Interpreting the IMF's Report on Slovakia

The IMF regularly visits all its member countries and produces a detailed report on their economy. This is the report done on Slovakia in August 2013:
http://www.imf.org/external/pubs/ft/scr/2013/cr13262.pdf

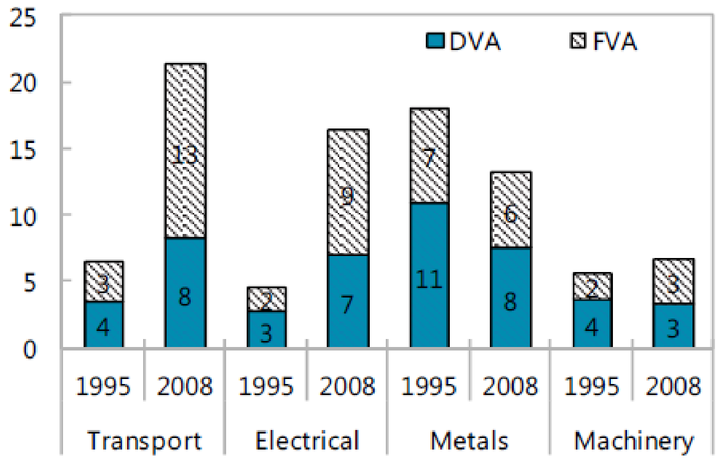
Real Effective Exchange Rate & Exports

We will focus on selected parts, beginning with the Box 1 on Page 6. which focuses on the real effective exchange rate. What is this?

The real exchange rate (RER) between two currencies is the product of the nominal exchange rate (the dollar cost of a euro, for example) and the ratio of prices between the two countries. The core equation is RER=eP^*/P, where, in our example, e is the nominal dollar-euro exchange rate, P^* is the average price of a good in the euro area, and P is the average price of the good in the United States.

For the most part, economists and policymakers are more interested in the *real effective exchange rate* (REER) when measuring a currency's overall alignment. The REER is an average of the bilateral RERs between the country and each of its trading partners, weighted by the respective trade shares of each partner. Being an average, a country's REER may be in "equilibrium" (display no overall misalignment) when its currency is overvalued relative to that of one or more trading partners so long as it is undervalued relative to others.
http://www.imf.org/external/pubs/ft/fandd/2007/09/pdf/basics.pdf

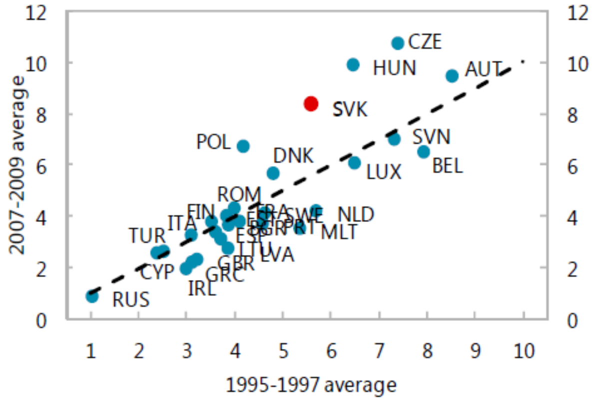
The Four Largest Export Sectors in Slovakia
(in percent of exports)



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

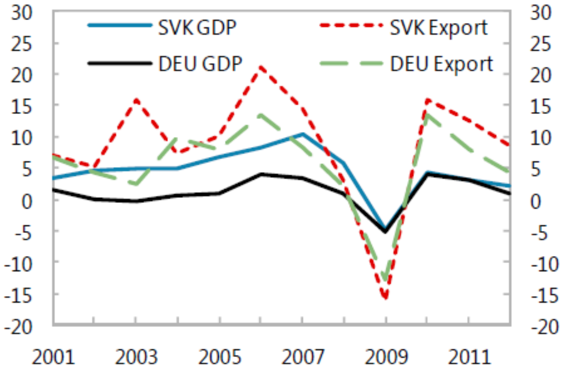
The above shows the heavy dependence of Slovakia on a few key industries in terms of exports. DVA is domestic value added and FVA foreign value added. DVA is the share of value added produced in Slovakia. For example. If you import 10 Euros in raw materials and semi finished products, produce a product and sell it for 15 Euros. The DVA is 5Euros. The graph shows transport exports have a relatively high FVA component.

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)

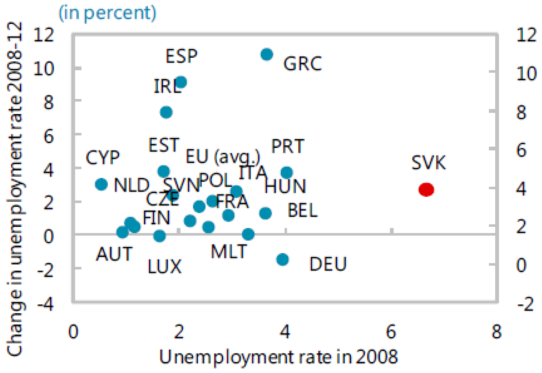


Sources: Haver and IMF staff calculations.

These two graphs show the heavy dependence of Slovakia on the german economy. Research shows that the vulnerability of individual countries to global shocks is heavily influenced by their participation and position in global supply chains (GSCs). 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.

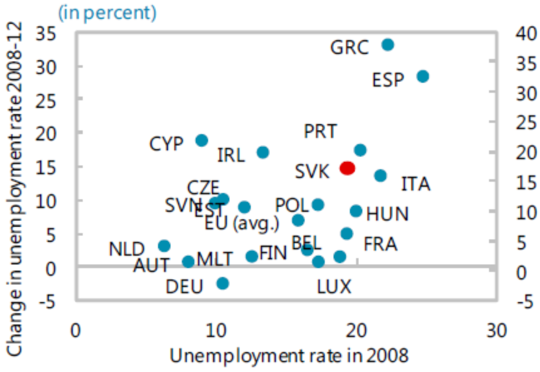
UNEMPLOYMENT

Long-term Unemployment Rate
(in percent)



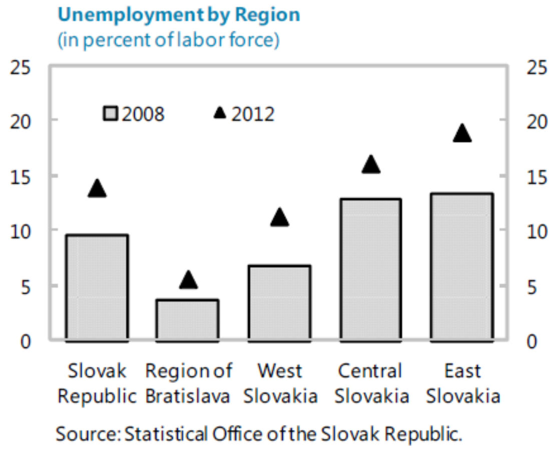
Sources: Eurostat and Haver.

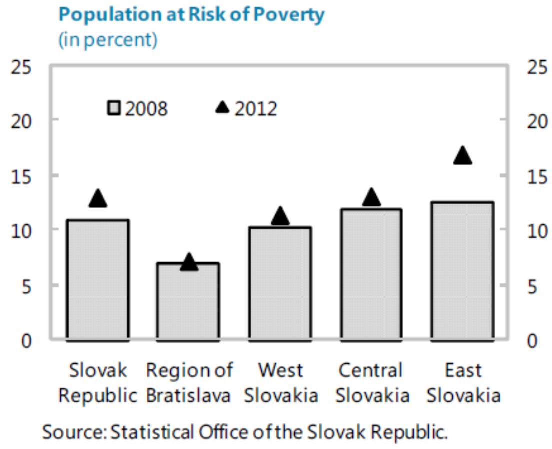
Youth Unemployment Rate
(in percent)



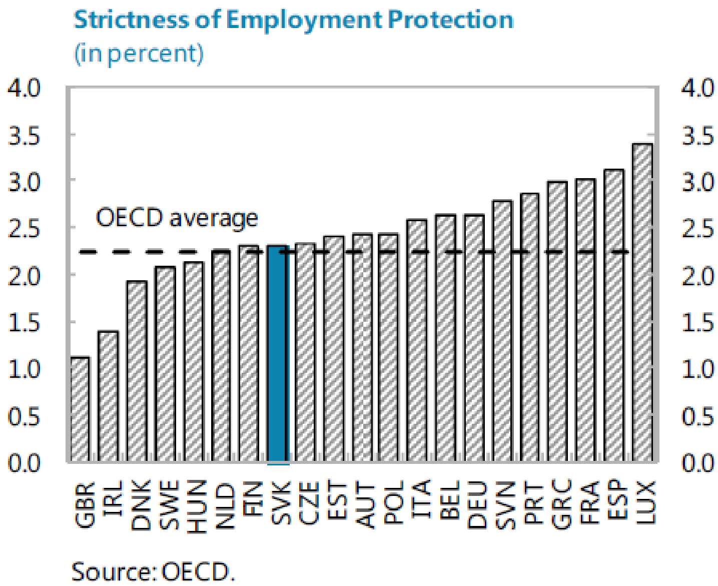
Sources: Eurostat and Haver.

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.





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.

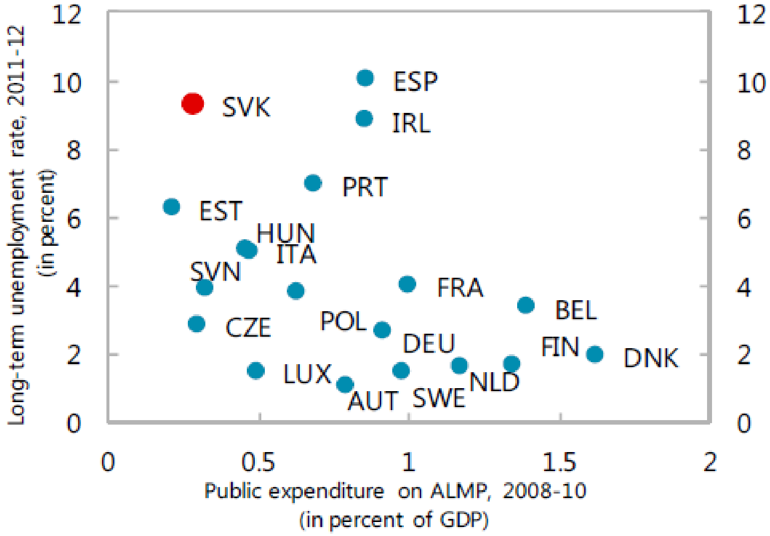


However, reported institutional features do not seem to explain such poor performance of the labor market. Slovakia's employment protection legislation, even after the recent unwinding of some 2011 reforms, appears broadly in line with peers, although continuous revisions, reflecting changes in the political 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.

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.

In addition, the composition of ALMP spending could be more effective. Start-up incentives and temporary activation works account for about onethird 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.

Long-Term Unemployment and ALMP spending

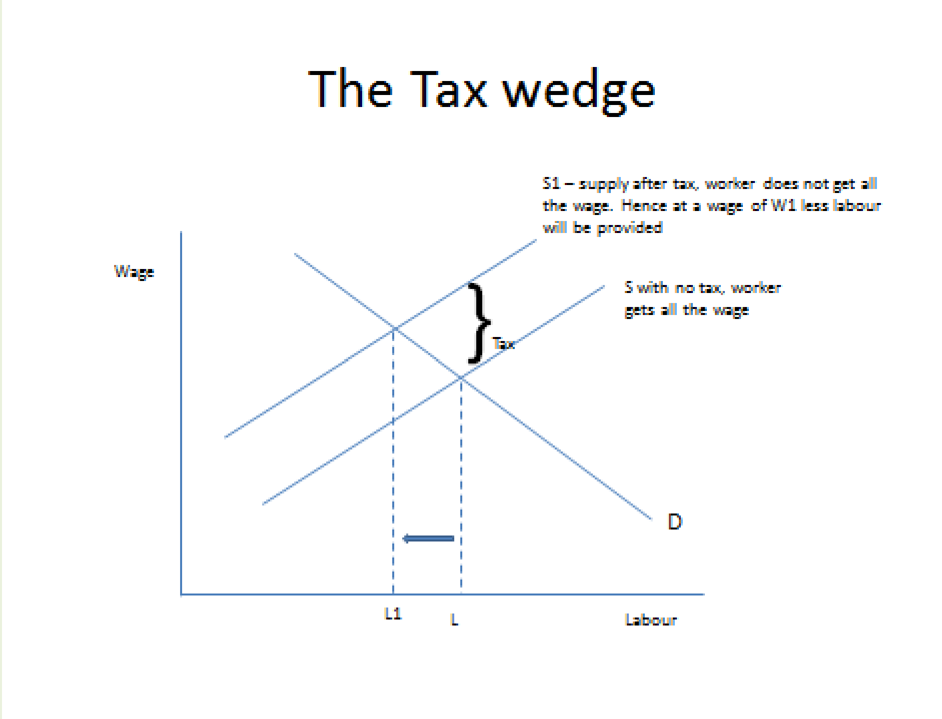


Sources: Eurostat; OECD; and Haver.

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).

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.

NOTE The tax wedge may be defined in different ways. But it revolves around the following. The tax wedge on labour is defined as the sum of income tax plus compulsory social security contributions paid by both employees and employers, for a single person earning as an "average worker". This tax wedge is expressed in percentage of labour costs.
http://www.oecd-ilibrary.org/docserver/download/8107021ec012.pdf?expires=1394362585&id=id&accname=guest&checksum=32225A6A9942E399516BB06F43A01546



All taxes distort incentives, but of course are necessary to fund public expenditure. Above we see a tax falling on the individual will reduce labour supply – people will work fewer hours (perhaps) and fewer people will work. Same if tax falls on employer – note economic theory says it makes no difference on who really pays the tax if it falls on employer or employee.

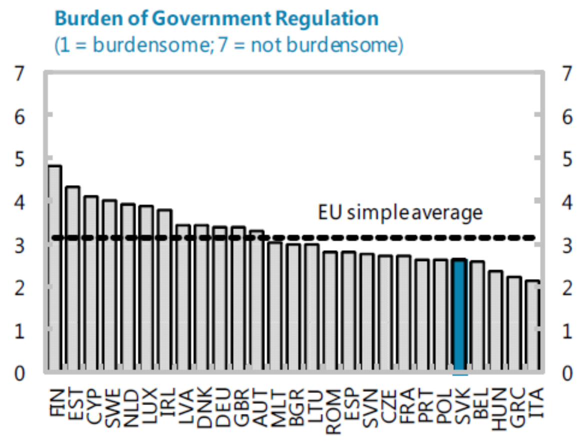
16. Actions to address unemployment and improve the business environment could lay the foundation for stronger and more job-rich growth. Over the medium term, actions in these areas could also have positive spillovers for moving up value chains and export diversification, which along with fiscal buffers, 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.

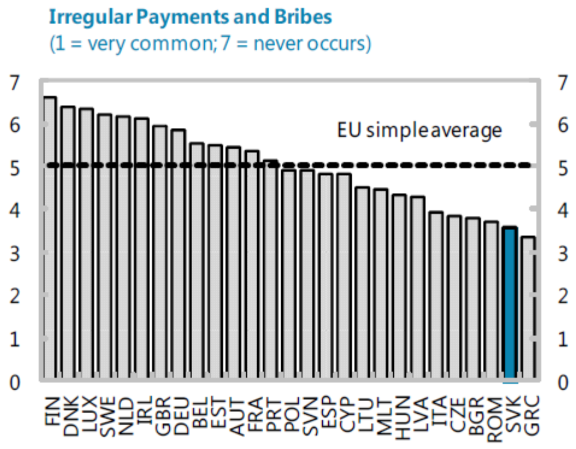
 Improve the quality of education and training. Employers cited the need to match educational curriculums and vocational training more closely to job requirements, and to combine practical experience with training. The demand for high-skilled labor is also likely to increase if Slovakia's production possibility 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).



Source: World Economic Forum, 2012-13.



Source: World Economic Forum, 2012-13.

FISCAL ISSUES

Slovak Republic: Fiscal Responsibility Act

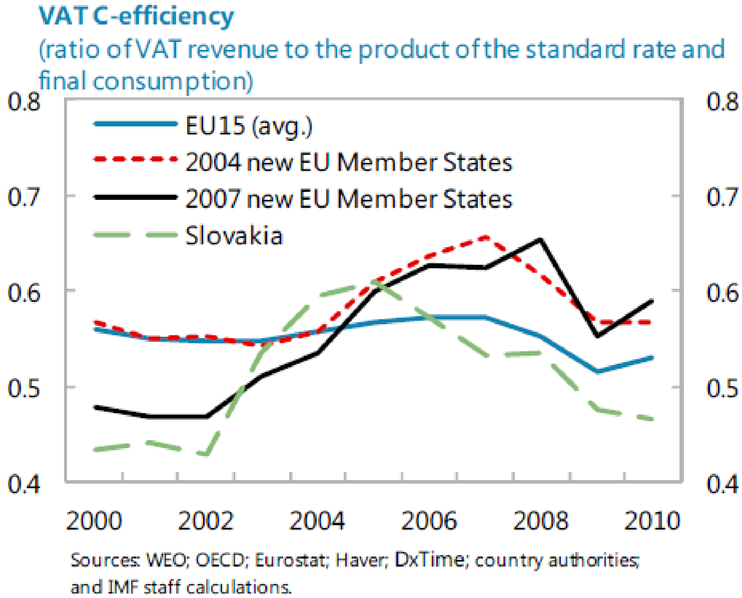
Debt level 1/ (in percent of GDP) until 2017	Debt level 1/ (in percent of GDP) from 2027 onwards	Action
50% - 53%	40% - 43%	The Ministry of Finance addresses a letter to the Parliament explaining the reasons for breaching the debt threshold and indicating measures for its reduction.
53% - 55%	43% - 45%	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.

It is possible that in the near future, gross government debt could 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 [i.e, government cuts] 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.

Note: a structural deficit of 0.5% indicates that on average the government has a deficit of 0.5%. Some years it may be less [even a surplus], other years more.

BOX 4: Page 19: Improving Tax Collection



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.

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.

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. BUT it will take time.

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.

Financial Stability

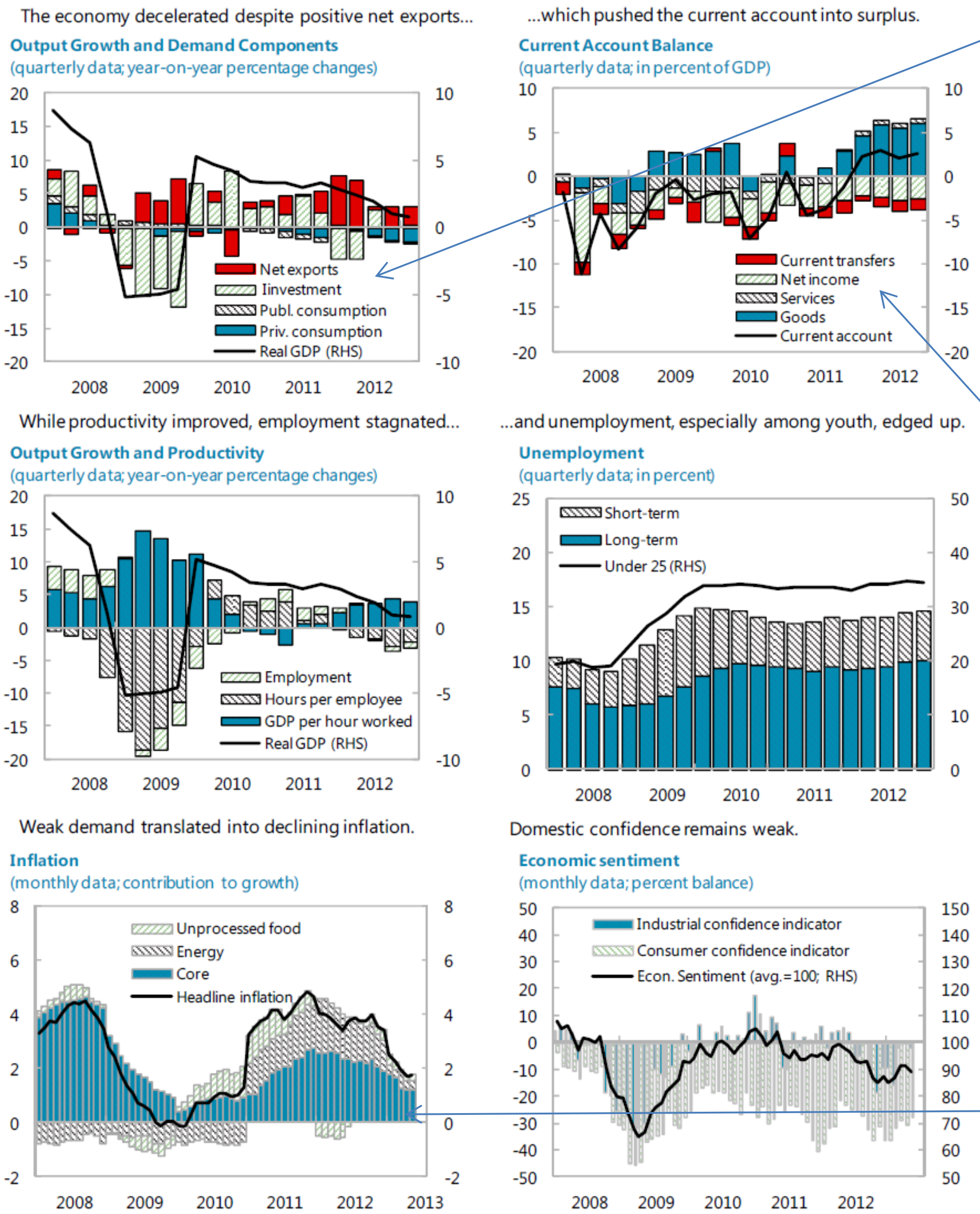
http://www.ecb.europa.eu/ssm/html/index.en.html

The single supervisory mechanism will create a new system of **financial supervision** comprising the ECB and the national competent authorities of participating EU countries. The **main aims** of the single supervisory mechanism will be to ensure the safety and soundness of the European banking system and to increase financial integration and stability in Europe. The ECB will be responsible for the effective and consistent functioning of the single supervisory mechanism, cooperating with the **national competent authorities** of participating EU countries.

The IMF argues that "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."

SUMMARY CHARTS

Figure 1. Slovak Republic: Main Economic Developments



Sources: Eurostat and IMF staff calculations.

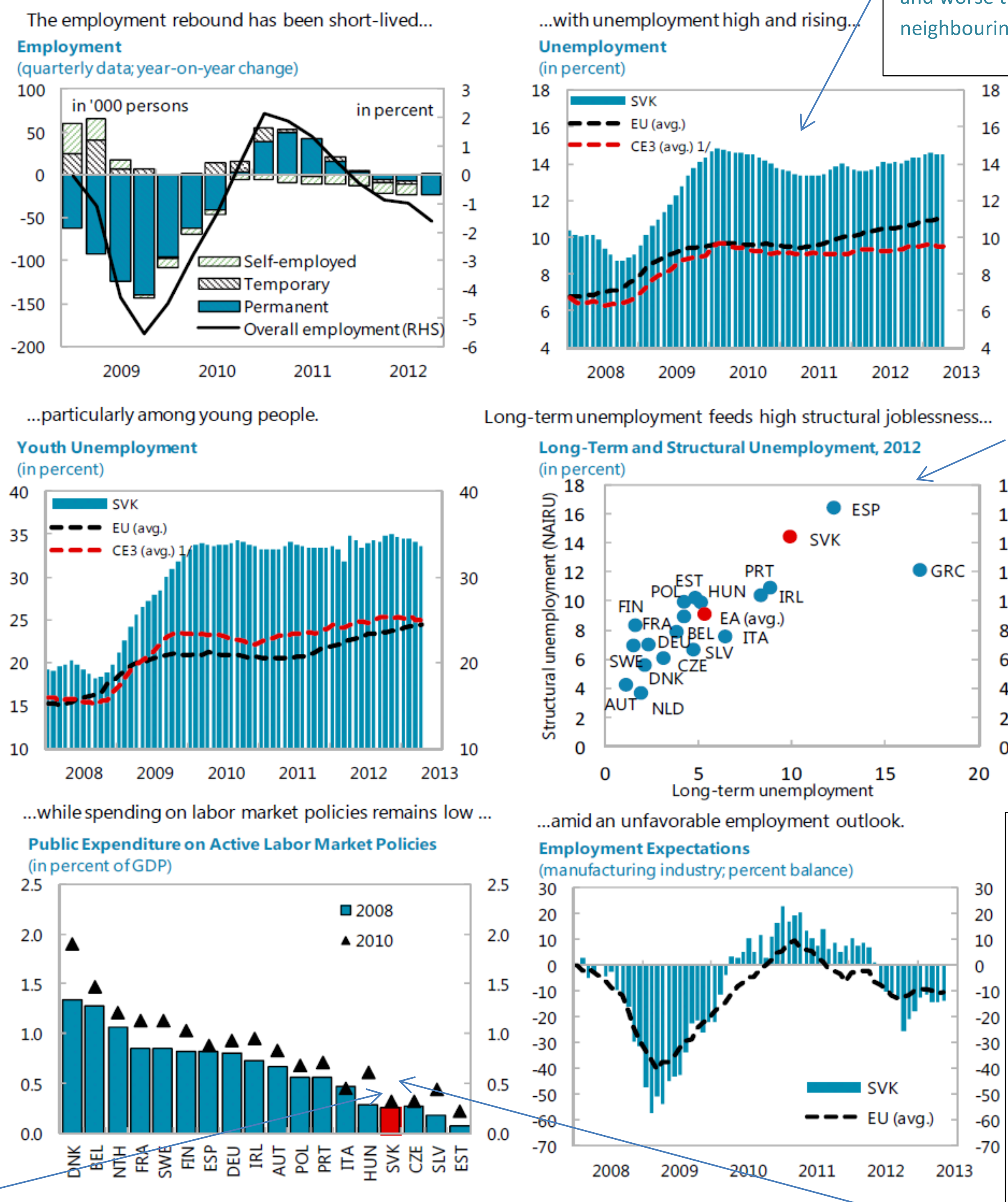
This shows much of the source for growth has been exports. Since the start of 2009 private consumption in particular has been a negative factor

Goods have been the main source of an export surplus. On services run a deficit. Current transfers are in part payments to EU.

Core inflation is low and falling. In recent years reason inflation was a little high was due to energy prices.

A poor performance, worse than the EU average and worse than neighbouring countries.

Figure 2. Slovak Republic: Labor Market Developments



The second highest NAIRU and the third highest long term unemployment

Its not just the low level its no change since 2008 when most other countries have

Given all the above, this is surprising. I don't think it's by any means a complete answer to the problem, but it is likely to have some effect and this makes it look like the policy makers don't care. Never a good idea.

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