF DOTS; IMF WEO; and IMF staff calculations.

Figure 6. Slovak Republic: Monetary and Banking Developments

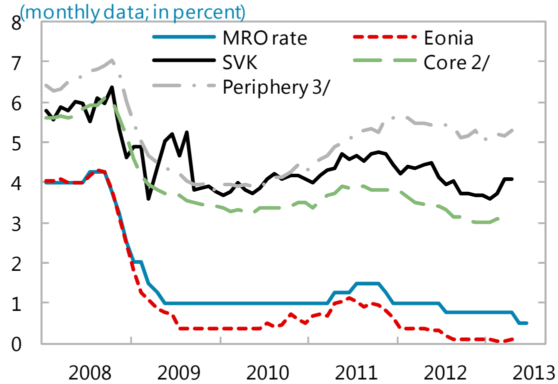
Credit growth remains subdued and deposit funded ...

Private Sector Credit and Deposits
(monthly data; year-on-year percentage change)



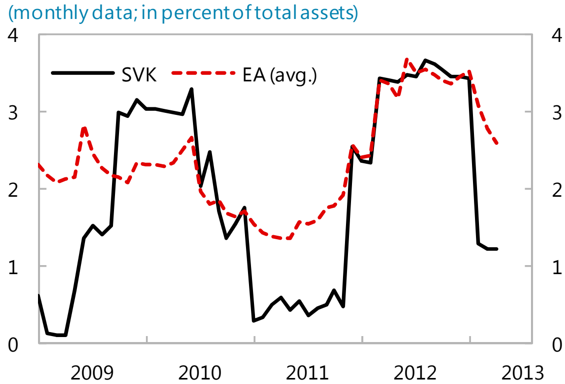
...with lending rates largely tracking ECB moves.

Money Market and Lending Rates 1/
(monthly data; in percent)



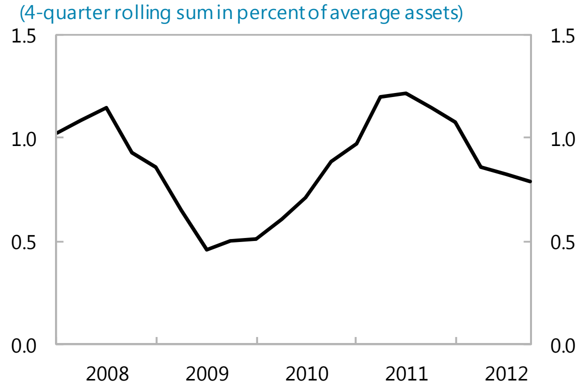
ECB borrowing is limited and much of the LTROs was repaid.

ECB Borrowing
(monthly data; in percent of total assets)



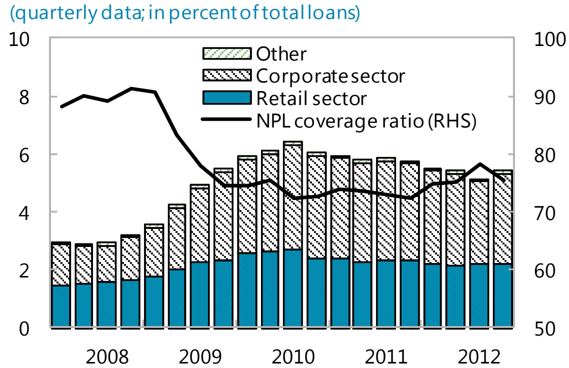
Profitability has declined due to the weak environment.

Bank Profitabilty
(4-quarter rolling sum in percent of average assets)



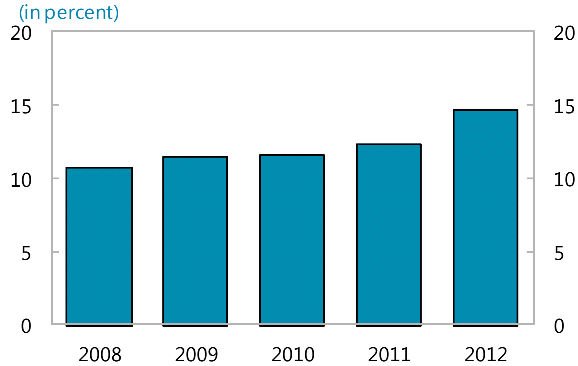
Impaired loans are contained and well provisioned...

Nonperforming Loans and Provisions
(quarterly data; in percent of total loans)



...and capital buffers have continued to strengthen.

Tier 1 Capital Adequacy Ratio
(in percent)



Sources: Haver; National Bank of Slovakia; Global Financial Stability Report; and IMF staff calculations.
1/ Interest rate on new loans of less than EUR 1 million to nonfinancial corporations (all maturities).
2/ Core comprises Finland, France, Germany and the Netherlands.
3/ Periphery comprises Ireland, Italy, Spain and Portugal.

Table 1. Slovak Republic: Selected Economic Indicators, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Projections					
	(Annual percentage change, constant prices, unless noted otherwise)								
Output/Demand									
Real GDP	4.4	3.2	2.0	0.6	2.3	2.8	3.3	3.5	3.5
Domestic demand	3.9	1.4	-3.1	-1.2	1.7	2.9	3.9	4.2	4.2
Public consumption	1.0	-4.3	-0.6	-0.9	1.2	1.1	1.1	1.3	1.4
Private consumption	-0.7	-0.5	-0.6	-0.5	0.9	2.0	2.8	3.2	3.2
Gross fixed capital formation	6.5	14.2	-3.7	-2.1	2.4	4.1	4.9	5.0	4.9
Exports of goods and services	16.0	12.7	8.6	2.3	4.2	4.6	5.1	5.5	5.5
Imports of goods and services	14.9	10.1	2.8	0.8	3.3	4.3	5.0	5.5	5.5
Output Gap	-0.8	-0.5	-1.2	-2.5	-2.2	-1.5	-1.0	-0.5	0.0
Potential Growth	1.6	2.9	2.7	1.9	2.0	2.0	2.8	3.0	3.0
Contribution to growth									
Domestic demand	3.6	1.2	-3.2	-0.9	1.2	2.2	2.8	3.1	3.1
Public consumption	0.2	-0.8	-0.1	-0.2	0.2	0.2	0.2	0.2	0.2
Private consumption	-0.4	-0.3	-0.3	-0.3	0.5	1.1	1.6	1.8	1.8
Gross fixed capital formation	1.3	3.0	-0.9	-0.5	0.5	0.9	1.1	1.1	1.1
Inventories	2.5	-0.7	-1.9	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	0.7	2.0	5.2	1.5	1.0	0.6	0.5	0.4	0.4
Prices									
Inflation (HICP)	0.7	4.1	3.7	1.7	2.0	2.1	2.2	2.3	2.3
Inflation (HICP, end of period)	1.3	4.6	3.4	1.7	2.1	2.0	2.2	2.3	2.3
GDP deflator	0.5	1.6	1.4	1.5	1.4	1.4	1.7	1.7	1.7
Employment and wages									
Employment	-1.5	1.8	0.1	-0.5	0.1	0.8	1.2	1.3	1.3
Nominal wages	5.1	3.7	4.1	2.1	2.9	3.1	3.4	3.7	3.7
Unemployment rate (percent)	14.5	13.6	14.0	14.6	14.7	14.2	13.3	12.3	11.3
	(In percent of GDP)								
Public Finance, General Government 1/									
Revenue	32.3	33.3	33.1	34.5	32.9	32.5	32.4	32.4	32.4
Expenditure	40.0	38.3	37.4	37.4	36.6	35.9	35.8	35.8	35.8
Overall balance	-7.7	-5.1	-4.3	-2.9	-3.8	-3.4	-3.4	-3.4	-3.4
Primary balance	-6.3	-3.5	-2.5	-0.9	-1.7	-1.3	-1.0	-0.9	-0.9
Structural balance (percent of potential GDP)	-7.2	-4.8	-4.4	-3.5	-3.4	-3.0	-3.0	-3.2	-3.4
General government debt	41.0	43.3	52.1	55.3	57.5	58.6	59.1	59.6	60.0
excl. EFSF and ESM contributions	41.0	43.0	49.7	52.1	54.0	55.2	55.9	56.5	57.1
	(In percent)								
Monetary and financial indicators									
Bank credit to private sector (growth rate)	4.8	8.6	2.9						
Lending rates 2/	4.6	4.7	4.4						
Deposit rates 3/	1.2	1.6	1.4						
Government 10-year bond yield	3.9	4.4	3.4						
	(In percent of GDP)								
Balance of payments									
Trade balance (goods)	1.2	1.4	5.1	5.7	6.4	6.7	6.8	6.9	7.0
Current account balance	-3.7	-2.1	2.3	2.3	3.1	3.5	3.7	3.8	4.0
Gross external debt	75.6	75.2	73.5	71.8	68.7	65.1	61.2	57.2	53.5

Sources: National Authorities and IMF staff estimates.

1/ No policy change scenario – i.e., it assumes no fiscal measures beyond those expected in 2013. See text table accompanying paragraph 22 for an active policy scenario.

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

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

Table 2. Slovak Republic: Fiscal Operations of the General Government, 2010–18
(In millions of euros)

				Projections 1/					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	21,282	22,993	23,651	25,213	24,906	25,654	26,900	28,308	29,778
Taxes	10,215	11,024	11,031	11,452	11,565	11,735	12,254	12,909	13,594
Personal income tax	1,513	1,741	1,880	1,940	1,998	2,077	2,174	2,283	2,399
Corporate income tax	1,659	1,666	1,704	1,961	2,036	2,153	2,275	2,395	2,520
VAT	4,129	4,651	4,238	4,201	4,325	4,279	4,497	4,748	5,012
Excises	2,078	2,129	1,973	1,950	1,949	1,958	1,981	2,085	2,194
Other taxes	836	837	1,235	1,400	1,257	1,268	1,327	1,397	1,470
Social contributions	8,252	8,635	9,065	9,823	9,961	10,470	10,802	11,351	11,927
Grants	653	793	807	1,484	1,533	1,583	1,939	2,041	2,147
Other revenue	2,162	2,541	2,748	2,454	1,847	1,866	1,906	2,006	2,111
Expenditure	26,328	26,491	26,758	27,329	27,755	28,371	29,697	31,300	32,896
Expense	24,647	25,027	25,431	26,192	26,575	27,141	28,404	29,939	31,464
Compensation of employees	5,065	4,914	5,014	4,706	4,804	4,821	4,845	5,100	5,366
Use of goods and services	3,200	3,111	3,088	2,954	3,145	3,007	3,368	3,546	3,730
Interest	885	1,084	1,322	1,437	1,527	1,724	1,959	2,201	2,282
Subsidies	894	863	994	906	879	876	839	883	929
Grants	1,047	1,322	1,071	652	647	667	686	722	760
Social benefits	12,798	12,757	13,291	13,568	13,880	14,421	14,985	15,775	16,597
Other expense	759	976	653	1,967	1,693	1,625	1,723	1,711	1,800
Net acquisition of nonfinancial assets	1,681	1,463	1,326	1,137	1,180	1,230	1,293	1,361	1,432
Gross Operating Balance	-3,366	-2,035	-1,781	-979	-1,669	-1,486	-1,504	-1,631	-1,686
Net lending(+)/borrowing(-) (overall balance)	-5,046	-3,498	-3,107	-2,116	-2,849	-2,716	-2,797	-2,992	-3,118
Net financial transactions	-5,518	-3,306	-3,169	-2,116	-2,849	-2,716	-2,797	-2,992	-3,118
Net acquisition of financial assets	61	-491	3,298	939	321	0	0	0	0
Currency and deposits	-209	-903	2,930	335	0	0	0	0	0
Debt securities	-1	-1	-3	0	0	0	0	0	0
Loans	-31	333	91	341	189	0	0	0	0
Equity and investment fund shares	-140	-128	343	0	0	0	0	0	0
Other financial assets	442	208	-63	264	132	0	0	0	0
Net incurrence of liabilities	5,579	2,815	6,467	3,055	3,170	2,716	2,797	2,992	3,118
Currency and deposits	-12	30	312	0	0	0	0	0	0
Debt securities	4,551	2,143	5,965	2,715	2,981	2,716	2,797	2,992	3,118
Loans	108	732	253	341	189	0	0	0	0
Other liabilities	932	-90	-63	0	0	0	0	0	0
Statistical discrepancy (nonfin. vs. fin. accounts)	*472*	*-192*	*62*	*0*	*0*	*0*	*0*	*0*	*0*
Memorandum items:									
One-off measures	-91	-47	364	1,133	332	44	20	0	0
Primary balance	-4,162	-2,413	-1,785	-679	-1,322	-993	-838	-791	-836
Net lending/borrowing (excluding one-off events)	-4,955	-3,451	-3,471	-3,249	-3,180	-2,761	-2,816	-2,992	-3,118
Structural balance	-4,780	-3,328	-3,184	-2,611	-2,609	-2,366	-2,540	-2,845	-3,113
Gross public debt	26,998	29,911	37,245	40,377	43,547	46,263	49,060	52,052	55,170
of which EFSF and ESM contributions	...	173	1,758	2,362	2,683	2,683	2,683	2,683	2,683
Cash on GG accounts	...	...	3,430	3,765	3,765	3,765	3,765	3,765	3,765

Sources: National Authorities and IMF staff estimates.

1/ No policy change scenario – i.e., it assumes no fiscal measures beyond those expected in 2013. See text table accomapnying paragraph 22 for an active policy scenario.

Table 2. Slovak Republic: Fiscal Operations of the General Government, 2010–18 (concluded)

(In percent of GDP)

				Projections 1/					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	32.3	33.3	33.1	34.5	32.9	32.5	32.4	32.4	32.4
Taxes	15.5	16.0	15.4	15.7	15.3	14.9	14.8	14.8	14.8
Personal income tax	2.3	2.5	2.6	2.7	2.6	2.6	2.6	2.6	2.6
Corporate income tax	2.5	2.4	2.4	2.7	2.7	2.7	2.7	2.7	2.7
VAT	6.3	6.7	5.9	5.8	5.7	5.4	5.4	5.4	5.5
Excises	3.2	3.1	2.8	2.7	2.6	2.5	2.4	2.4	2.4
Other taxes	1.3	1.2	1.7	1.9	1.7	1.6	1.6	1.6	1.6
Social contributions	12.5	12.5	12.7	13.5	13.2	13.3	13.0	13.0	13.0
Grants	1.0	1.1	1.1	2.0	2.0	2.0	2.3	2.3	2.3
Other revenue	3.3	3.7	3.8	3.4	2.4	2.4	2.3	2.3	2.3
Expenditure	40.0	38.3	37.4	37.4	36.6	35.9	35.8	35.8	35.8
Expense	37.4	36.2	35.6	35.9	35.1	34.4	34.2	34.3	34.2
Compensation of employees	7.7	7.1	7.0	6.4	6.3	6.1	5.8	5.8	5.8
Use of goods and services	4.9	4.5	4.3	4.0	4.2	3.8	4.1	4.1	4.1
Interest	1.3	1.6	1.9	2.0	2.0	2.2	2.4	2.5	2.5
Subsidies	1.4	1.2	1.4	1.2	1.2	1.1	1.0	1.0	1.0
Grants	1.6	1.9	1.5	0.9	0.9	0.8	0.8	0.8	0.8
Social benefits	19.4	18.5	18.6	18.6	18.3	18.3	18.1	18.1	18.1
Other expense	1.2	1.4	0.9	2.7	2.2	2.1	2.1	2.0	2.0
Net acquisition of nonfinancial assets	2.6	2.1	1.9	1.6	1.6	1.6	1.6	1.6	1.6
Gross Operating Balance	-5.1	-2.9	-2.5	-1.3	-2.2	-1.9	-1.8	-1.9	-1.8
Net lending (+)/borrowing (-)	-7.7	-5.1	-4.3	-2.9	-3.8	-3.4	-3.4	-3.4	-3.4
Net financial transactions	-8.4	-4.8	-4.4	-2.9	-3.8	-3.4	-3.4	-3.4	-3.4
Net acquisition of financial assets	0.1	-0.7	4.6	1.3	0.4	0.0	0.0	0.0	0.0
Currency and deposits	-0.3	-1.3	4.1	0.5	0.0	0.0	0.0	0.0	0.0
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.5	0.1	0.5	0.3	0.0	0.0	0.0	0.0
Equity and investment fund shares	-0.2	-0.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.7	0.3	-0.1	0.4	0.2	0.0	0.0	0.0	0.0
Net incurrence of liabilities	8.5	4.1	9.0	4.2	4.2	3.4	3.4	3.4	3.4
Currency and deposits	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	6.9	3.1	8.3	3.7	3.9	3.4	3.4	3.4	3.4
Loans	0.2	1.1	0.4	0.5	0.3	0.0	0.0	0.0	0.0
Other liabilities	1.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy (nonfin. vs. fin. accounts)	*0.7*	*-0.3*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Memorandum items:									
One-off measures	-0.1	-0.1	0.5	1.6	0.4	0.1	0.0	0.0	0.0
Primary balance	-6.3	-3.5	-2.5	-0.9	-1.7	-1.3	-1.0	-0.9	-0.9
Net lending/borrowing (excluding one-off events)	-7.5	-5.0	-4.9	-4.4	-4.2	-3.5	-3.4	-3.4	-3.4
Structural balance (percent of potential GDP)	-7.2	-4.8	-4.4	-3.5	-3.4	-3.0	-3.0	-3.2	-3.4
Gross public debt	41.0	43.3	52.1	55.3	57.5	58.6	59.1	59.6	60.0
of which EFSF and ESM contributions	...	0.2	2.5	3.2	3.5	3.4	3.2	3.1	2.9
Cash on GG accounts	...	...	4.8	5.2	5.0	4.8	4.5	4.3	4.1
GDP at current market prices (millions of euros)	65,870	69,108	71,463	73,008	75,736	78,983	83,014	87,392	91,944

Sources: National Authorities and IMF staff estimates.

1/ No policy change scenario – i.e., it assumes no fiscal measures beyond those expected in 2013. See text table accompanying paragraph 22 for an active policy scenario.

Table 3. Slovak Republic: General Government Balance Sheet, 2005–12

	2005	2006	2007	2008	2009	2010	2011	2012
	(In billions of euros)							
Net financial worth	**-2,467**	**-3,551**	**-4,470**	**-6,054**	**-11,087**	**-16,543**	**-18,015**	**-17,978**
Financial assets	**16,494**	**15,211**	**15,718**	**15,340**	**14,281**	**14,404**	**15,073**	**22,893**
Currency and deposits	2,577	2,820	3,639	3,658	2,462	2,315	1,154	3,892
Securities other than shares	194	148	312	310	305	304	498	839
Loans	1,434	1,282	1,172	1,202	1,269	1,238	1,354	3,290
Shares and other equity	9,339	8,793	8,501	8,375	8,578	8,438	9,361	12,408
Other accounts receivable	2,950	2,168	2,094	1,795	1,667	2,109	2,706	2,464
Financial liabilities	**18,961**	**18,762**	**20,188**	**21,394**	**25,368**	**30,947**	**33,088**	**40,871**
Currency and deposits	0	69	117	108	83	71	41	152
Securities other than shares	14,237	15,228	16,377	17,243	21,022	25,573	27,672	33,357
Loans	3,399	1,754	1,571	1,571	1,510	1,618	2,774	4,969
Other accounts receivable	1,325	1,711	2,123	2,472	2,753	3,685	2,601	2,393
	(In percent of GDP)							
Net financial worth	**-5.0**	**-6.5**	**-7.3**	**-9.1**	**-17.7**	**-25.1**	**-26.1**	**-25.2**
Financial assets	**33.4**	**27.7**	**25.6**	**22.9**	**22.7**	**21.9**	**21.8**	**32.0**
Currency and deposits	5.2	5.1	5.9	5.5	3.9	3.5	1.7	5.4
Securities other than shares	0.4	0.3	0.5	0.5	0.5	0.5	0.7	1.2
Loans	2.9	2.3	1.9	1.8	2.0	1.9	2.0	4.6
Shares and other equity	18.9	16.0	13.8	12.5	13.7	12.8	13.5	17.4
Other accounts receivable	6.0	3.9	3.4	2.7	2.7	3.2	3.9	3.4
Financial liabilities	**38.4**	**34.1**	**32.9**	**32.0**	**40.4**	**47.0**	**47.9**	**57.2**
Currency and deposits	0.0	0.1	0.2	0.2	0.1	0.1	0.1	0.2
Securities other than shares	28.9	27.7	26.7	25.8	33.5	38.8	40.0	46.7
Loans	6.9	3.2	2.6	2.4	2.4	2.5	4.0	7.0
Other accounts receivable	2.7	3.1	3.5	3.7	4.4	5.6	3.8	3.3
Memorandum items:								
Pulic debt	16,844	16,770	18,053	18,624	22,331	26,998	29,911	37,245
Net lending/borrowing	-1,083	-1,412	-994	-1,346	-5,040	-5,046	-3,498	-3,107
GDP	49,314	55,002	61,450	66,842	62,794	65,870	69,108	71,463

Source: National Authorities.

Table 4. Slovak Republic: Medium-Term Balance of Payments, 2010–18

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
				(In millions of euros)					
Current account	**-2,452**	**-1,427**	**1,631**	**1,707**	**2,341**	**2,742**	**3,051**	**3,347**	**3,664**
Trade balance (goods)	779	975	3,637	4,138	4,841	5,301	5,679	6,046	6,436
Exports, f.o.b.	48,273	56,960	62,748	62,819	65,789	69,132	73,214	77,953	82,971
Imports, f.o.b.	-47,494	-55,985	-59,111	-58,681	-60,948	-63,830	-67,536	-71,906	-76,536
Services balance	-744	-370	280	402	468	512	548	583	621
Receipts	4,396	4,750	5,569	5,847	6,123	6,434	6,814	7,255	7,722
Payments	-5,140	-5,120	-5,289	-5,445	-5,655	-5,922	-6,266	-6,672	-7,101
Income balance	-2,066	-1,678	-1,638	-2,000	-2,056	-2,104	-2,149	-2,194	-2,240
Receipts	2,569	2,418	2,584	2,559	2,713	2,880	3,059	3,247	3,445
Payments	-4,635	-4,096	-4,223	-4,559	-4,769	-4,984	-5,208	-5,441	-5,685
Current transfers	-421	-354	-649	-834	-912	-967	-1,026	-1,089	-1,153
Capital account	**1,019**	**864**	**1,376**	**891**	**908**	**996**	**994**	**1,022**	**950**
Financial Account	**2,562**	**2,562**	**65**	**-2,597**	**-3,249**	**-3,738**	**-4,045**	**-4,369**	**-4,614**
Direct foreign investment	621	1,188	2,402	1,337	1,387	1,442	1,493	1,547	1,620
Portfolio investment	1,238	-174	8,246	-168	-174	-181	-190	-201	-211
Other investment	808	1,894	-10,552	-3,767	-4,462	-4,999	-5,348	-5,715	-6,023
Financial derivatives	-105	-346	-31	0	0	0	0	0	0
Reserve assets	**-1**	**0**	**17**	**0**	**0**	**0**	**0**	**0**	**0**
Errors and omissions	**-1,128**	**-1,999**	**-3,088**	**0**	**0**	**0**	**0**	**0**	**0**
				(in percent of GDP)					
Current account balance	**-3.7**	**-2.1**	**2.3**	**2.3**	**3.1**	**3.5**	**3.7**	**3.8**	**4.0**
Trade balance (goods)	1.2	1.4	5.1	5.7	6.4	6.7	6.8	6.9	7.0
Exports, f.o.b.	73.3	82.4	87.8	86.0	86.9	87.5	88.2	89.2	90.2
Imports, f.o.b.	-72.1	-81.0	-82.7	-80.4	-80.5	-80.8	-81.4	-82.3	-83.2
Services balance	-1.1	-0.5	0.4	0.6	0.6	0.6	0.7	0.7	0.7
Receipts	6.7	6.9	7.8	8.0	8.1	8.1	8.2	8.3	8.4
Payments	-7.8	-7.4	-7.4	-7.5	-7.5	-7.5	-7.5	-7.6	-7.7
Income balance	-3.1	-2.4	-2.3	-2.7	-2.7	-2.7	-2.6	-2.5	-2.4
Receipts	3.9	3.5	3.6	3.5	3.6	3.6	3.7	3.7	3.7
Payments	-7.0	-5.9	-5.9	-6.2	-6.3	-6.3	-6.3	-6.2	-6.2
Current transfers	-0.6	-0.5	-0.9	-1.1	-1.2	-1.2	-1.2	-1.2	-1.3
Capital account	**1.5**	**1.3**	**1.9**	**1.2**	**1.2**	**1.3**	**1.2**	**1.2**	**1.0**
Financial Account	**3.9**	**3.7**	**0.1**	**-3.6**	**-4.3**	**-4.7**	**-4.9**	**-5.0**	**-5.0**
Direct foreign investment	0.9	1.7	3.4	1.8	1.8	1.8	1.8	1.8	1.8
Portfolio investment	1.9	-0.3	11.5	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Other investment	1.2	2.7	-14.8	-5.2	-5.9	-6.3	-6.4	-6.5	-6.6
Financial derivatives	-0.2	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Errors and omissions	**-1.7**	**-2.9**	**-4.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Net International Investment Position	-43,601	-44,534	-44,600	-42,002	-38,754	-35,016	-30,971	-26,602	-21,988
in percent of GDP	-66.2	-64.4	-62.4	-57.5	-51.2	-44.3	-37.3	-30.4	-23.9
External Debt	49,797	51,970	52,519	52,427	52,036	51,443	50,771	50,018	49,220
in percent of GDP	75.6	75.2	73.5	71.8	68.7	65.1	61.2	57.2	53.5

Sources: National Bank of Slovakia and IMF staff estimates.

Table 5. Slovak Republic: Financial Soundness Indicators of the Banking Sector, 2008–12
(In percent unless otherwise indicated)

	2008	2009	2010	2011	2012
Capital adequacy					
Regulatory capital to risk-weighted assets	11.1	12.6	12.7	13.4	15.7
Regulatory Tier 1 capital to risk-weighted assets	10.7	11.4	11.6	12.4	14.7
Capital to assets	8.2	9.6	9.7	10.8	11.7
Asset quality					
Nonperforming loans to gross loans	2.5	5.3	5.8	5.6	5.2
Nonperforming loans net of provisions to capital	6.7	14.3	16.7	15.5	13.3
Earnings and Profitability					
Return on assets (after tax)	1.2	0.6	1.2	1.5	1.0
Return on equity (after tax)	15.4	6.7	12.6	14.5	9.1
Interest margin to gross income	65.9	76.8	75.9	73.9	84.1
Noninterest expenses to gross income	57.3	62.3	57.5	52.5	64.3
Liquidity					
Customer deposits to total (noninterbank) loans	98.9	116.1	116.6	109.4	114.2
Liquid assets to total assets	52.1	43.4	40.9	37.4	38.3
Liquid assets to short-term liabilities	65.0	57.3	56.5	52.9	55.9
Sectoral distribution of loans to total loans					
Residents	95.6	93.4	93.6	93.6	92.4
Deposit-takers	0.3	0.1	0.0	0.0	0.0
Central bank	22.2	...	...	...	...
Other financial corporations	4.6	4.2	2.9	2.8	2.3
General government	1.9	2.6	3.2	2.9	2.6
Nonfinancial corporations	36.1	44.1	42.2	41.6	38.9
Other domestic sectors	30.5	42.5	45.3	46.2	48.6
Nonresidents	4.4	6.6	6.4	6.4	7.6
Other indicators					
Nonfinancial corporation debt (in percent of GDP)	80.4	82.8	80.8	82.1	85.7
Households debt (in percent of GDP)	24.8	27.1	27.5	28.5	31.1
Households debt (in percent of disposable income)	40.7	42.5	43.2	46.9	50.3
Gross asset position in financial derivatives to capital	17.5	9.0	7.6	8.0	5.5
Gross liability position in financial derivatives to capital	17.9	10.4	9.4	9.1	6.7
Trading income to total income	12.4	1.5	2.9	-4.1	1.4
Personnel expenses to noninterest expenses	38.3	38.5	38.6	40.1	39.9
Spread between reference lending and deposit rates (basis points)	428.0	430.0	395.0	376.5	359.0
Foreign-currency-denominated loans to total loans	17.4	2.0	1.5	1.6	1.5
Foreign-currency-denominated liabilities to total liabilities	21.7	2.8	3.2	4.1	3.6
Net open position in equities to capital	9.6	10.5	9.6	9.1	8.3
Net open position in foreign exchange to capital	-19.5	-0.1	-1.2	-1.7	0.1

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

Table 6. Slovak Republic: Public Sector Debt Sustainability Framework 2008–18

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	27.9	35.6	41.0	43.3	52.1	**55.3**	**57.5**	**58.6**	**59.1**	**59.6**	**60.0**	**-0.5**
o/w foreign-currency denominated	6.8	0.1	0.1	0.1	3.0	3.2	3.3	3.4	3.4	3.4	3.4	
Change in public sector debt	-1.5	7.7	5.4	2.3	8.8	3.2	2.2	1.1	0.5	0.5	0.4	
Identified debt-creating flows (4+7+12)	0.2	9.3	6.0	3.4	5.1	2.7	2.2	1.1	0.5	0.5	0.4	
Primary deficit	0.8	6.6	6.3	3.5	2.5	0.9	1.7	1.3	1.0	0.9	0.9	
Revenue and grants	31.6	33.5	32.3	33.3	33.1	34.5	32.9	32.5	32.4	32.4	32.4	
Primary (noninterest) expenditure	32.4	40.1	38.6	36.8	35.6	35.5	34.6	33.7	33.4	33.3	33.3	
Automatic debt dynamics 2/	-0.6	2.8	-0.3	-0.4	0.4	0.9	0.0	-0.2	-0.5	-0.4	-0.5	
Contribution from interest rate/growth differential 3/	-1.2	3.2	-0.3	-0.4	0.4	0.9	0.0	-0.2	-0.5	-0.4	-0.5	
Of which contribution from real interest rate	0.4	1.8	1.2	0.9	1.3	1.2	1.2	1.4	1.4	1.5	1.5	
Of which contribution from real GDP growth	-1.6	1.5	-1.5	-1.3	-0.8	-0.3	-1.2	-1.5	-1.8	-2.0	-2.0	
Contribution from exchange rate depreciation 4/	0.5	-0.5	0.0	0.0	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.2	2.2	0.9	0.4	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	
Other (EFSF and ESM contributions)	0.0	0.0	0.0	0.2	2.2	0.8	0.4	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-1.7	-1.6	-0.6	-1.1	3.7	0.5	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	88.1	106.1	126.9	130.1	157.5	160.1	174.8	180.3	182.4	183.9	185.3	
Gross financing need 6/	7.7	15.4	16.6	13.0	13.4	10.9	9.9	9.5	9.2	9.7	9.5	
in billions of U.S. dollars	7.6	13.5	14.5	12.5	12.3	10.5	9.9	10.0	10.3	11.5	12.0	
Scenario with key variables at their historical averages 7/						**55.3**	**56.6**	**57.4**	**58.3**	**59.1**	**59.8**	**-1.5**
Scenario with no policy change (constant primary balance) in 2013-2018						**55.3**	**56.7**	**57.4**	**57.9**	**58.4**	**58.9**	**-0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.8	-4.9	4.4	3.2	2.0	0.6	2.3	2.8	3.3	3.5	3.5	
Average nominal interest rate on public debt (in percent) 8/	4.4	4.9	4.0	4.0	4.4	3.9	3.8	4.0	4.2	4.5	4.4	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	6.0	3.5	2.4	3.1	2.3	2.3	2.5	2.5	2.8	2.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.6	7.2	-9.5	-0.3	0.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.9	-1.2	0.5	1.6	1.4	1.5	1.4	1.4	1.7	1.7	1.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	17.2	17.5	0.5	-1.8	-1.2	0.2	-0.1	0.1	2.3	3.1	3.5	
Primary deficit	0.8	6.6	6.3	3.5	2.5	0.9	1.7	1.3	1.0	0.9	0.9	

1/ General government gross debt.

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

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

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

5/ For projections, this line includes exchange rate changes.

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

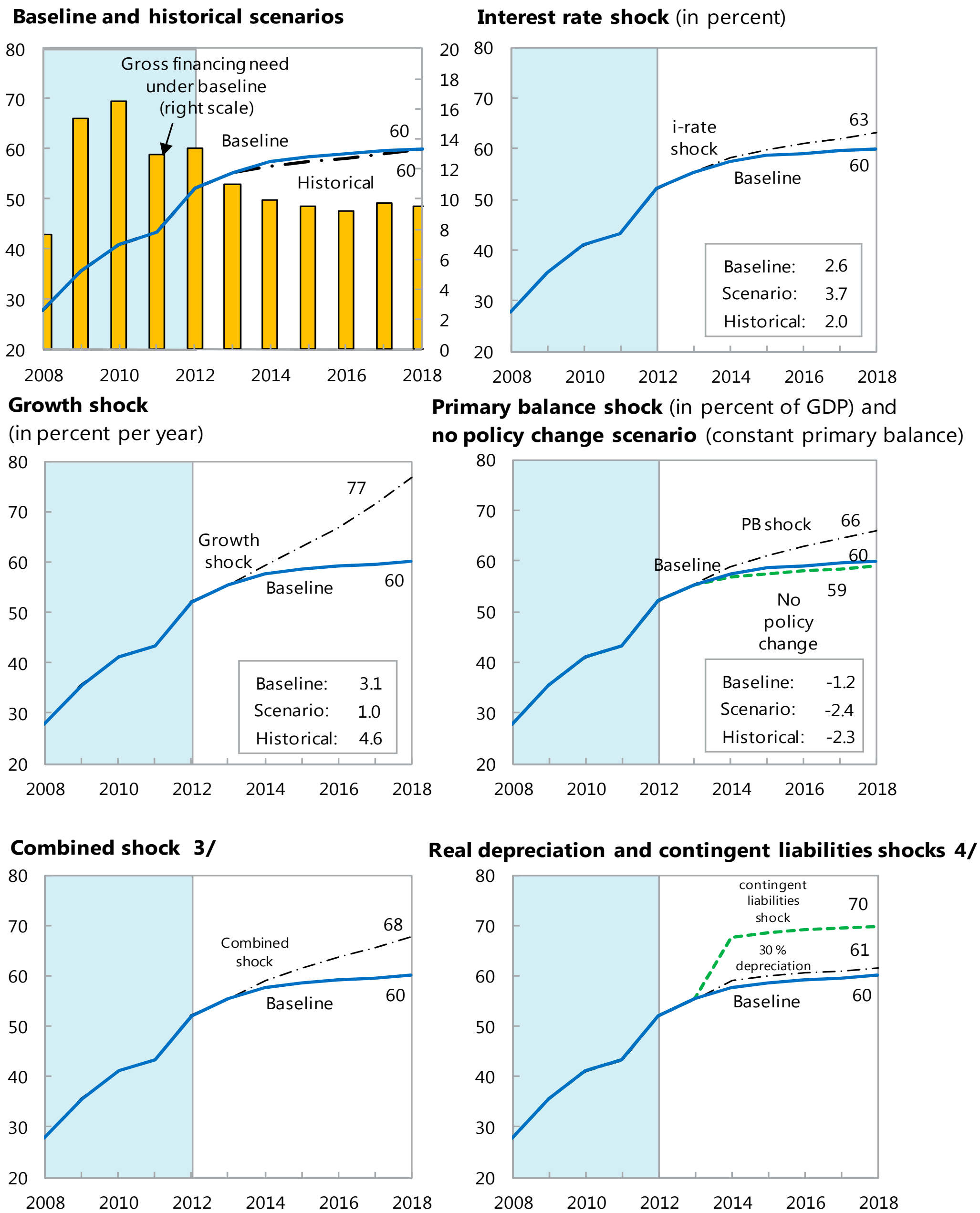
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

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

Figure 7. Slovak Republic: Public Debt Sustainability, Bound Tests 1/ 2/

(Public debt in percent of GDP)



Source: IMF staff estimates.

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

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

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

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, 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 7. Slovak Republic: External Debt Sustainability Framework, 2008–18

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	Debt-stabilizing non-interest current account 6/
Baseline: External debt	57.7	71.2	75.6	75.2	73.5			**71.8**	**68.7**	**65.1**	**61.2**	**57.2**	**53.5**	**3.4**
Change in external debt	8.2	13.6	4.4	-0.4	-1.7			-1.7	-3.1	-3.6	-4.0	-3.9	-3.7	
Identified external debt-creating flows (4+8+9)	-7.2	17.3	7.4	-5.0	-0.6			0.7	-0.9	-1.3	-1.7	-1.7	-1.7	
Current account deficit, excluding interest payments	4.8	1.1	2.4	0.5	-4.1			-4.3	-5.1	-5.7	-6.0	-6.3	-6.5	
Deficit in balance of goods and services	1.9	0.1	-0.1	-0.9	-5.5			-6.2	-7.0	-7.4	-7.5	-7.6	-7.7	
Exports	83.1	70.2	80.0	89.3	95.6			94.1	95.0	95.7	96.4	97.5	98.6	
Imports	84.9	70.3	79.9	88.4	90.1			87.8	87.9	88.3	88.9	89.9	91.0	
Net non-debt creating capital inflows (negative)	-3.0	9.9	3.6	-0.2	-1.7			3.4	3.8	4.0	4.1	4.1	4.1	
Automatic debt dynamics 1/	-9.0	6.2	1.4	-5.3	5.3			1.5	0.5	0.4	0.3	0.5	0.6	
Contribution from nominal interest rate	1.2	1.4	1.3	1.6	1.9			2.0	2.0	2.2	2.4	2.5	2.5	
Contribution from real GDP growth	-2.3	3.1	-3.1	-2.2	-1.6			-0.4	-1.6	-1.8	-2.0	-2.0	-1.9	
Contribution from price and exchange rate changes 2/	-8.0	1.7	3.2	-4.7	5.1			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	15.5	-3.7	-3.0	4.6	-1.2			-2.3	-2.2	-2.2	-2.3	-2.2	-2.0	
External debt-to-exports ratio (in percent)	69.4	101.5	94.5	84.2	76.9			76.4	72.4	68.1	63.4	58.7	54.3	
Gross external financing need (in billions of US dollars) 4/	27.7	27.4	38.6	37.5	34.7			24.6	23.6	23.1	22.6	22.0	21.4	
in percent of GDP	29.3	31.3	44.2	38.9	37.8	10-Year	10-Year	25.7	23.7	22.0	20.2	18.6	17.0	
Scenario with key variables at their historical averages 5/								**71.8**	**66.0**	**61.0**	**56.6**	**52.6**	**49.0**	**-5.3**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	5.8	-4.9	4.4	3.2	2.0	4.6	4.1	0.6	2.3	2.8	3.3	3.5	3.5	
GDP deflator in US dollars (change in percent)	19.2	-2.9	-4.3	6.6	-6.3	9.8	12.4	3.6	2.0	2.5	2.7	2.5	2.5	
Nominal external interest rate (in percent)	3.1	2.3	1.9	2.3	2.4	3.5	1.7	2.8	2.9	3.3	3.8	4.4	4.6	
Growth of exports (US dollar terms, in percent)	35.7	-22.0	13.9	22.9	2.3	23.9	22.3	2.5	5.3	6.1	6.9	7.3	7.3	
Growth of imports (US dollar terms, in percent)	38.0	-23.6	13.6	21.7	-2.6	22.0	21.5	1.6	4.4	5.8	6.8	7.3	7.3	
Current account balance, excluding interest payments	-4.8	-1.1	-2.4	-0.5	4.1	-2.5	2.9	4.3	5.1	5.7	6.0	6.3	6.5	
Net non-debt creating capital inflows	3.0	-9.9	-3.6	0.2	1.7	0.5	4.3	-3.4	-3.8	-4.0	-4.1	-4.1	-4.1	

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

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

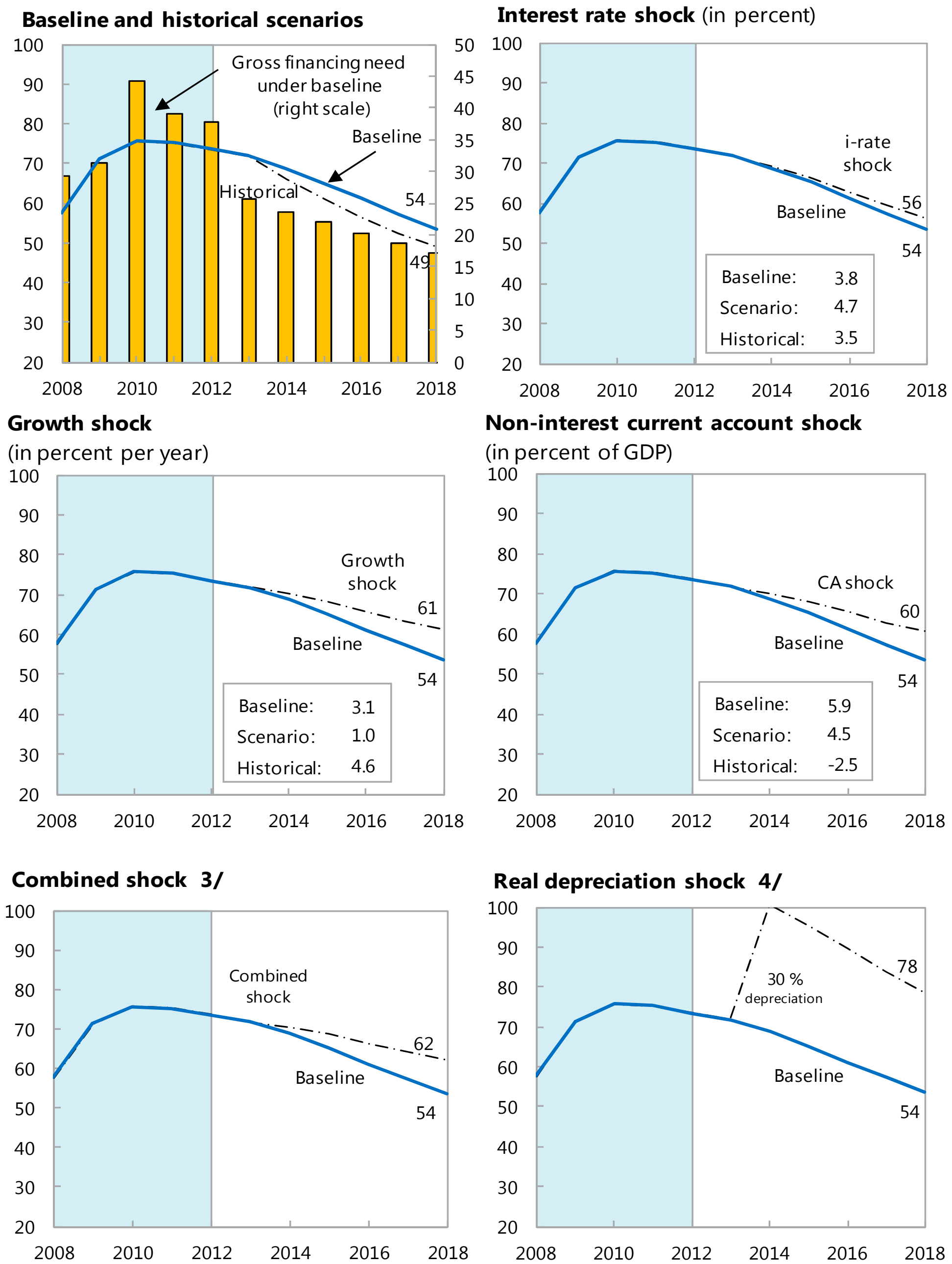
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Figure 8. Slovak Republic: External Debt Sustainability, Bound Tests 1/ 2/



Source: IMF staff estimates.

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

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2010.

Annex I. Slovak Republic: Risk Assessment Matrix

Risk	Relative Likelihood	Impact if Realized	Recommended Policies
Prolonged high unemployment	**Medium**	**High** • Sustained high unemployment would inhibit recovery in domestic demand and lower growth. • Hysteresis effects could lower potential growth and contribute to a generation of workers not well-integrated into the labor force. • Public debt is especially sensitive to growth shocks and could rise above 70 percent of GDP by 2018.	• Improve labor market / business climate (¶16).
Financial stress in the euro area re-emerges (triggered by stalled or incomplete delivery of national and euro area policy commitments)	**Medium**	**High** • Strong trade links to Europe, especially Germany, would hit Slovakia's exports and growth, exacerbating high unemployment. • Direct financial links to euro area countries under pressure are limited, as is funding from parent banks that could experience pressure, but NPLs could rise due to weaker growth and higher unemployment. Strong provisioning and capital adequacy help ameliorate risks from NPLs. • Financial market stress could raise interest costs and debt levels somewhat.	• Over long-term, diversify exports (¶16). • Financial links and risks are low (¶26). • Moderate pace of fiscal adjustment (¶21).
Protracted period of slower European growth (larger than expected deleveraging or negative surprise on potential growth)	**High**	**High** • Strong trade links to Europe, especially Germany, would hit Slovakia's exports and growth, exacerbating high unemployment. • Public debt is especially sensitive to growth shocks and could rise above 70 percent of GDP by 2018, well above debt brake levels.	• Over long-term, diversify exports (¶16). • Improve labor market / business climate (¶16). • High-quality fiscal measures (¶23).

[1/] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities.

Annex II. Slovak Republic: Authorities' Response to Past IMF Policy Recommendations

IMF 2012 Article IV Recommendations	Authorities' Response
Fiscal policy	
• Pursue deficit reduction without inhibiting growth (let automatic stabilizers operate). • Improve tax administration and expenditure efficiency. • Anchor the budget in a sound medium-term framework and include information on finances of public entities. • Carry out an actuarial analysis of the pension system.	• The government over-performed on the deficit target, taking additional measures to offset lower revenue from weaker growth. • The government adopted an Action Plan to Combat Tax Fraud in May 2012 and approved amendments of several related acts. • The Stability Program outlines a path to achieve the medium-term objective in 2018 with fiscal targets tighter than required by the EU given debt brakes under the Fiscal Responsibility Act. • An updated analysis of the Slovak pension system was prepared for peer-review in the EU's Ageing Working Group.
Financial sector policy	
• Subject all housing loans to the same LTV ratio. • Remove tax obstacles to promote rapid NPL resolution. • Enhance cooperation with home supervisors. • Promote financial deepening through looser second pension pillar investment restrictions and a secondary government bond market.	• Efforts are underway but need to be coordinated with EU legislation (e.g., mortgage credit directive). • Cooperation is carried out through Colleges of Supervisors pursuant to CEBS/EBA Guidelines. • Second pillar investment rules have been liberalized over past two years and brought very close to the UCITS investment directive.
Structural reforms	
• Improve investment climate, by strengthening the rule of law and fighting corruption. • Implement Labor Code reforms. • Better target vocational training to reduce skill mismatches. • Implement policies to reduce regional economic imbalances. • Reform rental housing market.	• An update to the 2011 strategy to improve the business environment was approved in 2013, work is underway on eGovernment services and public administration improvements, and an Action Plan to Combat Tax Fraud was adopted (see above). • Transparency will benefit from: measures on public procurement and the judiciary, and the registries for Insolvent Entities and Disqualified Persons. • Infrastructure construction is helping address regional imbalances and the business climate. • The Tertiary Schools Act was amended to improve educational quality and better match vocational education and training to labor market needs.

Annex III. Slovak Republic: Measuring the VAT Gap

Given low and declining VAT efficiency in Slovakia, improving VAT collection is one of the government's top priorities. To help raise VAT efficiency to the level of EU peers, an in-depth VAT gap analysis has been started with a view to measuring the compliance gap and better understanding the determinants of the poor VAT performance (through sectoral and other detailed revenue studies). This appendix summarizes the analytical framework (Section A) and preliminary findings (Section B).

A. Analytical Framework

Measuring the tax gap for better compliance management

1. **A good understanding of the sources of tax non-compliance is crucial to strengthen compliance management.** There are different forms of non-compliance (fraud, non-filing, incorrect reporting, non-payment, etc.), the relevance of which may vary by economic sector. It is therefore critical to have an in-depth understanding of the sources of non-compliance so as to better tailor remedial actions.

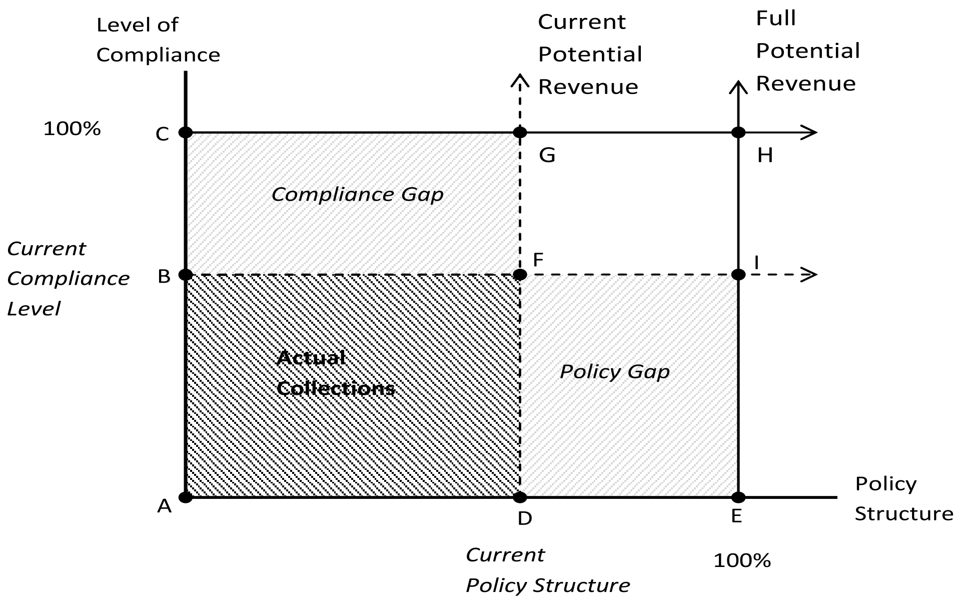
2. **A detailed analysis of the tax gap provides useful information in this respect, although it is not a panacea.** As all non-compliance behaviors would eventually lead to a loss of revenue, the amount of lost revenue, or "tax gap," is a good indicator of non-compliance. A detailed study of the sources of tax gaps could help understand, albeit indirectly, non-compliance behaviors. That would in turn help tax authorities develop an effective compliance management strategy. However, measuring tax gaps, together with complementary revenue analyses, would not always reveal how those gaps arise. This would require more in-depth scrutiny of taxpayer behaviors, for example through targeted tax audits.

3. **For compliance management purposes, the portion of the overall tax gap that is primarily due to non-compliance needs to be isolated.** The so-called "compliance gap" is defined as the difference between actual tax revenues and the theoretical amount that would be collected if all potential taxpayers fully complied with the applicable law. In this way, those revenues that the tax system does not collect by design (e.g., reduced rates and exemptions)—the "policy gap"—are excluded. This distinction between compliance and policy gaps is important, as the nature of the issues related to the policy gap is quite different from those related to the compliance gap; for example, while tax administration should aim at closing the compliance gap, reductions of the policy gap may not always be a sound policy objective. Even when curbing the policy gap is appropriate (e.g., overly wide exemptions), it would be a policy decision requiring the legislative changes.[1]

[1] Tax avoidance—taxpayer behavior which is technically legal but whose sole purpose is to enjoy tax benefits against the 'spirit' of the law—is also excluded from the definition, as it is beyond compliance management and would require policy action (i.e., legislative changes). However, measuring the revenue impact of tax avoidance behavior could be very difficult, not least because the tax regime is not expecting such behavior.

4. **Nevertheless, a broader perspective encompassing all components of the tax gap should be maintained**. It is indeed crucial to assess to what extent the overall gap is being influenced by either compliance issues or policy choices.[2] The relationship between the compliance gap, the policy gap and the overall tax gap is illustrated in Figure 1.

Figure 1. The components of the tax gap



In more analytical terms, a commonly used measure for revenue productivity is "C-efficiency", which is an indicator of the departure of the VAT from a perfectly enforced tax levied at a uniform rate on all consumption:[3]

$$\text{C-efficiency} = \frac{\text{VAT Revenue}}{\text{(Final Consumption)(Standard VAT Rate)}}$$

As discussed above, the C-efficiency can be decomposed into a policy gap and a compliance gap:

$$\text{C-efficiency} = (1 - \text{policy gap})(1 - \text{compliance gap})$$

In a nutshell, the design features of the VAT are essentially two: the exemptions (i.e., the extent of final consumption not subject to VAT) and the rate structure. Therefore, the policy gap can in turn

[2] In order to identify the size of the "policy gap" the current policy structure must be measured against some normative policy structure, similar to the process needed to estimate the value of tax expenditures. As the primary purpose here is to address non-compliance issues, we could simply assume that the normative policy structure is the current standard rate being applicable to all potential taxpayers and activities without any exemption (or alternatively, in the case of Slovakia, with only those exemptions specified in EU directives). In a different context, a broader definition of the policy gap might be useful; for example, to discuss policy options, the impact of a rate reduction from 20 percent to 19 percent could be considered as a policy gap.

[3] For further details on C-efficiency, see Michael Keen, 2013, "The Anatomy of VAT," IMF Working Paper WP/13/111.

be decomposed into an exemption gap and a rate gap, which captures the impact of differentiation in statutory rates across goods:

C-efficiency = (1 – exemption gap)(1 – rate gap)(1 – compliance gap)

This clearly shows that a good deal of caution should be used in interpreting the C-efficiency for compliance management purposes. Low C-efficiency does not necessarily imply that the compliance gap is large. For example, as the provision of pure public goods is not taxable under any VAT design, a low C-efficiency may be the result of a high share of those goods in final consumption.

Expenditure and production approach for VAT gap analysis

5. **The VAT gap can be measured in two ways: the expenditure approach and the production approach.** The former looks at the VAT as a tax on (final) consumption, whereas the latter as a tax on the value added in the production process. Accordingly, they are also referred to as the consumption approach and the value added approach, respectively.

Expenditure (consumption) approach

6. **The expenditure approach estimates the gap from the ultimate VAT tax base, that is, final consumption.** If there is no reduced rate or exemption, final consumption multiplied by the standard rate would be equal to the potential VAT yield. If there are reduced rates, the potential amount of VAT proceeds would be equal to the sum of final consumption of each commodity multiplied by the respective applicable VAT rate. The various rates that are applied to intermediate consumption can be ignored since the VAT is specifically designed to remove all tax burdens on intermediate inputs (including investment).

7. **The application of exemptions makes the VAT system more complex, as it puts certain supplies outside the VAT system, severing the VAT chain.**[4] While the mechanism of exemption is rather simple—the VAT is not levied on certain output categories and the VAT on their inputs is not creditable—the way it affects VAT revenue may not be straightforward, especially when it occurs in the middle of the production chain. There are broadly three cases to consider: (1) when final consumption supply is exempted, only the value added by the person making the supply escapes VAT (VAT already paid earlier in the production chain is not recoverable);[5] (2) when an exempt supply is made to a person making taxable supply, there is no revenue impact, as the complete VAT base will be restored (i.e., the value added that escaped VAT due to the exemption will be recouped); but (3) VAT inclusive supply used to make an exempt supply to a person making taxable

[4] The VAT threshold can be considered as a special case of exemption. So is public final consumption—e.g., provision of public goods.

[5] If there is a series of consecutive and uninterrupted exemptions leading to final consumption, those exemptions can be treated as a single exemption—with all of the value added by those making such exemptions escaping VAT.

supply will be subject to tax: such supply will be taxed twice and VAT itself is taxed.[6] Since the last case can be reasonably assumed to be small, the potential VAT revenue is determined as follows:

$$PV = \sum_{c=1}^{E-1}(FC_c \times \tau_c) + \sum_{c=E}^{M}\{(N^c + I^c) \times \tau^c\}$$

where,

PV = the potential net VAT,

FC_c = final consumption of commodity c (of *M* commodities, *E*th through *M*th commodities are exempt)

N^c = intermediate consumption to supply commodity c,

I^c = investment made to supply commodity c,

τ^c = the weighted average VAT rate applicable to input to supply commodity c, and

τ_c = the VAT rate that applies to commodity c (zero if zero-rated)

Although the expenditure approach starts from final consumption, for which reliable data should be relatively easy to obtain, the second term on exempt supplies (including provision of pure public goods) requires further estimation on intermediate consumption and investment patterns by exempt suppliers.

Production (value added) approach

8. The value added approach follows the process of VAT collection along the production chain—taxing output with input credited. Any registered VAT taxpayer would (i) collect VAT on imports, (ii) collect VAT on domestic supply, (iii) receive credit on VAT paid on input (including investment), and (iv) receive credit on VAT paid on input for export (zero-rated).[7] Assuming a single representative taxpayer per sector (i.e., ignoring taxpayer specific treatments, if any):

$$PV^s = \sum_{c}(M_c^s \times \tau_c) + \left[\sum_{c}(Y_c^s - X_c^s) \times \tau_c\right] \times r^s - \left[\sum_{c}(N_c^s + I_c^s) \times \tau_c\right] \times r^s \times (1 - e^s)$$

where,

PV^s = the potential net VAT for a sector,

M_c^s = imports by sector s of commodity c,

Y_c^s = output by sector s of commodity c,

[6] This additional tax on VAT inclusive input is one-off and will not cascade down the chain, as VAT would relieve any tax paid on input as long as taxable supply continues.

[7] To "collect" here means to collect and submit the VAT to the tax authorities. For example, VAT on input will be "collected" by the supplier, although the purchaser pays a VAT-inclusive price.

X_c^s = exports by sector s of commodity c,
N_c^s = intermediate demand (consumption) by sector s of commodity c,
I_c^s = investment by sector s of commodity c,
τ_c = the VAT rate that applies to commodity c (zero if zero-rated or exempt),
e^s = the proportion of output for a sector which is exempt output, and
r^s = the proportion of output for a sector produced by registered businesses.

9. The value added approach, while requiring detailed supply-use tables, enables sectoral gap analyses. As discussed above, the value added approach requires matrices of domestic output (Y), imports (M), intermediate consumption (N), investment (I) and exports (X) by individual sectors and products. Supply tables provide total supply comprising Y and M, while use tables provide total use comprising N, final consumption (FC), I and X.[8] From the supply-use identity, it can be shown that the above calculation (Y + M - (N + I + X)) is a decomposition of final consumption (FC). The value added approach, when matrices can be reasonably estimated, enables gap analyses by sectors, which would be instrumental in developing an effective compliance management strategy.

B. Preliminary Findings[9]

10. In Slovakia, a VAT gap model based on the value added approach is being developed with assistance from IMF staff. The model, which combines detailed tax returns and payments data, national accounts and other statistical data, is expected to complement and expand the earlier analyses by the Slovak authorities based on the expenditure approach.[10] The preliminary findings from the new value added model are summarized below.

11. The preliminary results indicate that the compliance gap is the main driver of Slovakia's VAT inefficiency. The policy gap is indeed relatively small. As discussed above, the policy gap is a function of the rate gap and the exemption gap. The relative sizes of those two metrics depend upon the system of rates and exemptions currently in force in Slovakia and the structure of the economy. In Slovakia, compared with other countries, relatively few categories of suppliers are taxed at reduced rate or exempted, and their share in the overall economy is relatively small. Figure 2 shows the hypothetical policy gaps that selected EU countries would experience if the Slovak structure of VAT rates and exemptions were applied. The low ranking of Slovakia confirms that the Slovak economy has more room to tax than peers. Since the policy gap proves to be small, Slovakia' low C-efficiency denotes very serious problems of tax compliance.

[8] Supply-use tables should provide sector-by-product matrices for Y and N, but only product vectors for M, I and X. Where a matrix is not available, it needs to be estimated from product vector and other information.

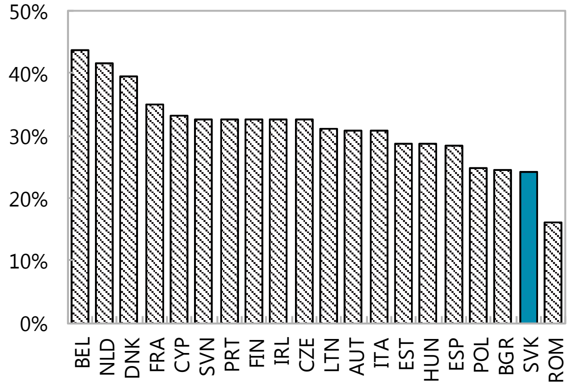
[9] The modeling for the VAT gap estimate and related revenue analyses (initially for 2008-2012) are still at preliminary stages. All the analyses in this appendix are subject to revisions and therefore should be understood and treated as illustrations.

[10] Institute for Financial Policy, Ministry of Finance of the Slovak Republic, 2012, "The estimate of the value added tax revenue loss".

Input credit

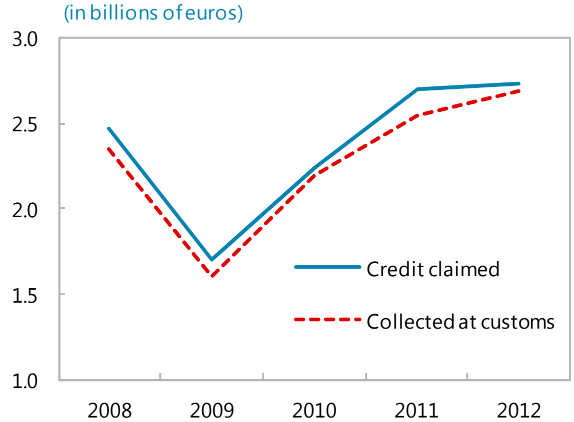
12. Over-crediting might be contributing more to the VAT gap than under-reporting. Reported gross VAT (VAT collected on output) seems broadly consistent with the model estimates. However, reported net VAT (VAT payable after deducting applicable input credit) is much smaller than the model results. This implies that those who are filing VAT returns are over-claiming input VAT credit.

Figure 2. Hypothetical Policy Gap under Slovak Policy Structure; 2009



13. Import credit claimed is systematically larger than the import VAT collected at the border. While the difference between the two aggregates is not substantial, the positive sign of the discrepancy is a concern, although it might also reflect data issues. As imports—in particular imports from non-EU countries subject to actual VAT payments at the border—are more likely to be accounted for than import VAT credit which can be claimed only by registered taxpayers, a discrepancy, if any, is expected to be negative. Cross-checking data between the revenue and customs authorities should allow verification of the legitimacy of import VAT credit claims.

Figure 3. Import VAT
(in billions of euros)



14. The legitimacy of input credit should be checked systematically, without hampering economic transactions. In Slovakia, claimed credits are cleared without delay (being either offset against gross VAT or refunded). This is a very good practice that should continue. However, such a good system, if misused, could pose serious risks for revenue. To strike a good balance between effective screening of fraudulent claims and smooth clearance of claimed credit, a risk-based approach should be considered. However, some forms of fraud, most notably "carousel" or missing trader intra-community (MTIC) fraud, do not directly appear in the model as fraudulent claims (MTIC fraud would replace intra-community imports with domestic supply, producing valid input credit but without collecting VAT on such domestic supply). Certain inferences would then be necessary to supplement the model outcomes.

Sectoral analysis

15. Compliance risk appears to be concentrated in a few sectors. The discrepancies between sectoral net VAT (VAT due on supply less VAT on input for the sector) and theoretical VAT revenue of the sector (derived through the value added model)—or sectoral VAT gaps—are concentrated in a few sectors. While there may well be legitimate causes behind some of the discrepancies (which would need to be reflected in the model through future refinement), all major discrepancies should

be clearly recognized and explained. If gaps are being generated by preferential treatments, policy makers should be aware of the costs of maintaining such regimes. Otherwise, these discrepancies signal a compliance gap, and thus targeted analyses should be conducted to determine the appropriate remedial actions to address the specific non-compliance issues in those sectors.

INTERNATIONAL MONETARY FUND

SLOVAK REPUBLIC

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 16, 2013

Prepared By	European Department

CONTENTS

FUND RELATIONS

(As of June 30, 2013)

Membership Status: Joined 1/1/1993; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	427.5	100
Fund holdings of currency	286.5	67.02
Reserve position	141.01	32.98
Lending to the Fund	53.93	

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	340.48	100
Holdings	312.39	91.75

Outstanding Purchases and Loans: None

Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	7/22/1994	3/21/1996	115.8	32.15

Projected Payments to Fund:

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

		Forthcoming			
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.01	0.02	0.02	0.02	0.02
Total	0.01	0.02	0.02	0.02	0.02

Exchange Rate Arrangement:

The currency of the Slovak Republic is the euro, which was adopted on January 1, 2009.
The Slovak Republic has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. The Slovak Republic maintains exchange restrictions for security reasons, based on UN Security Council Resolutions and Council of the European Union Regulations that have been notified to the Fund under the procedures set forth in Executive Board Decision No. 144–(52/51).

Article IV Consultation:

The consultation discussions were held in Bratislava during May 22-June 4, 2013. The mission met with Minister of Finance Kažimír; National Bank of Slovakia (NBS) Governor Makúch; officials from the Ministry of Finance, the NBS, the debt management agency (ARDAL), and the Ministries of Labor, Education, and Health; as well as representatives of financial institutions, think tanks, labor unions, employers' associations and enterprises.

The team comprised Messrs. John (head) and Giustiniani, Ms. Zhao (all EUR), and Mr. Ogata (FAD), and was assisted at headquarters by Messrs. Winnekens and Augustinyak and Mmes. de Moraes Rego and Adu. Mr. Jakoby (Senior Advisor to the Executive Director) accompanied the mission and Mr. Prader (Executive Director) attended the concluding meeting. The mission's concluding statement was published on the IMF website on June 4, 2013.

The previous consultation with the Slovak Republic was concluded on July 11, 2012 (IMF Country Report No. 12/178).

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). An FSAP update mission was held in December 2006. The FSSA update report was circulated to the Executive Board together with the staff report for the 2007 Article IV Consultation and published on the IMF website on July 17, 2007.
The report on the Fiscal ROSC was issued in August 2002 (IMF Country Report No. 02/189), and updates were issued in August 2003 (IMF Country Report No. 03/236) and in March 2005 (IMF Country Report No. 05/73). The report on the Data ROSC was issued in May 2005 (IMF Country Report No. 05/161).

Technical Assistance: See the attached table.

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

Table 1. Slovak Republic: Technical Assistance, 2000–12 1/

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	Multi sector mission
	July 2003	Government finance statistics
	February–March 2004	Data ROSC Mission

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

STATISTICAL ISSUES

1. **Coverage, periodicity, and timeliness of data provided to the Fund are adequate for surveillance purposes.** From the point of view of macroeconomic analysis and policy making, significant data improvements have been made, particularly in the national accounts. A data ROSC mission 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) a significant statistical discrepancy between the supply and demand sides for GDP; and (ii) weaknesses in the data on prices and volumes of imports and exports. The Slovak Republic has subscribed 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 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.

Real Sector and Prices

3. **Despite significant progress made so far, the compilation of the national accounts statistics still suffers some weaknesses.** The quarterly and annual national accounts data exhibit significant statistical discrepancies 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 statistical authorities are aware of these issues and improvements are pending.

Fiscal Sector

4. **General government statistics are compiled in accordance with the methodology of the ESA95.** The Ministry of Finance compiles its fiscal accounts according to ESA95 standards and reports general government net lending/borrowing and gross debt on a quarterly 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.

External Sector

5. External sector statistics are of good quality, and are reported on a timely basis to the Fund. However, the errors and omissions in the balance of payments statistics are large and reported financial account flows are subject to large volatility. The statistical authorities are aware of these issue and are working to address them.

Monetary Sector

6. Monetary statistics are of good quality, and are reported on a timely basis to the Fund.

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

(As of June 28, 2013)

	Date of Latest Observation	Date Received	Frequency of Data 6/	Frequency of Reporting 6/	Frequency of Publication 6/	Memo Items: Data Quality – Methodological soundness 8/	Memo Items: Data Quality – Accuracy and reliability 9/
Exchange Rates	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Jun. 2013	Jun. 2013	D	M	M		
Reserve/Base Money	May 2013	Jun. 2013	M	M	M	...	...
Broad Money	May 2013	Jun. 2013	M	M	M	...	...
Central Bank Balance Sheet	May 2013	Jun. 2013	M	M	M	...	...
Consolidated Balance Sheet of the Banking System	May 2013	Jun. 2013	M	M	M		
Interest Rates 2/	Current	Current	D	D	D		
Consumer Price Index	May 2013	Jun. 2013	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing 3/ – General Government 4/	2013Q1	Jun. 2013	A	A	A	LO, LO, LO, O	O, O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing 3/ – Central Government	2013Q1	Jun. 2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt 5/	2013Q1	Jun. 2013	Q	Q	Q		
External Current Account Balance	May 2013	Jun. 2013	M	M	M	O, O, LO, O	LO, O, LO, O, LO
Exports and Imports of Goods and Services	May 2013	Jun. 2013	M	M	M		
GDP/GNP	2013Q1	Jun. 2013	Q	Q	Q	O, O, LO, LO	LO, O, LO, O, LO
Gross External Debt	2013Q1	Jun. 2013	Q	Q	Q		
International Investment Position 7/	2012Q4	Jun. 2013	Q	Q	Q		

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
7/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
8/ 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).
9/ 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.

Press Release No. 13/310
FOR IMMEDIATE RELEASE
August 15, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with the Slovak Republic

On August 2, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Slovak Republic[1] and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Following a sharp downturn in 2009 in the context of the global economic and financial crisis, Slovakia emerged as one of the fastest growing economies in the EU, supported in particular by substantial foreign investment in the auto sector and subsequent exports. Growth slowed to 2 percent in 2012 as the impact of exceptionally large investments in 2011 faded. For 2013, the growth forecast is 0.6 percent, reflecting especially the weakening external environment. Domestic demand has been held back by persistently high unemployment—around 14 percent, with about two-thirds of this long-term, and an especially high rate among Slovakia's youth (around 35 percent).

Slovakia has reduced its fiscal deficit substantially since 2009, reaching a deficit of 4.3 percent of GDP in 2012, and enjoys moderate public and private debt levels. Inflation fell to 1.6 percent in June 2013, record trade and current account surpluses were recorded in 2012, and the banking system remains sound with healthy levels of capital and liquidity.

Executive Board Assessment

In concluding the 2013 Article IV consultation with the Slovak Republic, Executive Directors endorsed the staff's appraisal, as follows:

After a strong recovery in the wake of the global crisis, the Slovak economy is expected to continue growing, but at a significantly slower pace in 2013. The Slovak Republic has been among Europe's most dynamic economies in recent years, largely due to sizeable foreign

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

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

investment in the auto sector that led to rapidly rising exports, much faster growth than most others in the region, and limited vulnerabilities. Spillover risks are materializing, however, with weaker demand expected from trading partners, especially in Europe. This, coupled with still anemic domestic demand, has worsened the near-term outlook.

Risks are tilted to the downside. Domestic demand is expected to slowly recover but will remain restrained for some time due to ongoing fiscal adjustment as well as high unemployment. If prolonged, high unemployment risks negatively affecting growth, fiscal consolidation, and debt ratios, as well as long-term labor participation and productivity. If weakness in Europe is deeper or more drawn out than expected, this could reduce export demand and contribute to uncertainty holding back investment. Integration into international supply chains has brought great opportunities, but can also amplify risks from trade shocks, underscoring the importance over the medium term of new sources of growth and export diversification.

Addressing very high unemployment—particularly youth and long-term unemployment—should be a top priority. Efforts underway to strengthen education, training, and active labor market policies (ALMPs) including targeting to disadvantaged groups are welcome, but are still at an early stage. Public employment services should be strengthened and funding for ALMPs—which was increased in the 2013 budget—should be a priority even amidst budget consolidation. Effective use of EU Funds will be especially important in these areas. Steps to streamline administrative burdens for businesses are also welcome, and should be complemented by action to achieve a more stable, open, and predictable business climate with respect to labor regulations, the legal environment, procurement practices, and corruption.

Slovakia has demonstrated its strong commitment to sustainable public finances but further progress is needed. The fiscal deficit has come down substantially since 2009 and important structural reforms have been implemented, such as those that strengthen the pension fund's finances, but other sources of revenue or savings have been temporary or have affected valuable projects such as those financed by EU Funds. Slovakia's gross public debt, which includes contributions to support other euro area members and a healthy level of cash balances, remains manageable. However, to avoid economically harmful effects from debt rising above thresholds under the FRA (Forward Rate Agreement) as well as to comply with EU targets, substantial additional adjustment measures will be needed for a number of years.

The 2013 fiscal deficit target is achievable, but automatic stabilizers should be allowed to operate if risks to growth materialize. Provisions in the 2013 budget, additional steps taken so far, and the government's readiness to take further measures that would have little macroeconomic impact suggest the 2013 target can be met. There are risks to this scenario, including the possibility of still weaker growth or difficulties controlling public wages and local government budgets. And should growth further disappoint, automatic stabilizers should be allowed to operate to avoid a further drag on output when growth is weakest.

Efforts should focus on identifying high quality fiscal measures for 2014 and over the medium term. Further fiscal consolidation is needed to ensure medium-term debt sustainability, and in light of EU rules and a domestic debt brake that would mandate an overly sharp move to balance the budget. In addition to maintaining the current VAT rate, adjustment efforts should focus on improving VAT collection efficiency and reducing tax evasion, introducing a property value-based real estate tax, and improving spending efficiency. Moving more quickly to a higher retirement age and potentially raising the overall age target would improve the long-term sustainability of the pension system.

A traditional banking model and prudent supervisory approach have contributed to a sound banking system. Slovakia's banking sector is liquid and well capitalized, with low and well-provisioned nonperforming loans (NPLs), although a weaker economic outlook could have effects on credit quality. Bank taxes have risen at a time when the operating environment is weak and credit to firms is declining, hitting profits. The levy should be lowered to be more in line with other countries in Europe and the proceeds allocated to a more well-defined special resolution fund. The size of the banking system has facilitated close supervision (and risks are low), but the current supervisory framework could be enhanced through a more well-specified intervention and resolution framework, in line with expected European directives and banking union developments.

Slovak Republic: Summary of Economic Indicators, 2010–14

	2010	2011	2012	2013 (Projections)	2014 (Projections)
	(Annual percentage change, constant prices, unless noted otherwise)				
Output/Demand					
Real GDP	4.4	3.2	2.0	0.6	2.3
Domestic demand	3.9	1.4	-3.1	-1.2	1.7
Public consumption	1.0	-4.3	-0.6	-0.9	1.2
Private consumption	-0.7	-0.5	-0.6	-0.5	0.9
Gross fixed capital formation	6.5	14.2	-3.7	-2.1	2.4
Exports of goods and services	16.0	12.7	8.6	2.3	4.2
Imports of goods and services	14.9	10.1	2.8	0.8	3.3
Output Gap	-0.8	-0.5	-1.2	-2.5	-2.2
Potential Growth	1.6	2.9	2.7	1.9	2.0
Contribution to growth					
Domestic demand	3.6	1.2	-3.2	-0.9	1.2
Public consumption	0.2	-0.8	-0.1	-0.2	0.2
Private consumption	-0.4	-0.3	-0.3	-0.3	0.5
Gross fixed capital formation	1.3	3.0	-0.9	-0.5	0.5
Inventories	2.5	-0.7	-1.9	0.0	0.0
Net exports	0.7	2.0	5.2	1.5	1.0
Prices					
Inflation (HICP)	0.7	4.1	3.7	1.7	2.0
Inflation (HICP, end of period)	1.3	4.6	3.4	1.7	2.1
GDP deflator	0.5	1.6	1.4	1.5	1.4
Employment and wages					
Employment	-1.5	1.8	0.1	-0.5	0.1
Nominal wages	5.1	3.7	4.1	2.1	2.9
Unemployment rate (percent)	14.5	13.6	14.0	14.6	14.7
	(In percent of GDP)				
Public Finance, General Government 1/					
Revenue	32.3	33.3	33.1	34.5	32.9
Expenditure	40.0	38.3	37.4	37.4	36.6
Overall balance	-7.7	-5.1	-4.3	-2.9	-3.8
Primary balance	-6.3	-3.5	-2.5	-0.9	-1.7
Structural balance (percent of potential GDP)	-7.2	-4.8	-4.4	-3.5	-3.4
General government debt	41.0	43.3	52.1	55.3	57.5
excl. EFSF and ESM contributions	41.0	43.0	49.7	52.1	54.0
	(In percent)				
Monetary and financial indicators					
Bank credit to private sector (growth rate)	4.8	8.6	2.9		
Lending rates 2/	4.6	4.7	4.4		
Deposit rates 3/	1.2	1.6	1.4		
Government 10-year bond yield	3.9	4.4	3.4		

Slovak Republic: Summary of Economic Indicators, 2010–14 (continued)

	2010	2011	2012	Projections 2013	Projections 2014
	(In percent of GDP)				
Balance of payments					
Trade balance (goods)	1.2	1.4	5.1	5.7	6.4
Current account balance	-3.7	-2.1	2.3	2.3	3.1
Gross external debt	75.6	75.2	73.5	71.8	68.7

Sources: National Authorities and IMF staff estimates.
1/ No policy change scenario – i.e., it assumes no fiscal measures beyond those expected in 2013. The staff report for the 2013 Article IV Consultation includes a text table with an active policy scenario.

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

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