COMMISSION OF THE EUROPEAN COMMUNITIES

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94/0219 (CNS)

Proposal for a

COUNCIL DECISION

providing macro-financial assistance

for the Slovak Republic

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. SLOVAKIA'S REQUEST FOR COMMUNITY MACRO-FINANCIAL SUPPORT

On 13 June 1994, the Deputy Prime Minister and the Minister of Finance of the Slovak Republic, on behalf of the Slovak government, addressed to the Commission a formal request for complementary macro-financial assistance from the EU/G-24 in the amount of US$ 300 million. This additional financing is requested to complement the new resources that the IMF and the World Bank intend to provide to Slovakia in 1994 and 1995.

The Slovak authorities and the management of the IMF agreed in late May on the main elements of an economic policy programme to be implemented in the remainder of 1994 and in 1995. In support of this programme, the IMF Board approved on 22 July 1994 a 20-month stand-by arrangement in the amount of SDR 115.8 million (about US$ 160 million). The programme will also be supported by a second purchase under the IMF's Systemic Transformation Facility (STF) in the amount of SDR 64.35 million (about US$ 89 million) following a first purchase of the same amount in July 1993.

The World Bank, for its part, approved in November 1993 a US$ 80 million Economic Recovery Loan to support Slovakia's structural reforms and to help the country overcome the disruptions associated with the split of the CSFR. Of this amount, US$ 16 million were effectively disbursed in May 1994. In addition, the Slovak authorities are currently negotiating with the World Bank on an Enterprise and Financial Sector Adjustment Loan (EFSAL) to assist Slovakia in the reform of the banking sector and the restructuring of enterprises.

The amount of complementary macro-financial assistance being requested corresponds to the residual balance of payments "financing-gap" for the remainder of 1994 and 1995, as estimated by the IMF staff after taking into account existing loan commitments (including the IMF and the World Bank funds) and the envisaged recourse to the international capital markets by the National Bank of Slovakia (NBS).

The present proposal of the Commission is made as a follow up to the decision in principle taken by the ECOFIN Council on 11 July 1994 to provide complementary macro-financial assistance to Slovakia in the amount of up to ECU 130 million in 1994/95. The Community assistance is part of an overall EU/G-24 financing package in which non-EU/G-24 countries (mainly Japan, Austria and Switzerland) are also expected to provide some US$ 88 million in support of Slovakia.

2. MACRO-ECONOMIC PERFORMANCE AND POLICIES AFTER THE DISSOLUTION OF THE CSFR

The split of Czechoslovakia (CSFR) has so far had a worse impact on Slovakia than on the Czech Republic. First, the dissolution of the federation has put an end to the very considerable fiscal transfers that Slovakia used to receive from the Czech Republic through the federal budget, which the IMF tentatively estimates at about

7.5% of Slovak GDP in 1992. Second, with the separation Slovakia has also lost much of the federal government's solid reputation for orthodox macro-economic policies and market-oriented reforms. This has, in turn, restricted Slovakia's access to the international capital markets. Third, with most federal institutions being located in the Czech Republic and many of the better qualified professionals remaining in the newly-created Czech institutions, Slovakia's economic policy has been impaired by the lack of proper institutions and human capital.

The termination of the fiscal transfers from the Czech Republic and the vulnerable balance of payments position that resulted from the dissolution of the CSFR obliged the Slovak authorities to pursue rather restrictive macroeconomic policies. Together with the serious disruptions in inter-republican trade caused by the split of the CSFR and weak economic activity in the main Western and Eastern markets, these tight macroeconomic policies have contributed to the prolongation of the Slovak recession. Slovak *real GDP* is estimated to have declined by 4.1% in 1993, implying a fourth consecutive year of recession. The unemployment rate, for its part, reached 14.2% in April 1994, up from 10.4% at end-1992.

A restrictive *fiscal policy* was necessary to reduce the important general government deficit that emerged as a result of both the loss of the Czech fiscal transfers and the further weakening of economic activity. Despite the adoption by the government in the summer of a tough package of fiscal measures, the general government deficit reached 7,5% of GDP in 1993. *Monetary policy* also had to be tight in the first half and at the end of 1993 in order to defend the country's reserves amid speculation about a devaluation of the Slovak crown.

Regarding *exchange rate policy*, the Slovak authorities devalued the Slovak crown by 10% against convertible currencies last July. Furthermore, the Slovak crown has been devalued by 5% within the clearing system established in February 1993 with the Czech Republic to settle inter-republican transactions.

The introduction and subsequent increase of the VAT in 1993 and the devaluation of the crown resulted in an increase in CPI inflation from a year-on-year rate of 12.7% at end-1992 to 25.1% at end-1993. Since the final months of 1993, however, inflation has been showing a decelerating trend, with the average monthly rate of inflation falling slightly below 1%.

Despite the weakness of domestic demand and the devaluation of the Slovak crown, the Slovak *current account* showed a deficit of US$ 434 million (or 4.2% of GDP) in 1993. Slovakia is having difficulties to finance this deficit through *inflows of private capital*. At an estimated US$ 134 million in 1993, net foreign direct investment continues to be of little significance, and Slovak borrowers have issued only two international bonds since the split of the federation. All this has been reflected in a very vulnerable *international reserves* position. Although official reserves have been increasing in recent months, they still represented at end-June 1994 little more than one month of imports.

The delicate foreign exchange reserves position led the Slovak authorities to introduce restrictions on *current account convertibility* in February 1993. While these restrictions were lifted in December 1993, Slovakia introduced a 10% surcharge on imports of consumer goods in early March 1994.

Regarding *structural reforms,* after the completion of the first wave of large-scale privatization, the privatization process slowed down considerably. An increased emphasis on traditional privatization methods such as direct sales to foreign investors or management buy-outs (as opposed to mass-privatization methods such as the voucher scheme) was announced but the actual implementation of the programme was disappointing and suffered from a lack of transparency. A bankruptcy law finally came into effect in June 1993, under which a board of creditors will have three months to work out a rehabilitation plan. In the area of financial sector reform, the authorities have until now failed to put into practice a well-articulated set of measures to strengthen the Slovak banks' balance-sheets while increasing the degree of private ownership and competition within the banking sector.

3. THE ECONOMIC POLICY PROGRAMME FOR THE REMAINDER OF 1994 AND 1995

The major goals of the programme agreed with the IMF are a sharp reduction of inflation, the strengthening of the fiscal and external positions (including a substantial rebuilding of foreign exchange reserves) and the acceleration of the restructuring of the economy. Also, the authorities are committed to removing the 10% *surcharge on consumer imports* introduced in March 1994 and to make progress towards achieving full *current account convertibility* so as to reach Article VIII status at the IMF by 1 January 1996. The *exchange rate* is intended to serve as a nominal anchor supporting the fight against inflation, with no devaluations being envisaged under the programme.

The programme targets a decline in *inflation* to 12% at end-1994 and 8% at end-1995. *Real GDP* is expected to remain roughly unchanged this year and to rise by 2% next year. *The deficit of the general government* is set to decline to 4% this year and to 3% in 1995. *The current account deficit* is projected to decline to US$ 300 million (2.5% of GDP) in 1994 and to remain at a similar level in 1995. *Official foreign exchange reserves* are targeted to increase from US$ 650 million (1.2 months of imports) in mid-June to about US$ 0.9 bn (1.7 months of imports) and to about US$ 1.4 bn (2.4 months of imports) by end-1995.

Slovakia has complied with the two "*prior actions*" required before the IMF Board could consider the approval of the stand-by and the STF purchase. These are 1) the approval by the Slovak Parliament of amendments to the laws on the VAT and excise taxes (the two major elements of a supplementary fiscal package designed to cut the 1994 budget deficit by 1.5 of GDP) and 2) the introduction of restrictive wage regulations affecting loss-making enterprises in which the state or holders of voucher shares hold a majority stake.

In the area of *structural reform,* the government intends to accelerate privatization by supplementing conventional methods with a second wave of voucher privatization, to proceed with financial sector reform and the restructuring of state-owned enterprises and to encourage the development of the emerging private sector.

The second wave of large-scale *privatization,* affecting over 500 state enterprises with an equity book value of about US$ 6.6 billion, has already been initiated. About 40% of the shares will be sold through the voucher method and the remainder

through standard methods. The distribution of vouchers to citizens will be completed by end-September 1994 and the voucher auctions will take place in early 1995.

Several measures are being contemplated to strengthen the balance-sheets of Slovak *banks* and to reduce their degree of state-ownership. First, the National Bank of Slovakia (NBS) will introduce in the coming months bad loan classification criteria and compulsory provisioning rules and provisions by commercial banks will be made tax-deductible. Second, banking supervision and regulation will be improved on the basis of the two-year plan adopted by the NBS in February 1994. Third, with the financial and technical assistance of the World Bank (in the framework of the EFSAL currently under discussion) and the PHARE programme, the Slovak authorities intend to develop restructuring and privatization plans for the three largest commercial banks (VUB, the Slovak Savings Bank and the Investment and Development Bank), which remain under state control and together account for about 70% of all commercial loans and for about 90% of all the deposits of Slovak banks. The restructuring of banks will focus on their need for recapitalization and on addressing the problem of bad loans in their portfolios. Special attention will also be given to the appropriate restructuring of the loss-making enterprises (mostly state-owned) against which non-performing loans are held.

4. PREVIOUS MACRO-FINANCIAL ASSISTANCE TO THE CSFR

In February 1991, the Council (Decision 91/106/EEC) granted an ECU 375 million balance of payments loan to the former CSFR. This assistance was also granted in the context of an initiative by the G-24 to provide financial assistance supplementary to that offered by the IMF and the World Bank. The EC loan was disbursed in two tranches, respectively in August of 1991 and February of 1992. Commitments from the non-Community members of the G-24 reached US$ 387 million out of which US$ 362 million have been effectively disbursed.

Following the dissolution of the CSFR on January 1, 1993, the Council adopted on 24 January 1994 a Decision (94/61/EC) allowing for the division of the liabilities related to the 1991 EC loan. The Decision empowers the Commission to negotiate, in consultation with the Monetary Committee, the amendments to the original Loan Agreements necessary to establish the separate liability of the Czech and the Slovak Republic for, respectively, two thirds and one third of the loan. This operation will be formally concluded shortly.

5. THE PROPOSED NEW MACRO-FINANCIAL ASSISTANCE

The dissolution of the CSFR has meant a new negative shock for the Slovak economy at a time when it was still suffering from the shock associated with the collapse of the CMEA trade system and the difficulties accompanying the process of systemic transformation. In the circumstances, and following the decision in principle on the matter taken by the ECOFIN Council on 11 July 1994, the Commission is proposing that the Community grants Slovakia a balance of payments loan of ECU 130 million with a maximum maturity of seven years.

By contributing to ease Slovaki balance of payments constraint, such assistance should help Slovakia adjust to t new situation created by the dissolution of the

CSFR while putting an end to the contraction of output and employment, a contraction that would risk weakening the support of the Slovak population for the macroeconomic stabilization efforts and the structural reforms.

The Community loan, which would complement resources made available by the IFIs and other G-24 bilateral donors, should help strengthen the official foreign reserves position to the extent envisaged under the IMF programme. As a demonstration of confidence by the international community, this financial assistance would also act as a catalyst for private capital inflows, including foreign direct investment.

The Community loan would be disbursed in two tranches, subject to a satisfactory track record of Slovakia's macro-economic programme agreed with the IMF and progress with respect to structural reforms, including the observance of a number of performance criteria.

As in the case of similar operations in favour of Central and Eastern European countries, the Community would provide the funds through market borrowing with a guarantee by the general budget. Slovakia would subsequently borrow from the Community. The borrowing and lending operations will be perfectly matched and without any commercial risk for the Community.

On the assumption that the Guarantee Fund mechanism will be in place before the end of the year, the budgetary implications of a decision to grant loan assistance of up to ECU 130 million to Slovakia would imply an ECU 18 million provisioning of the Fund.

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal of the Commission[1] submitted after consulting the Monetary Committee,

Having regard to the opinion of the European Parliament[2],

Whereas the people of the Slovak Republic have close historic relationships with the peoples of the Community; whereas that country has undertaken fundamental political and economic reforms and is making substantial efforts to consolidate a market economy model;

Whereas the Slovak Republic and the Community signed on 4 October 1993 an Association Agreement replacing the one signed between the Czech and Slovak Federal Republic on 14 December 1991;

Whereas the dissolution of the Czech and Slovak Federal Republic has had negative implications for the Slovak economy at a time when it was still suffering from the external shock associated with the dismantlement of the Council of Mutual Economic Assistance trade system and from the difficulties accompanying the transition to a market economy;

Whereas the financial support of the reforms from the Community will strengthen mutual confidence and will bring the Slovak Republic closer to the Community;

Whereas the Slovak Republic has agreed with the International Monetary Fund (IMF) on a "stand-by arrangement" and a new purchase under the "systemic transformation facility" supporting the country's economic programme for 1994-95; whereas these facilities were approved by the IMF Board on 22 July 1994;

Whereas the authorities of the Slovak Republic have requested financial assistance from the international financial institutions, the Community and other bilateral donors; whereas, over and above the estimated financing which could be provided by the IMF and the World Bank, a residual financing gap of some US$ 300 million remains to be covered in the remainder of 1994 and 1995 in order to strengthen the Slovak Republic's

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reserve position and support the policy objectives attached to the government's reform effort;

Whereas the grant by the Community of a medium-term loan to the Slovak Republic is an appropriate measure to support the balance of payments and to strengthen the country's reserve position;

Whereas the Community loan should be managed by the Commission;

Whereas the Treaty does not provide, for the adoption of this Decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall grant to the Slovak Republic a medium-term loan facility of a maximum amount of ECU 130 million in principal with a maximum maturity of seven years, with a view to ensuring a sustainable balance-of-payments situation and strengthening the country's reserve position.

2. To this end, the Commission is empowered to borrow, on behalf of the European Community, the necessary resources that will be placed at the disposal of the Slovak Republic in the form of a loan.

3. This loan will be managed by the Commission in close consultation with the Monetary Committee and in a manner consistent with any agreement reached between the IMF and the Slovak Republic..

Article 2

1. The Commission is empowered to negotiate with the Slovak authorities, after consultation with the Monetary Committee, the economic policy conditions attached to the loan. These conditions shall be consistent with the agreements referred to in Article 1(3).

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in close coordination with the IMF, that the economic policy in the Slovak Republic is in accordance with the objectives of this loan and that its conditions are being fulfilled.

Article 3

1. The loan shall be made available to the Slovak Republic in two instalments. The first instalment shall be released on the basis of the approval of the the "stand-by arrangement" by the Board of the IMF and subject to the provisions of Ar [illegible]le 2(1).

2. The second instalment shall be released at least two quarters after the release of the first instalment, on the basis of a satisfactory progress in the Slovak Republic's application of the "stand-by arrangement" and subject to the provisions of Article 2(2).

3. The funds shall be paid to the National Bank of Slovakia.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest rate risk, or in any other commercial risk.

2. The Commission shall take the necessary steps, if the Slovak Republic so wishes, to ensure that an early repayment clause is included in the loan terms and conditions and that it may be exercised.

3. At the request of the Slovak Republic, and where circumstances permit an improvement in the interest rate on the loans, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average maturity of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by the Slovak Republic.

5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

At least once a year the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

Done at ....,

For the Council

The President

FINANCIAL RECORD

1. Budget line concerned

Article (...)guarantee for the Community loans to the Slovak Republic (to be created through an amending and/or a supplementary budget).

2. References(legal base)

Article 235 of the Treaty

3. Classification of the Expenditure

Obligatory

4. Description and Justification for the action

a) Description of the action

The budget entry reflects the commitment of the budget guarantee associated with the Community loan to the Slovak Republic designed to ensure a sustainable balance-of-payments position and strengthening international reserves of this country.

b) Justification for the action

The viability of Slovakia's external accounts heavily depends on external financial assistance from official sources.

5. Nature of the expenditure and method of calculation

a) Nature of the expenditure

Guarantee for the Community loan to the Slovak Republic.

b) Method of calculation

A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that this budget guarantee will not be called.

6. <u>Effect of the action on intervention credits</u>

Only in the case of an effective call on the guarantee.

7. <u>Financing of intervention expenditure</u>

- Endowment of the line by transfer, by reutilisation of reimbursed amounts (Article 27(3) of the Financial Regulation of 1977), or by amending and/or supplementary Budget.

- In order to fulfil its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 of the Council Regulation (EEC, Euratom) no. 1552/89 of 29.5.1989 will apply.

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1994 AND NOTIONAL MARGIN UNDER THE RESERVE FOR GUARANTEES (IN ECU MILLION)

Operations	Basis of the Calculation	Provisioning of The Fund (1)	Reserve Margin
			318(2)
Project related assistance			
EIB/CEEC	765	107	211
EIB/MED	100(3)	14	197
EIB/PVDLA	500(4)	70	127
EURATOM	150	21	106
Macro-financial assistance			
Moldova	45	6	100
Bulgaria	40(5)	6	94
Romania	125	18	76
Algeria	200(6)	28	48
Slovakia	130(6)	18	30

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(1) According to the provisioning rules agreed in the Council's common position of 13 September 1993
(2) Reserve amount in 1994 under the financial perspective
(3) Including amounts of estimated disbursements in 1993 and operations for Cyprus and Malta
(4) Including amounts of estimated disbursements in 1993
(5) Commission proposal to increase the amount of assistance (ECU 110 million) decided in 1992
(6) Commission proposal

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