

## Committee on Balance-of-Payments Restrictions

### 1999 CONSULTATIONS WITH THE SLOVAK REPUBLIC

#### Background Paper by the Secretariat

1. This paper has been prepared in accordance with paragraph 12 of the Understanding on the Balance-of-Payments Provisions of the GATT 1994.

#### **I. PREVIOUS CONSULTATIONS WITH THE SLOVAK REPUBLIC**

2. The Slovak Republic first introduced a 10% import surcharge for balance-of-payments purposes on 3 March 1994. The Committee consulted with the Slovak Republic in June 1994, 1995 and 1996.<sup>1</sup> On 1 July 1996, the surcharge was lowered to 7.5% and eliminated on 1 January 1997. Subsequently, the Slovak Republic took recourse again to Article XII introducing an import deposit scheme on 1 May 1997 which on 21 July 1997 was replaced by a 7% import surcharge. Consultations were held in October and December 1997 and the surcharge was phased out by 1 October 1998.<sup>2</sup>

#### **II. BALANCE-OF-PAYMENTS POSITION AND PROSPECTS**

3. Since 1994, with the exception of a few brief interludes, the Slovak Republic has maintained restrictive measures on imports for balance-of-payments reasons. Reserves have been fairly low throughout the period and have shown little recovery, neither in terms of imports (2.3 months of imports at end-1998) nor relative to short-term debt (49% of short-term debt); in addition, the current account deficit, mainly financed by foreign borrowing, has been more than 10% of GDP since 1996 (see Table I). Nor are the macro-economic indicators propitious: growth slowed (to 4.4%) in 1998 with declining domestic, and weak foreign, demand, inflation crept up slightly and the unemployment rate, as a result of lay offs in the public construction sector, has increased to 14%.

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<sup>1</sup> BOP/R/218; WT/BOP/R/14; WT/BOP/R/15.

<sup>2</sup> WT/BOP/R/40.

Table 1  
Selected Economic Indicators (1996-1998)

	1996	1997	1998
Real GDP (percentage charge)	6.6	6.5	4.4
CPI (period average)	5.8	6.1	6.7
Unemployment rate	12.6	12.9	14.0
Budget deficit (share of GDP)	-1.3	-5.2	-6.0
Gross national savings / share of GDP	29.7	28.1	29.3
Gross national investment / share of GDP	39.4	38.7	39.4
	(US\$ billion)		
Exports	8.8	9.6	10.7
Imports	-11.1	-11.7	-13.0
Trade balance	-2.3	-2.1	-2.3
Current account balance	-2.1	-2.0	-2.1
Official reserves	3.5	3.3	2.9
External debt	6.7	7.8	9.9
of which short-term	3.0	3.5	4.0
	(percentage GDP)		
Current account balance	-11.2	-10.1	-10.1
External debt	35.5	40.2	48.5
Debt service / exports of goods and non-factor services	14.7	12.5	13.2
Official reserves / months of import	3.2	2.9	2.3
Official reserves /short-term debt	86.8	60.1	48.9
Real effective exchange rate (per cent charge, period average)	0.1	6.1	-1.4

Source: IMF

4. Imports, driven by strong domestic demand, continue to exceed exports and in late 1998 surged, ahead of the devaluation and upon removal of the 3% surcharge. In the last two years, exports of intermediate goods (steel, base chemicals and petroleum products) fell as a consequence of growing global overcapacity; however, machinery and equipment, mainly automobiles, was a buoyant sector (Table 2). While the negative trade balance is the main component of the current account deficit, both the services and income balance have deteriorated, the latter as a result of higher interest payments due to larger amounts of external obligations.

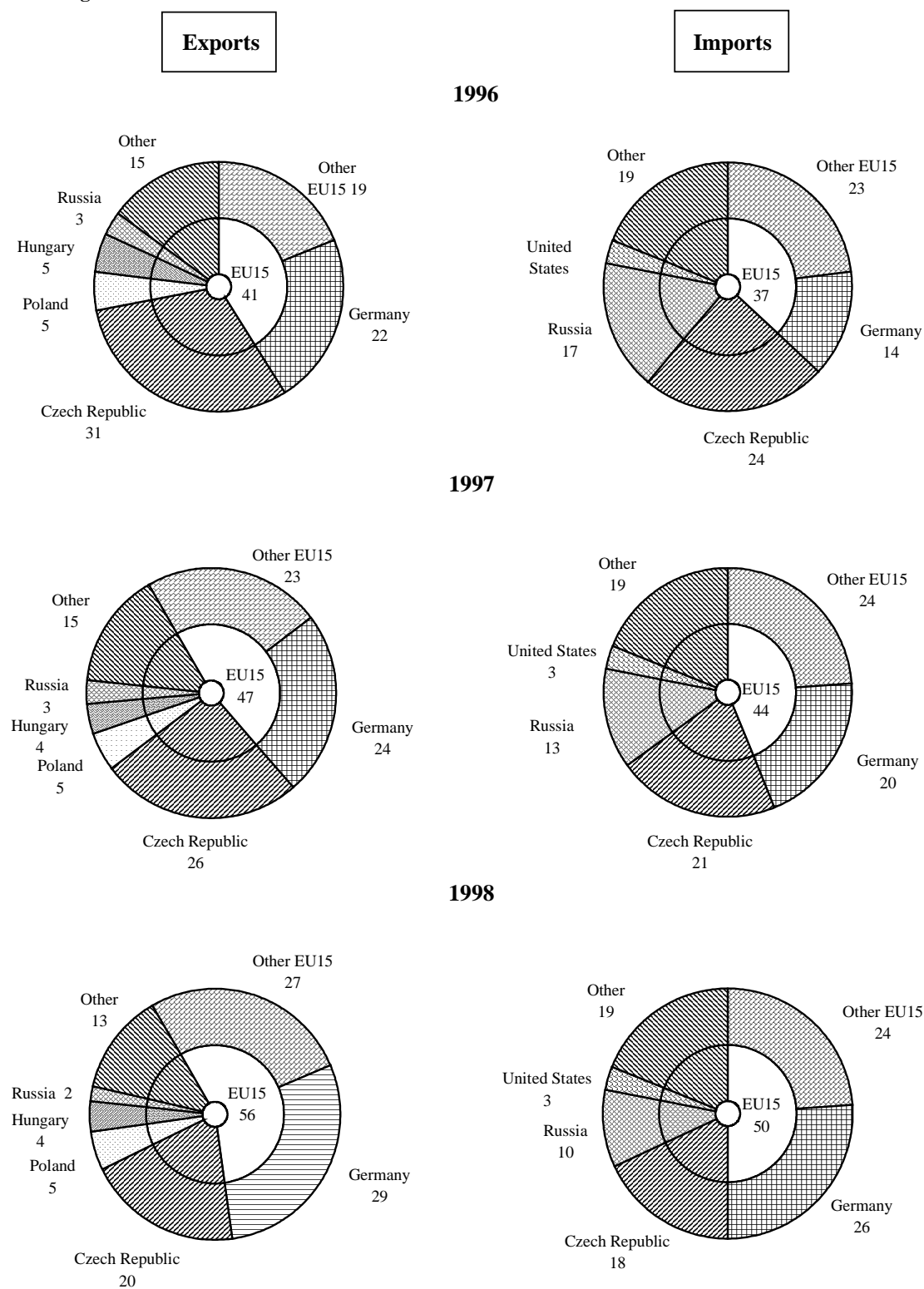
Table 2Commodity Composition of Trade (1996-1998)

Description	1996	1997	1998
Exports, f.o.b. (US\$ Million)	8,831	9,639	10,667
Food and live animals	3.8	3.4	3.2
Beverages and tobacco	0.7	0.7	0.5
Crude Materials	4.5	4.2	3.6
Fuels and related products	4.9	4.6	3.5
Animal and vegetable oils and fats	0.1	0.2	0.2
Chemicals and related products	12.4	10.8	8.9
Intermediate manufactured products	38.3	34.0	30.0
Machinery and transport equipment	23.2	28.4	37.3
Miscellaneous manufactured articles	12.1	13.7	12.7
Other	0.1	0.0	0.0
Imports, f.o.b. (US\$ Million)	11,123	11,672	12,959
Food and live animals	6.0	5.6	5.3
Beverages and tobacco	1.1	1.0	0.9
Crude materials	4.9	4.4	3.9
Fuels and related products	16.7	15.7	10.9
Animal and vegetable oils and fats	0.2	0.2	0.2
Chemicals and related products	11.5	11.6	10.7
Intermediate manufactured products	15.3	16.5	18.1
Machinery and transport equipment	35.2	35.9	40.0
Miscellaneous manufactured articles	9.0	9.0	10.0
Other	0.1	0.0	0.0

5. Fierce competition from Russia and East Asian competitors in the intermediate goods sector has added to the difficulties for Slovakia's traditional exports. Furthermore, in the transition to a market-based economy, energy supplies, hailing mainly from Russia, are now imported at market rather than artificially low prices; Slovakia has a substantial trade deficit with Russia. On the other hand, Slovakia continues to benefit from its association agreement with the European Union, where it sells an increasing share of its export goods. In two years, as the chart clearly demonstrates Germany has replaced the Czech Republic as Slovakia's major trading partner (Chart I).

**Chart I: Origin and destination of merchandise trade, 1996, 1997 and 1998**

Percentage shares



6. With respect to the capital account, inflows of foreign direct investment, concentrated in the transport equipment sector, have been modest over the last few years, while external debt, of which 40% is short-term, has escalated considerably, rising from 35% to 49% of GDP between 1996 and 1998. While Slovakia was able to borrow easily on international capital markets and did so, more recently several international agencies have downgraded their credit ratings, from investment to speculative grade. Cumulative inflows of foreign direct investment of US\$1.8 billion, since 1990, compare unfavourably with several other transition economies: equity investment by non-resident investors has been limited because the previous government's privatization policy, geared towards promoting the development of a national entrepreneurial class, barred foreign investors until the post-privatization phase and excluded "strategic" sectors such as gas, electricity and telecommunications. In fact, privatization of state-owned enterprises has lacked transparency and been principally effected through management buyouts and insider sales. Nor has privatization been successful in generating receipts; revenues amounted to 1.5% of GDP in 1995-1998 as a result of large discounts from book value and long repayment periods.

7. The fiscal deficit increased from 1.3% to 6% of GDP in two years with increased public spending on health and major public investment projects, e.g. highway construction, accompanied by weak tax collection. The weak fiscal position has led the central bank to maintain a tight monetary policy, which also reflects dissatisfaction with the pace of enterprise restructuring. Monetary policy has been the principal anchor of macroeconomic stabilization, with the central bank following a strict anti-inflationary programme, which has kept the consumer price index at a reasonable level. Financing domestically has been expensive; interbank lending rates were 24% in 1997 and 19% in 1998, yet debt has grown with relatively easy access to foreign borrowing. Along with the strong currency, high real interest rates helped to attract the capital inflows which financed the current account deficit.

8. The real effective exchange rate appreciated by 23.5% in 1996 and 1997 reflecting nominal wage growth and low productivity improvements. Following the rouble crisis of August 1998, the koruna came under pressure and, after exhausting US\$1 billion of reserves to defend the currency, the peg was abandoned in October. Since the koruna was set free to float, the market exchange rate has been trading at about 10% below the previous central parity. While a floating rate is more likely to allow for improvements in external competitiveness, the high import content of Slovakia's exports prevent depreciation from exerting a strong impact on the trade balance and the currency's depreciation has raised the costs of servicing the external debt.

9. Like other ex-centrally planned economies, Slovakia's industrial structure was geared towards heavy capital-intensive industry and, absent market signals to reflect costs, production capacity significantly exceeded factor endowments; as a result industry became heavily reliant on imports of energy and raw materials. Exports have been heavily concentrated in a narrow industrial base. Delays in undertaking structural reform have also been instrumental in aggravating macroeconomic imbalances and particularly the savings-investment imbalance. Restructuring of the corporate and banking sector has been slow with various laws and government policies hampering the advent of a more competitive environment. The share of non-performing loans held by the major and dominant state-owned banks amounted to 37% of their portfolios; loan-loss provisioning and capital adequacy ratios need to be improved. An overhaul of the Banking Act giving the central bank greater authority in banking supervision as a part of a corrective action program based on explicit, quantifiable criteria, would go some way to preventing the moral hazard in the banking sector. Elsewhere, state enterprises are heavily indebted and facing bankruptcy and need considerable restructuring before they can be sold to private investors. Although a bankruptcy law was introduced in 1997, procedures are costly and prolonged; in addition, the commitment to maintaining existing employment levels in state and privatized enterprises has necessarily affected financial performance.

10. In sum, the interaction of macroeconomic imbalances, the unsustainable current account deficit, increasing external debt, and an unsound banking sector present clear risks.

### III. ALTERNATIVE MEASURES TO RESTORE EQUILIBRIUM

11. Since the last consultations in 1997, a new Government has been put in place which has vowed to redress the fiscal imbalance that is at the heart of Slovakia's macroeconomic difficulties. The fiscal deficit is targeted to be reduced to SK20 billion (compared to SK43 billion in 1998), 3% of GDP, by the end of 1999. At the beginning of this year, a package of fiscal measures was introduced, a package which was strengthened in May. Wages in the state administration have been frozen and on the revenue side, administered prices are being liberalized. Regulated prices for public services, such as electricity, gas and transportation, have been increased, as have excise taxes on tobacco and petroleum products; the lowest VAT rate of 6% has been raised to 10% and tax collection efforts have been strengthened. Revenues from indirect taxes are expected to yield SK8 billion this year and, with higher prices for public services, government subsidies will be reduced from SK3.4 to SK1.6 billion.

12. With the monetary authorities no longer required to defend a currency peg, the central bank will have a freer hand in managing domestic money supply, where growth has already been curtailed, although there will be some inflationary pressure from the increase in indirect taxes legislated this year. Monetary policy will be relaxed in line with fiscal tightening and a shrinking of the current account deficit.

13. The current Government's economic strategy aims to accelerate restructuring and improve the transparency of public decisions, in particular, in the privatization process, where it intends to introduce greater competition. Weaknesses in the bankruptcy law and procedures are being addressed by a recent amendment which makes it a criminal infraction for debtors not to submit a settlement petition within 60 days of "indebtedness" (insolvency?) and simplifies and makes more effective related procedures. A programme for recapitalizing the three major state-owned banks is underway. Tax and duty exemptions have been introduced in order to attract foreign investment. Rapid progress in enterprise and bank restructuring would boost investor confidence and attract much-needed foreign capital which in turn would ease the financing constraint on the current account deficit. Continued stabilization and structural reforms should allow the economy to return to a path of sustainable growth.

### IV. SYSTEM, METHOD AND EFFECT OF THE RESTRICTION

14. On 1 June 1999, the Slovak Republic introduced a 7% import surcharge applied on an mfn basis to all imports with the exception of some agricultural items, basic raw materials and inputs.<sup>3</sup> Where inputs are exempt from the surcharge, user industries will benefit from increased effective protection. The surcharge, levied on the customs value of the goods, applies to about 80% of tariff lines and is expected to generate about SK9.4 billion for the seven months of fiscal year 1999 (1½% of GDP). By comparison, revenue from the surcharge provided SK7.5 billion in its five months plus of operation 1997 and SK6.8 billion, when the phasing down was already in effect, in the first nine months of 1998. In the current situation, depressed demand combined with a de facto 10% devaluation, the surcharge is likely to have a greater apparent effect on the curtailment of imports.

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<sup>3</sup> WT/BOP/N/46, 17 June 1999.

Balance-of-payments (US\$ million) 1996-1998

	1996	1997	1998
Trade balance	-2.293	-2.084	-2.290
Exports	8.831	9.641	10.666
Imports	-11.124	-11.725	-12.956
Services and income balance	-8	-47	-137
Services, net	36	73	17
Income balance	-45	-120	-154
Current transfers	203	173	366
Current account	-2.098	-1.958	-2.061
Foreign investment, net	295	235	248
Direct	199	47	221
Portfolio	96	187	27
Medium and long-term credits	986	1.153	1.601
Short-term capital	882	416	-67
Capital account	2.192	1.804	1.782
Overall balance	237	146	-550