Slovak Republic: Staff Concluding Statement of the 2017 Article IV Mission

February 1, 2017

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Slovakia is an economic success story. Twenty years of sustained economic convergence has lifted real incomes to more than 70 percent of the European Union average. However, with regional disparities and ageing pressures among the most severe in Europe, significant challenges remain. Fiscal and structural policies need to support a sustained and more equitable convergence. Also, growing bank exposure to the real estate sector requires the authorities' continued vigilance and further pre-emptive policy measures may be needed.

Economic growth continues apace. The economy grew by an estimated 3.3 percent last year. Rising employment, low inflation, and rapid household credit growth boosted consumption, although low absorption of EU funds, reflecting the beginning of the new programming period, dampened investment and imports. The economy is operating at close to its full potential, and unemployment rate has returned to its pre-crisis level. With the supply of available, highly-skilled workers nearly exhausted, labor market began to absorb lower-skilled individuals and those coming off of long spells of unemployment. Tight labor markets pushed up wages even as average productivity growth slowed. Looking ahead, growth is expected to be broad-based and remain at 3.3 percent this year. In the medium-term, higher investment in the automotive sector is projected to accelerate growth.

The optimistic medium-term outlook is not without risks. The United Kingdom's plans to exit the European Union increase uncertainty and could affect Slovakia through slower growth in key trading partners. Europe's political calendar, with elections in the Netherlands, France, and Germany in 2017, adds to this uncertainty. However, strong external fundamentals along with moderate public indebtedness and financing needs provide a cushion against possible external shocks. The rapid growth of credit to households is a potential domestic risk, particularly if the labor market falters following a negative external shock.

There are also significant long-term challenges. Productivity growth, which has been the key driver of Slovakia's strong convergence, has nearly halved since 2008. With population aging, a further slowdown is likely unless countered by structural reforms. Similarly, Slovakia's economic success has not been evenly shared by all regions, with the gains heavily concentrated in the Bratislava region. Underdeveloped infrastructure, lower educational attainment, and low labor mobility have held back the Eastern and Central regions, keeping a sizable part of the population unemployed or outside the labor force. Addressing these challenges would require effective and timely absorption of EU funds.

Creating Fiscal Space to Address Regional Disparities and Aging Pressures

Overall fiscal balance improved in 2016. The headline deficit narrowed to an estimated 2 percent of GDP largely driven by much lower EU funds absorption due to the start of a new programming period. The authorities made modest progress toward further gains in revenue efficiency and expenditure restraint. Sovereign risk spreads remain historically low.

With a closed output gap, the planned fiscal consolidation is timely. However, the 2017-2019 budget relies on lower capital expenditure, modest revenue measures and an intention to contain growth in public sector wages and social benefits, to reach the objective of a balanced budget by 2019. The mission's findings suggest that this objective may be undermined by pressures to increase wages in the context of a tight labor market, as well as demand for higher social spending. To support authorities' intended fiscal consolidation, the mission recommended the following actions:

- *Spend more effectively*. The mission supports the authorities' "value for money" initiative as a useful initial step to pave the way to a comprehensive spending review. Savings identified through current and future reviews should, at least in part, be used to support the consolidation effort rather than being fully reallocated for spending within the same sector. Any revenue over-performance should be allocated transparently.

- *Enhance tax efficiency*. Increasing Slovakia's value-added tax efficiency to the EU average could produce an additional 0.9 percent of GDP in revenues. In particular, a compliance strategy underpinned by further tax administration reforms would complement the legal and administrative measures taken in recent years. The establishment of a well-defined corporate income tax base and targeting compliance efforts on the economic sectors with highest evasion rates would further support revenue gains.

- *Broaden the tax base*. The convergence of property and environmental tax collections to EU average levels would entail (i) basing the property tax on market values instead of surface area (ii) removing the zero-rate applied to inheritance when property is held for more than five years; and (iii) increasing environmental taxes. These measures could produce added revenues of up to 2 percent of GDP.

These measures will create space to help address looming fiscal needs arising from high regional disparities and population aging. Developing a comprehensive strategy to reduce regional disparities is essential and will require sizable investment in infrastructure and human capital in the long run. Improving the quality of education in poorer regions will require a stronger commitment and additional resources beyond the small scale initiatives currently supported by EU funds. Due to an aging population, pension and health care spending is projected to grow by one-third between 2013 and 2060, roughly 4.5 percent of GDP. Lower productivity growth and further openings of the Pillar II pension system could further aggravate the rising pension expenditures trend.

Steady implementation of recently adopted pension reforms is imperative. The authorities undertook noteworthy and significant pension reforms in 2012. Successful implementation of these reforms is projected to reduce pension expenditures through 2030 before aging dynamics drive expenditures up. Additional measures can be considered to further ease the fiscal burden by linking social contributions to annual rather than monthly income, and indexing pension awarded upon retirement to inflation and the retirement age to life expectancy more closely. In addition, recourse to Pillar II openings should be avoided. In the health sector, current efforts to centralize procurement and restructure the hospital network should be advanced to meet the evolving needs of an aging population in a cost-effective manner.

Any modification to the Fiscal Responsibility Act, Slovakia's fiscal anchor, should be carefully considered. To strengthen cash management, modifications to allow for government cash balances to be netted out from gross debt can be considered when assessing performance relative to the debt ceiling. However, the introduction of any escape clause for investment spending should be avoided to allow the budget process to remain a forum for assessing the relative merits of competing demands for government spending. A sizable amount of EU funds for the 2014-20 programming period has been allocated to infrastructure investment. The focus needs to be on identifying priority projects that clearly facilitate further investment and increased labor mobility in under-developed regions, establishing clear selection criteria and following a competitive procurement process.

Safeguarding Financial Stability

The banking system is stable and well capitalized, but there are growing vulnerabilities. Banks are profitable despite the operating challenges posed by the low interest rate environment and the burden of regulatory fees. Asset quality remains strong with non-performing loans at 4.6 percent. However, after five years of double-digit loan growth to households, real estate loans now account for over half of total private sector credit. While strong credit growth mostly reflects financial deepening, household indebtedness in Slovakia is now one of the highest in central and eastern Europe. In addition, interest rates on over 80 percent of new mortgage loans reset in less than five years.

The authorities have taken proactive steps to manage financial system risks. To preserve lending standards, the National Bank of Slovakia has tightened requirements on loan-to-value (LTV) ratios for new loans and announced a tightening of the debt-service-to-income ratio in 2017. To address systemic risks, the NBS also increased the required capital for other significant institutions by as much as 2 percent, and imposed a systemic risk buffer of up to 1 percent in 2017. With mounting evidence that the credit cycle is on an upswing, the NBS announced that the countercyclical buffer would rise from zero to 0.5 percent on August 1. These macro-prudential measures will help preserve lending standards and increase capital buffers.

Further steps could be considered to prevent a deterioration of credit quality in the current high credit growth environment. In line with the latest Basel proposals, the authorities are encouraged to impose higher risk weights on mortgage loans with LTV ratios over 80 percent or on mortgage loans for investment properties. Further lowering the maximum LTV ratio, which is among the highest in the euro area, could reduce the average credit risk on new loans. Finally, eliminating the preferential treatment of capital gains from housing investment may curb demand for real estate investment. At the same time, lowering the bank tax to 0.1 percent as originally planned would relieve pressures on banks' profitability.

Ensuring a Steady Pace of Convergence

Slowing productivity growth poses risks to long-term convergence. Slovakia has achieved enviable success in increasing its market share within the EU. Strong cost competitiveness and early links with German automotive supply chains contributed to this outcome. Sustaining the convergence path will require further reforms to ensure optimal and efficient use of the labor force and a better business environment.

Judicious use of active labor market policies can ease labor market segmentation. Current efforts to de-emphasize activation programs in favor of measures to put the long-term unemployed, who are predominant in the less developed regions, into steady jobs and to stimulate on-the-job training are appropriate. Efficiency savings identified in the ongoing expenditure review of labor market policies should help ensure value-for-money from these programs. To help address the current skills mismatch in the Bratislava region, the procedures for granting work permits to foreign workers could be simplified. In the long run, vocational training needs to be strengthened to ensure better skills match in the labor market.

Reforms to improve the business environment will boost productivity growth. Surveys conducted by international organizations indicate that perceptions of corruption and a lack of impartiality in the judiciary negatively affect views of Slovakia's business climate. To address these shortcomings, Slovakia needs to implement measures to improve the efficiency, transparency, and independence of its judicial system. Enforcement of the ban on offering and accepting unethical advantages by government officials in the management of public property will be important. In addition, mandatory disclosure rules for public companies, government contracts, and government officials should be extended to cover local government, as well.

The IMF staff team would like to thank all counterparts in the government, the NBS, and the private sector for the excellent organization, hospitality, and the open and constructive discussions.