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Statement by Mr. Raczko and Mr. Gąsiorowski on Slovak Republic
(Preliminary)
Executive Board Meeting
June 6, 2007

We would like to thank staff for the well prepared set of papers and Mr. Prader and Mr. Jakoby for their Buff statement.

We congratulate our neighbors for the impressive performance last year, with very strong growth and well founded expectations for its continuation in the coming years. The authorities' past policies contributed considerably to this favorable development.
We note that the Slovak Republic has a significant current account deficit. However, its size can be explained taking into account necessary imports for the buoyant automotive industry, funded in part by strong foreign direct investment (FDI). Another reassuring factor may be that capital goods represented the most dynamic category of imports in 2006. In the case of the Slovak Republic, the automotive industry will certainly be a significant export driver and therefore we find support for staff's forecasts of declining current account deficit in the next years. Although export growth is expected to pick up further, export performance may depend heavily on automobile exports, thus exposing the country to cycles in the industry.

The authorities made good progress toward euro adoption. By operating a hybrid monetary policy framework, the National Bank of Slovakia (NBS) managed to reverse the upward trend in inflation, while continuing to meet the requirements of ERM2.The central bank expectations of average HICP inflation falling sharply from 4.3 percent in 2006 to 1.5 percent in 2007 represent the authorities' opinion that achieving the inflation reference rate is possible in 2007. Progress on the inflation reduction was possible due to the appreciation of the koruna, which mitigated the growth of energy prices and adjustment of the utility prices controlled by the government.

As staff rightly point out, an appropriate parity for conversion that would avoid locking in an overvalued exchange rate is the key challenge to a successful performance in the monetary union. The persistent appreciation pressure was the reason of 7.8 percent revaluation of the central parity in March 2007. In the opinion of the NBS, the new exchange rate adequately reflects the fundamentals of the economy. Indeed, the high growth rate and essential FDI inflows, which are linked with the extra benefits of EU membership, speed up the real convergence process. On the other hand, the new central parity has been immediately tested by the financial markets and the current exchange rate has been over 6 percent above of the new level. Hence, we welcome that the authorities are stressing that the final parity for conversion might be weaker than market value at the time of setting of the parity, as recommended by staff. Clearly, this should make capital inflows less attractive by preventing "one-way bets". It should also help to achieve the exchange rate criterion by avoiding strong, but reversible capital inflows. We would like to underline that the expectations about the future central parity should be anchored to contain the speculative upward pressure on the currency in the ERM2 mechanism.

In this respect, the staff's opinion is not clear to us. Staff suggested that the room for an additional appreciation of the koruna still existed and adjustment of exchange rate did not have significant impact on the international competitiveness of the Slovak economy. *Therefore, we would like to ask staff for a clear assessment of the level of the new central parity. Is it appropriate based on the long term equilibrium rate and should it be treated as a future conversion rate after the end of ERM2 period?* Staff's clear support for the authorities' view in this respect may help to mute the exchange rate volatility and avoid the risk of potential exchange rate overshooting.

There are still risks to the inflation outlook. Staff notes the wage pressures on the background of a tight labor market. In addition, consumer spending could be higher than expected, particularly if social spending is boosted. Additional policy measures could become necessary to make low inflation sustainable. Hence, we support Mr. Prader and Mr. Jakoby's view that the further lowering of the NBS policy may pose some risk to the economy. First, low interest rate may fuel a credit boom. Second, nearly zero spread between the NBS and ESB rates may abruptly invert the appreciation trend. To limit the inflation risk, the standard prescription of tighter fiscal policy appears appropriate.

As to the fiscal policy, we share staffs' view that further efforts are required to achieve the envisaged fiscal consolidation. The strong growth environment should facilitate a small contractionary stance. Therefore, we agree with staff's recommendation that the authorities should aim at saving revenue overperformance in 2007 and we welcome the authorities' efforts described by Mr. Prader and Mr. Jakoby to seek savings at the central level. We also welcome the authorities' awareness of the fiscal performance of local governments.

We understand the authorities' commitment to socially inclusive growth. However, the authorities shall select such instruments that would preserve sufficiently flexible labor market and would not hinder competitiveness of the economy. Therefore, we would encourage the authorities to consider the merits and fiscal consequences of the earned income credit for low-income workers proposed by staff.

We welcome the robustness of the banking system depicted in the FSAP Update. We note that the bank lending is performed mainly in the korunas and – on the liabilities side – predominantly financed by domestic deposits. We also learnt that the pension funds from the second pillar are primarily invested in the bank deposits, presumably, because of the fact that the Slovak stock exchange is very shallow. These two facts explain the low rates of return generated by the second pillar funds. In this light, Slovakia's smooth accession to the euro zone becomes even more important.