DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR THE

SLOVAK REPUBLIC

As approved by the Board of Directors at its Meeting on 6 July 2004

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EXECUTIVE SUMMARY

The Slovak Republic continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. The Slovak Republic has made considerable progress in transition with an estimated 80 to 90 per cent of economic activity in private hands, a large degree of price liberalisation, an open foreign trade regime and no major constraints to foreign investment. Following remarkable years of reform and adjustment the Slovak Republic joined the EU on 1 May 2004.

In autumn 1998, a reform-oriented multi-party government came to power which embarked on a series of major reforms including a banking sector reform, corporate restructurings and an energy sector reform. The new government elected in September 2002 continued with bold reforms including a tax reform (19 per cent flat personal and corporate income tax rate), a reform of the labour code introducing more flexibility and a pension reform increasing the statutory retirement age and establishing a second pension pillar. GDP growth has been the highest of all central European countries, at 4.4 per cent in 2002, fuelled by increased consumption, and 4.2 per cent in 2003, as a result of export growth. FDI was substantial with USD 4 billion in 2002 as a result of large privatisations and decreased to slightly below USD 600 million in 2003. GDP growth and FDI have contributed to reduce the unemployment rate which has been around 20 per cent for several years to 17 per cent in 2003.

It is the ambition of the government after the EU entry to complete its reform agenda, to meet the Maastricht criteria and join the Euro Area and to create a business-friendly environment which allows sustained growth and a high level of FDI.

In spite of all these positive developments, the Slovak Republic is still faced with a number of challenges. Key areas include fiscal consolidation, pension and health care reform, funding for education, inflation, corruption and law enforcement. Tackling these issues successfully will require a high level of political stability and consistency in approach. Further challenges in areas the EBRD can and will address and influence, are, among others:

- **SMEs:** The government and its agencies as well as banks are recognising the importance of the SME sector. It still needs to get more attention in terms of financial instruments available to them and improvement of the environment they operate in.

- **Privatisation:** The parliament has approved the further privatization of many of the strategic companies including Slovenske elektrarne and the electricity distribution companies. The government now needs to implement the revised privatisation strategy.

- **Use of EU funds:** The necessary institutional structures for the implementation of the Structural and Cohesion Funds have been put in place. A good pipeline of projects and the availability of co-financing will allow Slovakia to fully benefit from EU funds as soon as the programme starts.

- **Regional Imbalances/Infrastructure:** The government is recognising that it will have to accelerate the implementation of infrastructure projects if it wants to boost the lesser developed regions of Slovakia and that it will have to consider Public-Private Partnership models to achieve such acceleration.

Since the last country strategy was approved, the Bank activities in the Slovak Republic have increased significantly. The Bank signed projects in an amount of EUR 119.7 million and EUR 137.3 million in years 2002 and 2003, respectively. The Bank had a significant transition impact in supporting SMEs by providing credit lines to banks and leasing companies, providing support to equity funds and to companies in privatisation (Slovenska poistovna; ZSE). The Bank's contribution in the infrastructure sector has remained moderate due to the availability of other sources of financing, the limited size of municipal projects and the ongoing restructuring of the water sector.

Looking forward and taking into account key transition challenges and the principle of additionality, the Bank's objective is to expand its activities focused on the following priorities:

- In the **enterprise sector**, the Bank will (i) continue to actively support restructuring and consolidation of the local private sector alongside strategic investors or through equity funds, (ii) support foreign direct investment in regions of higher unemployment, particularly for green-field and brown-field projects, as well as tourism projects and (iii) continue to support SMEs including those in the agribusiness sector indirectly through financial intermediaries. All initiatives for the enterprise sector will be aimed at reducing regional imbalances.

- In the **financial sector**, the Bank will (i) expand the volume and spectrum of funding and guarantee instruments to local banks and leasing companies for the support of SMEs, municipalities and agribusinesses (ii) invest in equity funds and (iii) support the development of the second pension pillar.

- In the **energy sector**, the Bank will (i) support potential investors with respect to the privatisation of Slovenske elektrarne, (ii) support the completion of the privatisation of the electricity distribution companies, (iii) work with developers of independent power plants and (iv) seek to develop energy savings projects for companies, municipalities and other public entities.

- In **infrastructure**, the Bank will (i) support municipalities and water companies to access funding from EU grant programmes through co-financing of infrastructure and environmental projects (water, solid waste, urban transport) and provide EU sponsored facilities to local banks for small municipalities, (ii) support industrial outsourcing of environmental services, (iii) consider a role in the restructuring of the two railway companies and (iv) explore the scope for financing road infrastructure through Public-Private Partnerships. In putting together optimal funding structures for clients it will work closely with the EIB and the EU as well as with local banks and in supporting projects it will seek to reduce regional imbalances.

LIST OF ABBREVIATIONS

EC	European Commission
EFSAL	Enterprise and Financial Sector Adjustment Loan
EIB	European Investment Bank
ESCO	Energy Service Company
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
GDP	Gross Domestic Product
HSMS SECAL	Health Sector Modernisation Support Sectoral Adjustment Loan
IFC	International Financial Corporation
ILO	International Labour Organisation
IMF	International Monetary Fund
IPPC	Integrated Pollution and Prevention Control
NATO	North Atlantic Treaty Organisation
OECD	Organisation for Economic Cooperation and Development
PPP	Public- Private Partnership
RONI	Regulatory Office for Network Industries
SEPS	Slovenská elektrizačná prenosová sústava
SKK	Slovak Koruna
SMEs	Small and Medium Enterprises
SPP	Slovenský plynárenský priemysel, a.s.
USD	United States Dollar
VAT	Value Added Tax
VUB	Všeobecná úverová banka, a.s.
WB	World Bank
ZSE	Západoslovenská Energetika, a.s.

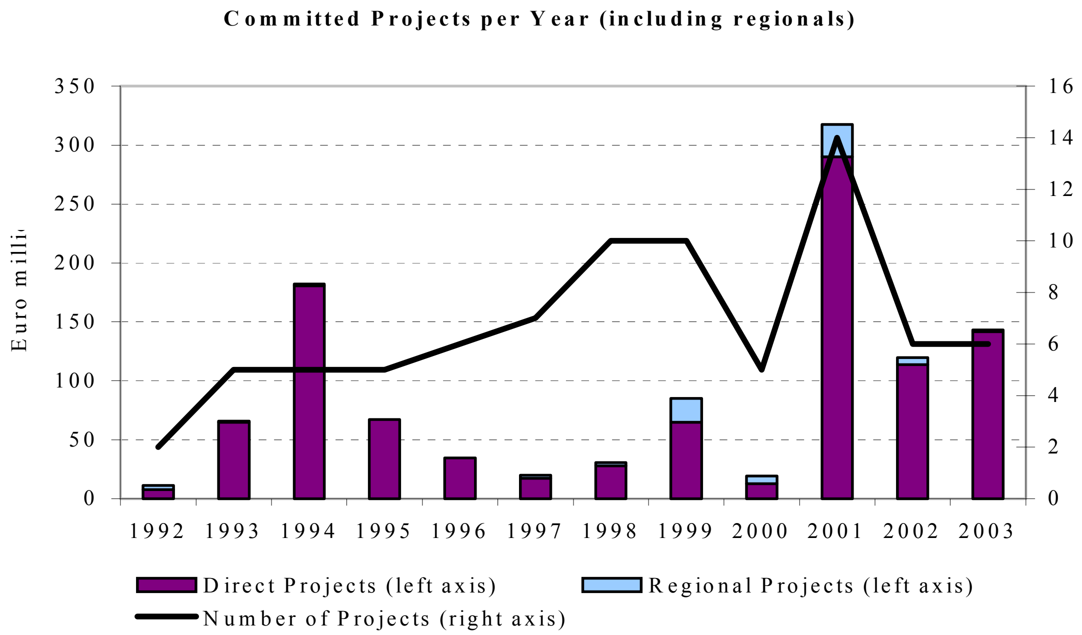
1. THE BANK'S PORTFOLIO

1.1 Overview over Bank Activities to Date

The Bank has been an active participant in Slovakia's transition to a market economy, financing mainly private sector projects across a broad spectrum of economic sectors. Up to end of 2003, the Bank has committed EUR 1,011.9 million representing 4.5 per cent of Bank-wide commitments. For details on the Bank's commitment by industry and on a project by project basis see Annexes 1 and 2.

Chart 1 illustrates the activity of the EBRD in Slovakia in terms of number of projects and amounts committed by EBRD in Slovakia since 1992. As shown on the Chart, the activity of EBRD increased significantly from year 2001, with commitments of EUR 343.8 million, EUR 119.7 million and EUR 137.3 million, for the years 2001-2003.

Chart 1:



The current portfolio is EUR 679.9 million or 4.6 per cent of total Bank portfolio. The non-sovereign/sovereign ratio is 99 per cent and the private/state ratio 83 per cent. Compared to 2001, the impaired assets declined, resulting in a ratio of Performing to Operating Assets of 95 per cent. 40 per cent of the portfolio relate to Financial Institutions, a reflection of the Bank's significant role in the privatisation of the Slovak financial sector and the granting of the EU/EBRD SME Finance Facility to banks and leasing companies. The involvement of EBRD in the energy sector has been significant with 34 per cent of total portfolio. The Bank's role in infrastructure (transport, municipal and environmental infrastructure) has remained marginal.

1.2 Implementation of the previous country strategy

During 2002 and 2003, the Bank signed 12 projects of which three were regional projects relevant for the Slovak Republic.

In the **enterprise sector,** the objective was to support company restructuring and support of green-field investments. – The Bank was instrumental in the establishment of a turnaround fund focusing in the restructuring of local companies (so far one investment) and it invested, jointly with an Italian Sponsor, in a chemical plant in northern Slovakia.

In the **financial sector**, the Bank set out to support SMEs and to further the development of non-banking financial institutions. – The Bank granted several credit lines to banks and leasing companies and invested equity in the largest Slovak insurance company, together with a German sponsor, as well as in a turnaround fund mentioned above.

In **energy**, the Bank's objective was to participate in the privatisation of electricity distribution companies and to support private investors in particular with respect to the development of independent power plants. - The Bank bought a 9 per cent stake in the western Slovakian electricity company. No new power plants were built during this period although initiatives do exist.

In **infrastructure**, the Bank wanted to make a bigger impact but it could not do so as a result of (i) the availability of other sources of funding (EIB and commercial banks), (ii) the small size of municipal projects and as well as the financial position of municipalities and (iii) the ongoing restructuring of the regional water companies which did not allow projects to proceed. However, the new focus on Public Private Partnership models as well as the evolving water sector may provide possibilities for the future.

1.3 Transition impact of the Bank's portfolio and lessons learned

1.3.1 Relevance and Transition impact of previous Country Strategies

The Bank evaluated the relevance and transition impact of previous Country Strategies for Slovakia as follows:

- **Financial Sector**
  The Bank set appropriate priorities in the financial sector over the ten year period, i.e. low priority between 1994 and 1996 and then increasing. In year 2001, the Bank managed to foster the privatisation process through its involvement in Slovenska sporitelna, VUB and Unibanka. In years 2001-2003, it signed a number of EU/EBRD SME Finance Facilities. In terms of Non-Banking Financial Institutions, it participated in a pension fund (2000) and acquired a stake in Allianz Slovenska poistovna (2003). The Bank also participated in a number of equity funds (mostly regional except for the Value Growth Fund – a fund focusing on the restructuring of Slovak companies). With these projects it achieved a good transition impact in the Banking Sector and a satisfactory one in the Non-Banking Financial Sector.

- **Enterprise Sector**
  The Bank set more or less the right priorities in the enterprise sector, i.e. high priority initially and then reducing. Prominent General Industry projects include Slovalco (1994), Bucina (1998), Aquachemia (2000) and various investment of the Slovak Post Privatisation Fund. In property, the Bank financed the Polus Centre, a major shopping centre and office building. In the agribusiness sector, the grain receipt program was introduced successfully in 1998. The Bank also got involved in telecoms with two projects (Slovak Telecoms and mobile operator Globtel). The transition impact is satisfactory with the exception of Agribusiness where it is higher as a result of the innovative grain receipt programme.

- **Energy and Infrastructure**
  The relevance of the strategic priorities in the various country strategies can be considered as satisfactory. Prominent projects in the Energy and Natural Resources sector include the oil refinery Slovnaft (1995); energy savings projects (Dalkia and Landis&Gyr ESCO); the Bank's participation in a bond issue for SPP, the Slovak gas company (1999); the restructuring loan for the electricity utility Slovenske elektrarne (2002) and finally the acquisition of 9 per cent in the western Slovakian electricity distribution company. In Transport, Municipal and Environmental Infrastructure, the Bank's activity is limited to one sovereign road project (1993) and a small heating project (1996). The transition impact varies for the different sub-sectors but ranges from good for Energy Efficiency to marginal for Transport.

- **Overall Assessment and Rating**
  The priorities set forth in the various Strategies broadly match the business opportunities. In terms of the implementation of the Strategies, the Bank implemented the investment priorities set forth in the Strategies well but could have had a more intense policy dialogue. The transition impact has been good in sectors such as Banking, Agribusinss and Energy Efficiency and satisfactory in most other sectors.

- **Recommendations for future Strategies**
  Among others, it is recommended that (i) the strategy should be more focused with respect to immediate interventions and areas for policy dialogue and that (ii) it should indicate for each sector how future projects, related technical co-operation and policy dialogue proposals support the strategic orientation. Section 3.1 and other relevant Sections address these points, where relevant.

1.3.2 Financial Performance of the existing portfolio

The Slovak portfolio risk rating was 4.72 in 2003 down from 4.85 in year 2002. The rating compares favourably with the risk rating for central Europe of 5.02 in 2003 and 5.03 in year 2002.

1.3.3 Mobilisation of co-financing

In addition to its own investments, the Bank helped to mobilise a further EUR 2,153 million of co-investment over the 1992-2003 period, representing a multiplier of 3.1 (total project cost/EBRD commitments). The total value of projects the EBRD participated in is EUR 3,164 million. In 2001, a loan for the chemical company Aquachemia was co-financed and in 2002 a restructuring loan to Slovenske elektrarne. No co-financings are recorded for 2003, as a result of EBRD's focus on equity.

1.3.4 Lessons Learned

- The Bank did encounter difficulties in projects not involving western strategic investors (e.g. Bucina; investments of Slovak Post Privatisation Fund) due to lack of transparency, good corporate governance and standards of business conduct. Managerial know-how and restructuring skills of management teams need to be critically assessed during the Bank's appraisal process and any identified shortage needs to be properly addressed. However, even projects involving foreign strategic investors can run in problems (e.g. Aquachemia).
- Political risks and constraints need to be analysed in privatisation deals. Political factors can block good governance. Adherence to good governance needs to be negotiated in the documentation (e.g. Slovaft).
- Carving out and ring-fencing of companies from loss making conglomerates is feasible with the involvement of a foreign partner.
- EBRD equity can offer benefits to foreign partners in various sectors (e.g. Norsk Hydro; Allianz; E.ON, Erste Bank; Unicredito), either in terms of political comfort or risk sharing. EBRD's active participation at board level contributes to a high quality debate.
- With respect to the EU/EBRD SME Finance Facility, the work of the consultants provided by the EBRD make a real difference in setting up SME departments, designing scoring systems and providing training (e.g. VUB).

1.4 Portfolio Ratio

- The non-sovereign ratio/sovereign is 99 per cent. The only sovereign loan is the International Road Corridor Loan from 1993.
- The private/state ratio is 83 per cent. The two operations in the state sector relate to the restructuring loan for Slovenske elektrarne and the Bank's stake in electricity distributor ZSE which is still 51 per cent state-owned.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

- **Political background**
  The Slovak Republic continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. It has been an independent state since the dissolution of the Czech and Slovak Federal Republic in 1993. The Slovak Republic is a multiparty democracy, with power shared between a President elected by popular vote and the 150-member Parliament. In May 1999, Rudolf Schuster defeated the former Prime Minister Vladimir Meciar in the first direct presidential election. In the second round of the 2004 presidential election held on 17 April, Ivan Gasparovic won 59.9 per cent of the votes, with a 43.5 per cent turnout. He defeated Vladimir Meciar. A reform-oriented government, led by Prime Minister Mikulas Dzurinda, was re-elected after parliamentary elections in 2002. The next parliamentary elections are scheduled for September 2006. The Slovak Constitution provides for an independent judiciary. However, corruption and inefficiency within the judiciary remain serious.

- **Regional integration**
  Slovakia was invited to start accession negotiations with the European Union in December 1999. Following the successful conclusion on 13 December 2002 of the EU's accession negotiations with Slovakia, Slovakia, together with nine other candidate countries, was invited in December 2002 to join the EU. The Treaty of Accession was signed on 16 April 2003. In a referendum held on 16-17 May 2003, Slovak voters approved membership of the EU, with 92 per cent voting in favour. The turnout was 52 per cent, just above the 50 per cent needed to make the referendum valid. Slovakia joined the EU on 1 May 2004. In November 2002, Slovakia was invited to join NATO. In April 2003 the parliament ratified Slovakia's accession to NATO, which Slovakia joined in April 2004. Slovakia's bilateral relations with its neighbours remain stable.

- **Integrity issues**
  Organised crime is a serious problem in Slovakia - not least because of the widely reported links between the Meciar administration up to 1998 and criminal groups. According to the Comprehensive Monitoring Report on Slovakia's preparations for EU membership published in October 2003, there is a high public and professional perception of widespread corruption in Slovakia, and tackling it should be a priority. The most affected areas appear to be the health care sector, education, the police and the judiciary. Corporate crime, according to the report, is a specific problem in Slovakia and the business climate is still to a degree characterised by legal uncertainty. The report emphasises the need for the strict enforcement of the existing rules, but also notes that the awareness of the need to fight corruption - including in the media - is increasing. A National Programme for the Fight against Corruption was elaborated in 1999 and was followed up by an Action Plan. Implementation is in progress but progress appears to be slow. According to the Government, three-quarters of the concrete actions have been carried out or addressed to a large extent, but many proposed actions appear to be vague.

Slovakia is ranked in the 58th place (together with Columbia, Croatia, El Salvador and Peru) in the 2003 Transparency International's Corruption Perceptions Index which takes in 133 countries. In 2002 Slovakia was ranked 52nd out of 102 countries (together with the Czech Republic and Latvia). The Index, which draws on 14 surveys from seven independent institutions, reflects the perceptions of businesspeople, academics and country analysts. It focuses on corruption involving public officials and does not reflect secret payments to finance political campaigns, the complicity of banks in money-laundering or bribery by multinational companies.

- **Legal Environment**

  The Slovak Republic has made considerable reforms to its legal framework, leading to improvements in the country's legal and business environment. In May 2004 the Slovak Republic became a member of the EU, and the harmonisation with EU legislation is almost complete. The country continues to make progress in further consolidating and deepening the stability of its institutions guaranteeing democracy, the rule of law and human rights. However, effort is still required to address shortcomings such as corruption, excessive bureaucracy and inconsistency in legislation.

  The Slovak Republic is a parliamentary democracy where separation of powers and independence of the judiciary are recognised. The judiciary is legally independent, and improvements have recently been made to consolidate the de facto independence of the judges. Such improvements have generated a certain confidence of the business community in the court system. However, inefficiencies and corruption in the judiciary remain a serious concern. As regards personal freedoms and human rights, the Slovak Republic is viewed as one of the better performing transition countries, which positively affects the economic and legal reforms in the country.

  The country continues to make efforts in investment promotion and has steadily been enhancing its international credibility in the area of foreign direct investment. One of the most important initiatives was a recent tax reform, effective from 1 January 2004, which introduced a uniform corporate and personal income tax rate of 19 per cent. Furthermore, dividend distribution and distribution of liquidation surpluses, from both domestic and foreign companies, are no longer subject to Slovak tax. Another main legislative development was the adoption of an amendment to the Civil Code regarding secured transactions, prepared with the Bank's assistance, introducing the most advanced framework for secured credit of any country in Europe with effect from 2003. Security can now be taken over any asset that is capable of being transferred, and all types of claims may be secured. The creation of security is simple and rapid and is publicised through registration. Other improvements include new investment incentives legislation and changes to the Commercial Code, introducing better corporate governance measures. The country's foreign exchange legislation has been further liberalised, and a new accounting act effective from 2003, harmonised Slovak accounting standards with EU regulations as well as with International Accounting Standards and introduced a new concept of fair and true presentation of accounting data and valuation of certain assets.

  The privatisation process is almost complete, and in 2003 the parliament passed a legislation formally closing the Privatisation Ministry. From 2004 many of the remaining state-owned assets previously considered to be strategic are eligible for sale.

- **Environment**

  The Slovak Republic has achieved considerable alignment with the EC environmental *acquis*, although it still needs to adopt a large number of ministerial regulations in order to complete transposition in practically all areas. The air quality directives, Integrated Pollution Prevention and Control, Environmental Management Systems and some waste directives (chemicals and motor vehicle recycling, waste management, packaging waste and landfills) were transposed in 2003. In 2004 the water-related directives and emission trading facilitating directives are being transposed. The Slovak Republic made some progress lately by introducing new regulations in nature protection areas. (See Annex on Environment)

  The first greenhouse gas emission trading under the Kyoto Protocol was executed by the Slovak Republic and a major Japanese trading house.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic conditions for Bank operations

- **Output**

  Total output increased significantly over the last two years, by 4.4 per cent in 2002 and 4.2 per cent in 2003, making the Slovak Republic the fastest growing economy in central Europe. GDP growth should remain at or above current level in 2004 and in the medium-term. 2003 saw a welcome re-balancing of growth, as net exports more than offset stagnating private and public consumption and declining productive investment, while in 2002 growth was fuelled by fast rising household income and public spending ahead of general elections.

- **Inflation**

  Headline inflation remained subdued to 3.3 per cent in 2002 due to a relatively tight monetary policy and deferred administered price increases. It increased substantially in 2003, reaching 8.5 per cent on average, following significant increases in regulated prices and excise taxes. It should decline only slightly in 2004, as a result of further price hikes and the unification of the VAT rate, but is expected to rejoin Maastricht level by 2007 if the absence of any second round effects of the price and tax increases already visible is confirmed.

- **Fiscal Deficit**

  An ambitious strategy for fiscal consolidation has been initiated in 2003, with the objective of meeting the Maastricht criterion by 2006. While fiscal deficit reached 5.7 per cent of GDP in 2002, it was reduced to 3.6 per cent in 2003, below the 5 per cent official target, partly thanks to exceptional savings on expenditure and non-tax revenues. The target of 3.9 per cent in 2004 seems within reach, while completion of the objective of reaching Maastricht level by 2007 might be slightly less assured. As a matter of fact, although it has been included in these targets, the impact of the pension reform could translate into an expenditure increase higher than the 1 per cent of GDP expected by the government, depending on how many workers decide to opt for pension funds.

- **Current Account Deficit**
  In 2002, the current account deficit remained at the very high level of 8 per cent of GDP for the second year in a row, due to an unsustainable trade deficit that was close to 10 per cent of GDP as a result of fast rising net imports fuelled by sustained domestic demand. In 2003, an impressive surge in exports, by 22.6 per cent in real terms, combined with the austerity plan implemented just after the parliamentary elections, held in September 2002, resulted in a very significant adjustment, as the deficit of the current account decreased to below 1 per cent of GDP.

2.2.2 Transition success and transition challenges

- The Slovak Republic has achieved strong although uneven progress in transition reforms over the past decade, with a marked acceleration in the last two years. Major liberalisation reforms, such as price liberalisation, trade and exchange rate liberalisation, as well as small-scale privatisation were successfully implemented in the early nineties. In the period between 1994 and 1998 the reform effort slowed down, as the government, among other measures, cancelled the second round of voucher privatisation and partially replaced it by discounted sales to well connected local investors. Incoherent economic policies, administrative interventions in the enterprise sector, connected lending, lack of strategic investors in privatised companies and inadequate, poorly enforced legislative and regulatory framework resulted in defaults and bankruptcies of large companies, including in the banking sector. Strong output growth, in excess of 4 per cent in 1994-1998, was fuelled by large infrastructure investments financed with expensive short-term loans. As a result, macroeconomic stability was threatened, with fiscal deficits exceeding 5 per cent of GDP and current account deficits reaching close to 10 per cent of GDP between 1996 and 1998.

- Changes in the government in 1998 led to a reversal of both macroeconomic and structural policies. The currency was floated, leading to moderate depreciation, and fiscal policy tightened. The new government re-launched the privatisation process, restructured the banking sector through recapitalisation and transfer of non-performing loans, established a financial-market regulator, adopted amendments to the bankruptcy legislation, and launched energy reform with increases in utility prices towards cost recovery levels. As a result both internal and external imbalances were reduced, although the fiscal deficit continued to be as high as 6 to 10 per cent of GDP in 1999-2001, largely because of the cost of the banking sector restructuring. Output growth resumed rapidly from the low level of 1.5 per cent recorded in 1999, the year of the strongest adjustment, to 4.4 per cent in 2002. However, the renewed reform effort also led to an inevitable increase in unemployment rate to close to 20 per cent of the labour force.

- The election of an even more reform-oriented government in September 2002 marked an acceleration of the pace of structural reforms, beyond the requirements of accession to the EU, accompanied by a strong improvement in the macroeconomic environment. This includes a comprehensive reform of the tax system, the transformation of the current pension system into a three-pillar system, legislative amendments allowing for the full privatisation of most of the remaining large state-owned companies, and the restructuring of the health care sector. Full liberalisation of the energy market is expected to take place this year for industrial customers, while a majority of energy and other utility prices have now reached cost recovery levels. These positive developments are reflected in the growing interest of large industrial foreign investors in the country, including prominent car manufacturers like Peugeot-Citroën and Hyundai-Kia. Credit rating agencies, including Moody's, Standard and Poor's and Fitch, recently upgraded the Slovak Republic in recognition of the substantial progress achieved in the last two years.

Enterprise Performance: *While large foreign companies are investing in increasing numbers in the country, a growing gap between the performance of foreign-owned and local enterprises is giving way to the emergence of a dual economy.*

- A combination of a productive and relatively cheap labour force, a good geographical position, and ambitious economic reforms attracts an increasing number of large foreign industrial companies. In the past eight years productivity in the manufacturing sector increased by more than 40 per cent, which represents an annual growth rate of almost 5 per cent. In the same period real wages evolved roughly in line with productivity, so that the competitive advantage of the Slovak Republic compared to more advanced countries was preserved. In 2000, the share of labour costs in the value-added generated by the manufacturing sector stood at 48 per cent, while it was much higher in the 15 Member States of the European Union before the May 2004 enlargement (EU-15), at 68 per cent. The same developments characterise other sectors, be it industry as a whole or the combination of services and industry, where the comparative advantage of the Slovak economy over the EU-15 is of the same order of magnitude as in the manufacturing sector.

- At the same time the Slovak Republic stands more or less on a par with some of its peers in Central Europe (the Czech Republic and Poland, in particular) as regards unit labour costs. However, the Slovak Republic appears to have been doing relatively better in catching-up in terms of productivity level, moving from 42.9 per cent of the EU-15 average in 1995 to 56.2 per cent in 2002, a 13 percentage-point increase in seven years. In the same period Poland gained 6 ½ points to reach 48.8 per cent of the EU-15 average in 2002 and Hungary 9 points at 62.6 per cent. In that regard the renewed interest of foreign investors in the country appears to be the reflection of a bridging process by the Slovak Republic of the gap accumulated until recently with comparable countries in the region as regards FDI. In other terms these developments are the result of the progress achieved in recent years in terms of structural reforms and political stability, in addition to a good geographical location at the centre of Europe and low labour costs.

- They also illustrate an increasing specialisation of the Slovak economy. In 2003 the transport equipment industry, largely dominated by Volkswagen which has been operating in the country since 1993, represented 30 per cent of total exports. This trend will most certainly be reinforced when Peugeot-Citroën and Hyundai-Kia start producing in 2006. Both have announced, in the last two years, the construction of factories due to produce up to 300,000 vehicles per year each, the level of production reached by Volkswagen in 2003. This evolution also translates into a relatively large and growing gap between the performance of foreign-owned and domestic companies, as stressed by the OECD in its latest survey of the Slovak economy. The emergence of a dual economy is illustrated by the wide dispersion of profitability and wages according to the nature of company ownership, with the international sector operating at a noticeably higher level than domestically-owned enterprises.

Business Environment: *quality of the business environment is still lagging behind despite progress made in recent years, and further reduction in labour taxation is needed to lower high structural unemployment.*

- Despite the announcement by foreign investors of large projects, which signals to some extent an improvement in the country's business climate, conditions for running a business in the Slovak Republic remain among the most difficult in central Europe, especially for small and domestic enterprises. These impediments relate to the legal environment in several ways. They also derive from weak implementation of the legislation by the judiciary system and regulators as well as numerous instances of corruption, as is well documented in several international studies.

- Significant – but still insufficient – progress designed to improve the business environment has been made in many respects over the last two years. The tax system was simplified with the introduction of a flat tax rate of 19 per cent on both personal and corporate income and the unification of the VAT rate to 19 per cent as well. These measures are likely to contribute to the promotion of SMEs and small businesses in particular, as well as to the reduction of the magnitude of the grey economy. Further modernisation of the judiciary and legal service sector, which has been initiated recently, will be critical for accelerating and maintaining economic growth, along with fighting corruption. In that regard the establishment of an electronic commercial registry is an important example, as it improves the execution of the commercial law and the overall transparency of the business environment. The adapation of the laws on bankruptcy and the simplification of the procedure for creating a new business have also been undertaken. Finally, the start of the reform of the judiciary should also contribute to enhance the investment climate.

- The reform of the labour code was another important step taken by the current government, allowing for more flexibility in the labour market. The use of fixed-term and part-time contracts was relaxed along with the possibility to raise the cap on overtime work, while the procedures to make an employee redundant were simplified as regards severance payments and advance notice. Other measures include the reduction in mandatory social contributions by 3.6 percentage points, although further reduction of the tax burden appears nevertheless necessary since mandatory social contributions still represent 47.8 per cent of total labour cost, one of the highest levels in the OECD. Labour taxation remains a significant obstacle to the reduction of a high structural unemployment rate which came back close to its historical value at 19 per cent in the first quarter of 2004, after a temporary decline to 17 per cent in 2003. Long-term unemployment represents 60 per cent of total unemployment and almost half of the unemployed are low-skilled workers, with only primary education.

Privatisation: *Almost all of the country's total output is generated by the private sector, as privatisation is drawing near to completion, and only a few large companies in industrial and service sectors remain to be sold.*

- In 2003, between 80 and 90 per cent of GDP were generated by the private sector according to the EBRD's estimate and the annual figure provided by the Statistical Office of the Slovak Republic, respectively. However the grey sector still represents between one sixth and one fifth of the economy, according to estimates. Virtually the whole output was produced by private producers in sectors generally characterised by small-scale ownership, like agriculture (98.9 per cent of total output, with only 47.5 per cent in forestry as it remains state-owned to a large extent), construction (99.5 per cent) and trade (99.8 per cent). In some other sectors, where full privatisation of generally large companies has not yet been completed, the share of the private sector in production ranges from 63.5 per cent in transport to 82.5 per cent in industry, including energy.

- In these sectors only a few, predominantly large, state-owned companies remain to be fully privatised. These enterprises operate mainly in the energy sector (with the dominant electricity producer, Slovenske elektrarne, and the regional transmission companies), telecommunication (Slovak Telekom in which the government still holds a 49 per cent stake) and transport (regional bus companies, Slovak Airlines, the country's airports). The law on "strategic companies", which prevented the state from lowering its stake in them below 51 per cent, was amended in late 2003 in order to allow for full privatisation of most of the remaining large state-owned companies. It excludes however the post, the two railway companies and national forests.

SMEs: *SMEs play an important role in the Slovak economy, representing a relatively large share of employment, while many financial as well as administrative and legal obstacles remain to their development.*

- SMEs (i.e. employing from 10 to 249 persons) represented in 2002 just about a quarter of the total of 37,000 incorporated companies employing less than 250 persons, the remaining number being micro-enterprises, i.e. with less than 10 employees. In addition, the Slovak Republic recorded a much larger number of 85,000 non incorporated small businesses and entrepreneurs. A large number of SMEs and small businesses (referred to as SMEs from here) operate in the service sector, with 64 per cent of the total number, and much more marginally in industry, with 15 per cent of the total, where almost 80 per cent of value-added is generated by large enterprises.

- The contribution of SMEs to economic activity is nevertheless significant, as they represented 62 per cent of total employment in 2002, with those employing more than 9 persons amounting to 38 per cent of total employment. At the same date, they produced 41 per cent of total output, with a third of total value-added generated by enterprises with more than 9 employees. Finally SMEs contributed to slightly more than a quarter of total exports in 2002. SMEs in the Slovak Republic have a potential for further development, through productivity gains in particular. In effect the share of their labour costs in the value-added they generate represents roughly two-thirds, to be compared with one half in large companies.

- However the development and modernisation of SMEs remain impaired by various types of obstacles to business. The most important one is access to finance, both to debt and equity. Banks have only recently started to focus more on SMEs while access to equity remains very limited. While SMEs represent over 20 per cent of total value-added in the manufacturing sector, their gross investment accounts for just this proportion of the sector's total while their personnel costs amount to 36 per cent of the sector's total. In addition, only 17 per cent of SMEs declared to lead innovation activity against 43 per cent of large enterprises in the manufacturing sector. As far as the general business environment is concerned, SMEs are more strongly affected by the existing administrative and legal barriers than large and/or foreign-owned companies.

Banking Sector: *Privatisation is now completed and soundness and profitability of the sector have been restored; some significant further consolidation of the sector is to be expected in the coming years.*

- The banking sector, like the insurance sector, has been completely privatised by now with close to 90 per cent of banking assets controlled by foreign investors. The soundness of the banking sector has significantly increased in recent years, after completion, in 1999-2001, of the cleaning-up of the banks' portfolio of non-performing loans accumulated in the previous years. The capital adequacy ratio of the sector now stands at record levels, above 20 per cent, and the share of non-performing loans was lowered to below 10 per cent of total loans. Profitability, which comes increasingly from non-lending financial services with declining interest margins, has been restored but grows slowly, as it remains under pressure from increasing competition following the entry of a significant number of foreign players.

- These trends are expected to lead to further consolidation in the sector in coming years. The banking sector now consists of 21 commercial banks, of which only 2 do not have any foreign participation in their capital and 3 are branch offices, a number that could be reduced by close to one half in the medium term. The lending policy of commercial banks remains relatively cautious favouring large foreign-owned companies, and more recently households with a near-doubling of mortgage lending, at the price of over-liquidity in the sector. This situation appears to be still detrimental to domestic companies and more specifically SMEs, with only a modest increase in the volume of credit they were allocated. However, commercial banks seem to be now targeting the SME sector more actively.

- The share of credit denominated in foreign currencies in the total amount of credit extended to the private sector has been constantly on a growing trend. It increased from 12.3 per cent at the end of 2000 to 16.0 per cent the following two years, and finally 17.8 per cent at the end of 2003. This presumably illustrates the impact of still relatively high, although declining, domestic interest rates and the perception of a low exchange rate risk, but should warrant renewed attention in terms of financial sector supervision. The supervision of the financial sector (banks, insurance companies and capital markets) is to be unified under the auspices of the National Bank of Slovakia from 2006. The small size of the capital market, where the main players are banks and insurance companies that have strong links, as well as the operational independence of the central bank justify this decision.

Pension Funds: *The creation of privately managed mandatory pension funds will create a new challenge for the Slovak financial sector, as a large share of their assets might have to be invested on the local market.*

- In 2003 the Parliament adopted a law complementing the current pension system, which currently consists of an unfunded component and voluntary private pension funds, with a second pillar consisting of mandatory pension funds, to be managed by private operators from January 2005. These funds are to be funded by a 9 percentage-point contribution from the current 28 per cent taken from workers' wages. In July 2004, amendments to the relevant law reduced the minimum share of these funds to be invested in assets traded on the domestic market from 50 per cent to 30 per cent. According to the current provisions of the reform, the managers of the new pension funds will have to invest at least half of the funds received in assets traded on the domestic market. These funds are estimated to reach annually SKK 10-15 billion (EUR 350 million or around 1 per cent of 2003 GDP). For the sake of comparison, assets managed by such funds represented slightly more than 5 per cent of GDP in Poland in 2003 and half this magnitude in Hungary, according to available estimates.

- In its current form, this scheme is likely to be faced with a strong constraint, as the local capital market lacks sufficient size, depth and liquidity to offer appropriate investment opportunities to the newly created pension funds. As a matter of fact the market capitalisation of the Bratislava stock exchange is much lower than that of a majority of other Central European countries. The free float of shares is tiny and trading was limited, in late 2003, almost exclusively to mandatory public offers following take-overs. Another challenge related to the pension reform will be that of supervision of the newly created pension funds, especially in a period of unification of the supervision system of the financial sector under the auspices of the National Bank of Slovakia from 2006.

Telecom sector: *The actual opening of the telecommunication sector has been lagging behind, as recent legal reforms providing for the liberalisation of the sector are still to be implemented fully.*

- The telecommunication market has been recently officially opened allowing consumers to choose their provider and new operators to enter the market, with currently more than a dozen of them operating. However actual liberalisation is lagging behind and the level of competition reached among market players is not sufficient to guarantee the benefits that can be expected from the application of the rules to be adopted as part of accession to the EU. As noted by the OECD in its recent survey, prices for fixed-telephony services in the Slovak Republic are still the highest of all its members, representing twice the organisation's average. Fair access to the local loop for new entrants is still obstructed by the incumbent operator Slovak Telecom, controlled by Deutsche Telekom, which is the only operator to offer effectively a comprehensive range of services. At the same time, the mobile-telephony market is still a duopoly, with licenses held by only two foreign operators.

- As regards the regulatory environment there is a need to finalise the adaptation and effective implementation of the new relevant legislation, adopted at the end of 2003, as part of the transposition of the *acquis communautaire*. The administrative capacity of the market regulator also needs to be enhanced for the necessary conditions for a healthy competition to exist. The human resources and expertise the regulator can rely on need strengthening as well as its operational independence and its legal powers in terms of tariff calculation methodology and publication of inter-connection tariffs, according to the Comprehensive monitoring report published by the European Commission in November 2003.

Energy Sector: *Following substantial progress in the restructuring of the sector, privatisation and liberalisation of the market can be expected to move closer to completion in the near future.*

- Substantial progress has been made in restructuring the energy sector. An independent regulatory body (the Regulatory Office for Network Industries – RONI) was established as well as an independent transmission company (SEPS). The government sold 49 per cent stakes in the three electricity distribution companies in 2002 and intends to sell further stakes in the near future. It also plans to privatise 66 per cent of Slovenske elektrarne, which runs conventional and nuclear production facilities, and expressions of interest were received.

- Liberalisation of the sector is proceeding, as an increasing number of large customers has been progressively allowed to buy freely growing shares of their consumption. As a result more than a third of the electricity and gas markets were open to competition in 2003. The market is to be fully liberalised for industrial customers by July 2004, after medium-sized users have been allowed to select their own suppliers as of January 2004, and for households by July 2007. Electricity and gas prices have been increased significantly – by between 30 and 60 per cent – over the last two years by the regulator. They are now considered to have reached – or be close to – cost-recovery levels for every category of consumers, thus eliminating cross-subsidisation.

- Further steps, in line with the measures implemented so far, are to be taken for the full efficiency gains deriving from competition to be felt on the energy market by all consumers. These include securing open access to transmission and distribution infrastructures for all market players at fair prices. In addition the Slovak Republic is still wasteful of energy as measured by an energy intensity ratio which is currently above EU average.

Infrastructure and regional development: *Large infrastructure investments are necessary, especially in transport links, to contribute to the development of the eastern parts of the country and should benefit from EU funds.*

- Large infrastructure investments are necessary in order to increase the attractiveness of the country to foreign investors as well as to unlock the eastern parts of the Slovak Republic, with a view to achieving a more balanced development at the regional level. Regional disparities are quite marked between the capital region of Bratislava, where GDP per capita in purchasing power parity terms is on a par with the EU-15 average, and the rest of the country, where GDP per capita is lower than half of the EU-15 average. The selection by Hyundai-Kia of a location for its plant illustrates the critical importance of good transport links to foreign investors. The choice of Zilina, in the north-western part of the Slovak Republic, was in effect conditional on the construction of a 40-kilometre-long motorway section. Peugeot-Citroën also cites the proximity of quality transport links as one of the critical factors in its picking Trnava, in the west of the country.

- According to the single programming document agreed on with the European Commission, EU Cohesion and Structural Funds will be used for developing transport links, essentially roads and railway, and environmental purposes, like protection and rational use of water and air, or processing of waste. A third type of objective will be the upgrading of local infrastructure, including renovation of schools and health care facilities, modernisation of employment services, programmes for job applicants and rural development. The completion of this last objective will depend to a great extent on the capacity of regions and municipalities, in the context of the decentralisation of responsibilities and spending initiated by the government, to mobilise co-financing in order to complement EU funds. In addition, the transformation of the water industry from state-owned to regional companies owned by municipalities will require organisational work to ensure that they function efficiently and take full advantage of private sector participation where possible.

- The development Public-Private Partnerships (PPP) might not only offer an appropriate solution to the problem of the co-financing but also provide an efficient scheme for the management of some projects for which some degree of commercialisation can be envisaged. Another challenge related to EU Cohesion and Structural Funds will be that of the administrative capacity of the Slovak authorities to manage them, as the country has been deemed in July 2003 by the European Commission to be one the least prepared of all accession countries in this field. This factor, in addition to some possible difficulty in engineering a strong pipeline of projects, might lead the Slovak Republic not to be able to draw all of the potential funds it is entitled to.

Agri-business and rural development: *Productivity and quality of the production remain low and further adjustments in the agricultural sector are to be expected.*

- The agricultural sector is of less importance for the Slovak economy than it is in comparable transition countries, like some of the other new EU members, including Poland or Slovenia for example. However it still accounts for 5 per cent of total employment and contributes 4.5 per cent of the total value-added generated in the economy, against 4 and 2 per cent respectively on average in the EU-15 and 17 and 5 per cent respectively in the group of new EU members, where Poland strongly influences the average.

- Productivity of agriculture remains low in the Slovak Republic when compared to the EU-15, although it reaches one of the highest levels in central Europe. However, when measured as the gross value-added generated by one unit of full-time labour equivalent, productivity of the Slovak agriculture was only 20 per cent of the EU-15 average at current exchange rate in 1998 (40 per cent using purchasing power parity). Further efficiency gains are necessary, as the net entrepreneurial income of the agricultural industry (including subsidies) has been negative in recent years, like in the Czech Republic, the industry being barely profitable by now. The input/output ratio of the Slovak agriculture is also the highest, along with that of the Czech Republic, reaching 70 per cent for an average of 55 per cent in new EU members and 48 per cent in the EU-15.

- Quality of the production also needs significant improvement at a time when the Slovak agri-business sector is just about to be exposed to further competition from producers in the current EU-15. Indeed half of the Slovak food-processing companies failed to meet EU standards in 2003 according to the Commission. Expected adjustments in the agricultural sector will call for significant efficiency gains in the agricultural industry as well as the promotion of other forms of rural activities. In that regard the structural funds to be provided for rural development by the EU in 2004-2006, in an amount of EUR 400 million, could play a critical role in avoiding too large a dependence of the Slovak rural sector on EU transfers.

Health care sector: *Finalisation of the restructuring of the almost insolvent health care sector needs to be completed for efficiency purposes as well as in order to contribute to the consolidation of public finances.*

- Until recently the health care sector was approaching insolvency because of large arrears and debts amounting to a total of SKK 30 billion (somewhat below 3 per cent of 2003 GDP), of which arrears represent one third with another third owed to non-public entities. Total health expenditure already represented 6 ½ per cent of GDP in 2003 and the objective of the government is to limit it at this level, with three-quarters to be covered by social security. Patients' co-payments were introduced in 2003 for health services in order to create additional resources and reduce abuse, although substantial under-the-table payments are still required in practice. They helped reduce the pace of expansion of the health care sector's debt by half in 2003.

- The extension of co-payments by patients for additional health services, along with the continuation of the restructuring of hospitals and the reform of pharmaceutical policy, are planned by the government in 2004. They are intended to stop debt accumulation by the sector from this year, after the pace of expansion of the debt stock was halved in 2003. Further rationalisation of the supply and functioning of the health care sector, as well as of its funding, appears in effect to be necessary in addition to the workout of the stock of debt and arrears that has been launched. New legislation has been prepared by the government to address these remaining issues and be adopted in 2004 by the Parliament.

2.3 Access to capital and investment requirements

- **Domestic credit**
  As a result of the sale of virtually all banks to competing international banking groups, the Slovak Republic is over-banked and competition is fierce. Total credit has started to grow again in volume, after completion of the sector's restructuring, and now represents 58 per cent of GDP, after a peak at almost 70 per cent followed by a trough at 55 per cent in previous years. Although the private sector represented only slightly more than one half of total credit in 2003, credit is readily available for good clients and most banks are now also pro-actively targeting the SME sector. However, banks are not able to increase their debt exposure to clients indefinitely, creating a gap which has to be reduced through equity and equity-type products. Despite a surge in consumer credits and mortgage loans, banks remain faced with substantial over-liquidity which is invested mainly in state bonds.

- **Capital markets**
  The Bratislava Stock Exchange is small, with a market capitalisation equal to 37 per cent of GDP in 2003, of which shares represented only a quarter with very limited free float. The privatisation of large listed companies to strategic investors has led to a non negligible number of de-listings. The market is also relatively illiquid, with an annual trading turnover equal to only 2 ½ times market capitalisation (91 per cent of GDP). It remains a secondary source of financing for the private sector, with no initial public offering since its creation in 1993, and benefits mainly the public sector with a well developed and growing government bond market, which represents 95 per cent of total turnover.

- **Foreign direct investment**
  The Slovak Republic experienced a substantial increase in foreign direct investment in 2002 to USD 4 billion (16 per cent of GDP), due to large privatisation deals, in the energy sector in particular. This brought the total stock of foreign direct investment accumulated over the past decade to USD 10 billion, a near-doubling. The decline of net FDI inflows down to slightly below USD 600 million in 2003, appears accidental in that it is essentially attributable to the absence of major privatisation deals that year. Completion of the privatisation of the remaining large state-owned companies, in the energy sector in particular, will increase this figure in coming years. In addition the announcements of substantial investment plans by large foreign companies, like Peugeot-Citroën and Hyundai-Kia, will add up to USD 2 billion over the next two years. However this stresses the need to increase the country's attractiveness to smaller-scale green-field foreign direct investment.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

Key Short Term Operational Priorities

Based on its analysis of Slovakia's current transition challenges, the Bank has identified eight key priorities for the forthcoming period.

- Actively support the restructuring and consolidation of the local private sector through equity investments alongside strategic investors and through equity funds.
- Support foreign direct investment in green-field and brown-field projects, particularly in less developed regions.
- Support the further restructuring and privatisation of the energy sector through debt and equity and develop energy efficiency projects.
- Support SMEs through EU sponsored credit lines and risk sharing facilities to banks and leasing companies.
- Support municipalities though the Municipal Finance Facility.
- Support the agribusiness sector through the EU sponsored Rural Finance Facility.
- Work closely with the regional water companies and create funding structures that would facilitate the use of EU cohesion and structural funds.
- Support railways restructuring and modernisation.

With respect to all eight priorities the EBRD has specific leads or indications by the prospective clients that an involvement of EBRD would be desirable or the EBRD has devised specific products (e.g. Municipal Finance Facility, Restructuring Fund) to support a specific priority. In pursuing these priorities it will carefully consider transition impact and additionality.

Policy Dialogue

- The Bank has successfully completed a legal transition project (secured transactions). It wants to build on the excellent co-operation with the government and embark on a new legal transition project in an area relevant for EBRD. However, the Bank recognises that the legal transition is well advanced and that funds are available from other donors for additional legal work. The Bank would therefore focus on a very specific legal issue related to EBRD's operational work.
- The Bank will continue its dialogue with the government in relation to the liberalisation and privatisation of the energy sector.
- The Bank will maintain contact with the government and its agencies in relation to co-financing opportunities involving EU cohesion and structural funds.
- The Bank will seek a dialogue with the government in relation to specific project-related issues, where appropriate.

Environment

- The Bank will continue to ensure that all its existing projects within the Slovak Republic comply with the Bank's requirements and new projects will be structured in accordance with the Environmental Policy. Many of the challenges mentioned in Section 2 have environmental dimensions (such as sub-optimal energy efficiency, environmental, health and safety management and food quality) which will be a focus of attention and of awareness raising not only during environmental due diligence but also during on-going dialogue with all clients. The Bank will strive to identify with project sponsors ways to address environmental, health, safety and quality issues, including mobilizing, where appropriate, technical co-operation support. In addition, several potential investment operations address directly some of the Slovak Republic's key environmental concerns, e.g. in the municipal and energy infrastructure sectors. In support of FDI, particular emphasis will continue to be paid to helping investors understand the environmental issues (such as risks, liabilities and opportunities) and regulatory environment associated with their potential investments.

- Environmentally sound growth within the SME sector will continue to be facilitated by ensuring that the EBRD partner banks and leasing companies conduct environmental due diligence on their clients, prescribe environmental conditions and monitor their environmental performance. The Bank will continue to provide capacity building support and seek to raise the awareness on the need to work with SME clients to identify and support environmental improvements.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 The Enterprise Sector

Transition Goals

On the basis of the Transition Challenges in the Enterprise Sector as described in Section 2.2.2., the following Transition Goals are relevant for the future activities of the Bank in this field:

- Reduction of the widening gap between successful international companies in Slovakia and local companies through company restructuring, support for SMEs and mergers and acquisitions.
- Development of the SME sector through improvement of their access to a broad range of financial products and the environment they operate in.
- Reduction of regional imbalances by supporting FDI, SMEs and company restructuring in less developed regions.
- Increase of the competitiveness of the agri-business sector through consolidation and boarding of the range of activities.

Operational Priorities

- Actively support restructuring and consolidation of the local private sector (i) alongside strategic investors through providing equity and acquisition financing for their local operations and (ii) through the activities of the restructuring fund EBRD is involved in.
- Support FDI, particularly targeting green-field and brown-field projects in less developed regions of the country. Provide guidance to investors with limited country experience.
- Expand spectrum and volume of financing products available for SMEs in co-operation with local financial intermediaries.
- In telecoms, support private operators of fixed and mobile networks and support the potential further privatisation of Slovak Telecom.

- In agri-business, support corporates including their expansion into other Eastern Europe markets and work with local banks with respect to the EU-supported Rural Finance Facility.
- In the property and tourism sector, focus on the introduction of new equity-type instruments for (i) international standard warehousing and logistics management, (ii) hotels in regional centres with growth potential, (iii) residential developments and (iv) selectively support tourism projects.
- With respect to the environment, pay increasing attention to ensuring environmentally sound and sustainable raw material supply, particularly where the industry is utilising significant amount of natural resources, such as forests.

3.2.2 The Financial Sector

Transition Goals

On the basis of the Transition Challenges in the Financial Sector as described in Section 2.2.2., the following Transition Goals are relevant for the future activities of the Bank in this field:

- Improvement of the type and quality of the financial services offered to corporates as the corporate sector becomes more sophisticated.
- Support of the growth of the corporate sector through equity, quasi-equity and mezzanine financing to reduce the equity gap.
- Development of the SME sector through improvement of their access to a broad range of financial products from FIs.
- Broaden the financial intermediation through introducing innovative products for the various sectors of the economy.

Operational Priorities

- *Private Equity Funds*: (i) focus on investing the remaining capital and on monitoring of investment portfolios in existing funds, and (ii) selectively commit capital to new, mostly regional funds raised by proven management teams.
- *Bank debt*: (i) in cooperation with the EU and/or other European institutions, aim to provide credit lines to Slovak banks for on-lending to SMEs, smaller municipalities and agribusinesses, (ii) consider ways of providing bridge and co-financing, with Slovak banks, for EU-funded projects, and (iii) structure a partial risk-sharing guarantee facility for an SME or a mortgage portfolio to one of the major banks.
- *Non-bank financial institutions:* (i) support the introduction of the 2nd pillar into the pension system, (ii) remain involved in the policy dialogue with the Slovak authorities on issues related to the development of the insurance sector, (iii) aim to provide leasing EU/EBRD SME Finance Facility and (iv) look for opportunities to invest in a pilot securitisation issue.
- *Agribusiness:* Work with financial intermediaries to increase the availability and sophistication of financing to the agribusiness sector.
- *Environment:* Continue with the environmental due diligence training for financial intermediates to ensure that they will have the skills to manage environmental issues associated with their portfolios.

3.2.3 The Energy Sector

Transition Goals

On the basis of the Transition Challenges in the Energy Sector as described in Section 2.2.2., the following Transition Goals are relevant for the future activities of the Bank in this field:

- Completion of the planned privatisation of Slovenske elektrarne and the further privatisation of the three distribution companies.
- Implementation of the further liberalisation of the energy market as planned in July 2004 (corporates) and 2007 (households).
- Decommissioning of two units of the Bohunice nuclear plant in years 2006 and 2008.
- Reduction of energy waste across the country in the public and private spheres which could result in significant environmental benefits as well as an increase in the competitiveness of the economy and a reduction in public expenditure.
- Participation in the new international market mechanisms created to address climate change (Kyoto Protocol; EU Emission Trading Scheme).

Operational Priority

- Focus on equity and structured finance transactions where the market seeks additional comfort. Exceptions would be larger transactions where the Bank could provide assistance such as in the restructuring and refinancing of Slovenske elektrarne prior to and post its privatisation.
- Continue through the Bohunice International Decommissioning Support Fund (BIDSF) to support the decommissioning of the Bohunice units as well as to finance projects which will increase the efficiency of the system and seek ways to use the BIDSF to enhance the attractiveness of a potential energy efficency credit line for banks.
- Look for opportunities to include or enhance energy efficiency components in industrial projects and explore the potential for Energy Service Company (ESCO) projects targeting social facilities such as hospitals and schools.
- Scan the market for possible carbon credit transactions under the Joint Implementation mechanism of the Kyoto Protocol.

3.2.4 Infrastructure and Environment

Transition Goals

On the basis of the Transition Challenges in Infrastructure and Environment as described in Section 2.2.2., the following Transition Goals are relevant for the future activities of the Bank in this field:

- Reduction of regional imbalances through investment in transport infrastructure supported by EU cohesion and structural funds.
- Development of Public-Private Partnerships to meet the enormous financing needs in infrastructure and to share management and risks of projects with the private sector.
- Completion of the restructuring of state-owned enterprises in the transport sector, in particular the railways companies.

- Improvement of the ability of municipalities to prioritise and prepare their project requirements so that they can access the EU grant programmes.
- Transformation of the water companies in a manner which allows them to successfully meet the enormous challenges in connection with the tremendous capital investment requirements in order to meet EU health and environmental standards.

Operational Priorities

- Support next stages in railway sector restructuring and modernisation and, if feasible, pre-privatisation support to the train operating company.
- Explore potential cooperation with the National Motorway Agency by blending technical cooperation assistance in commercialisation strategies with selected road sector investments, if and when identified and continue to explore the scope for financing transport through public-private partnership projects.
- Support municipalities and water companies through co-financing of infrastructure projects and support them indirectly through the Municipal Finance Facility with local banks.
- Support private investors with respect to a possible privatisation of district heating companies.
- Support industrial outsourcing of environmental services through providing capital and support to professional environmental companies.

4. OTHER IFIS AND MULTILATERAL DONORS

4.1 European Union (EU)

Since January 2000, there have been three pre-accession instruments financed by the European Community to assist Slovakia, together with the other applicant countries of central Europe in their pre-accession preparations. In addition to the Phare programme, that has been providing support to the countries of Central and Eastern Europe since 1989, SAPARD (Special Accession Programme for Agricultural and Rural Development), which provides aid for agricultural and rural development and ISPA (Instrument for Structural Policies for Pre-Accession), which finances infrastructure projects in the fields of environment and transport, have been made available. These programmes concentrate their support on the Accession Partnership priorities that help the candidate countries to fulfil the criteria for membership. The combined amount for Pre-accession assistance since 2000 is around EUR 106 million.

The European Commission announced on 18 December 2003 a total envelope for cohesion and structural funds of EUR 1,611 million for 2004-2006: EUR 570 million cohesion funds to co-finance transport and environmental infrastructure and EUR 1,041 million structural funds to co-finance projects in industry and services, human resources and basic infrastructure.

EBRD Co-operation with the EU: In addition to the intense contacts between EBRD and Brussels, the EBRD in Bratislava has maintained a close relationship with the EU delegation in Bratislava. The initial focus was on the use of Phare and ISPA funds for projects which needed co-financing. More recently the EBRD has had discussions mainly in connection with the Cohesion and Structural Funds. In 2003, the EBRD organised a seminar together with the Ministry of Finance of Slovakia and the EU Delegation in Slovakia on the use of cohesion and structural funds and the role of EBRD. Since the responsibility for the use of the Cohesion and Structural Funds rests with various local authorities, the EBRD is strengthening its relationship with the Managing Authority and the various Implementing Agencies.

4.2 International Monetary Fund (IMF)

The latest concluding statement by the IMF mission, after its visit to Slovakia (27 May 2004), noted that, in 2003, strong export and output growth had been sustained despite an adverse external environment. These positive developments are considered to reflect a strong competitive position vis-à-vis western Europe and neighbouring countries, the coming on-stream of past FDI, skilful macroeconomic management and improvements in the business climate (privatisation of public enterprises, a strengthened legal framework, and labour market reform). According to the IMF the short-term outlook remains favourable, with a 4 per cent GDP growth rate in 2004 sustained by recovering consumption and investment, a low current account deficit, and contained inflationary pressures. The main challenge is now to pursue a policy mix that will lead to a sustainable fiscal position and disinflation, along with the completion of the unfinished structural reform agenda (health care, education, legal framework, devolution of fiscal responsibilities). The implementation of such a strategy should provide, along with recent FDI decisions, the basis for further increases in productivity and rates of growth over 5 per cent in the medium term.

4.3 World Bank (WB)

The WB provides technical assistance for structural reforms of the health sector, social benefit reform, public finance management, legal and judicial reform, accounting and auditing reform, legal and regulatory reform, enterprise and financial sector adjustment. The two largest ongoing lending operations are the Enterprise and Financial Sector Adjustment Loan (EFSAL) in an amount of USD 200 million and the Health Sector Modernisation Support Sectoral Adjustment Loan (HSMS SECAL) in an amount of USD 55 million. Under the EFSAL was signed in 2001, the following components are covered: restructuring and privatisation of the banking system, strengthening of banking regulation and supervision, implementation of a workout strategy for classified claims and improvement in the legal framework centered on the bankruptcy and collateral laws and corporate governance. This programme is coordinated with other donors and international organisations. HSMS SECAL was signed in 2003 and its objectives are to improve fiscal discipline through structural changes in the health sector, that will alleviate the chronic problem of arrears in the sector, encourage greater technical, and allocation efficiency, and institute a system that will promote fiscal sustainability; improve the quality and cost-effectiveness of the health sector; and mitigate any possible negative impacts on health care access, especially for vulnerable populations.

EBRD Co-operation with the WB: The EBRD is observing closely the activities of the WB in Slovakia. However, given the areas of activity of the WB as described above, there is limited need for close co-ordination. It is obvious that many of the projects initiated and implemented by the WB such as EFSAL, substantially improve the environment for the private sector operations the EBRD is involved in.

4.4 International Finance Corporation (IFC)

In 2002, the IFC closed its office having financed four projects. Three of the four projects were done in 1998: The IFC provided a small loan to Scametatra to construct and operate a moulded plastic components plant followed by another loan to this company for expansion. It provided a USD 30 million loan to finance a capacity and technological upgrade of the mobile operator, Eurotel, and it invested in West Export-Import, a pharmaceutical distribution company. In 2000, it purchased, alongside EBRD, a 12.5 per cent stake in VUB as the first stage of the bank’s privatisation. Also, the IFC provided Technical Assistance and Advisory Services. Specifically, IFC advised the Government on amending the existing law on supplemental retirement pensions. In 1999 and 2001, the Foreign Investment Advisory Service (FIAS), a joint facility of the IFC and the WB, identified the administrative, legal, regulatory and tax impediments to FDI and suggested ways to improve the business environment. IFC’s Technical Assistance

Trust Fund program supported a review of Slovakia’s existing system of tax regulation and statutory accounting in relation to financial derivatives, a study of the barriers to commercial mortgage lending and a study of barriers to SME lending.
The IFC re-opened its office in 2003 mainly to roll out an energy efficiency credit and risk sharing line for local banks.

EBRD Co-operation with the IFC: Co-operation was close in connection with the acquisition of 12.5 per cent of VUB by EBRD and IFC. However, given IFC’s low level of activity in Slovakia today, there is limited need for close co-ordination.

4.5 European Investment Bank (EIB)

Since 1990, the EIB provided 24 loans, including global loans for financing of smaller scale projects. As of mid October 2003, the total volume committed is EUR 1,478 million. Important sectors for the EIB are transport (EUR 428 million), telecommunications (EUR 280 million), energy (EUR 236 million) and automotive (EUR 200 million). Global loans for smaller scale projects in an amount of EUR 228 million were extended to five banks. In addition, two smaller municipal infrastructure projects were financed directly (EUR 42 million). In April 2004, the EIB signed a EUR 95 million loan for the co-financing of projects in combination with EU grant aid from the Cohesion and Structural Funds. The loan will provide pre-financing of the programmes before actually receiving the corresponding grant payments. Projects to be financed include local infrastructure projects, environmental projects, industry projects and tourism. Looking ahead, the EIB will give priority to transport, telecommunications, energy production, distribution and saving schemes, industry, environment and health and education.

EBRD Co-operation with the EIB: EBRD and EIB maintain a close relationship. The activities do, to a large extent, not overlap but are complementary: In Slovakia, the EBRD focuses more or less exclusively on the private sector whereas a large part of the EIB projects are concluded with the Government as counterpart, in particular in transport. With respect to the financing of industrial projects, the EIB requires guarantees from commercial banks in most cases. EBRD would not consider participating in such guarantee schemes but would focus on providing equity or equity-type financing. The co-financing and pre-financing of a large number of relatively small projects by EIB in combination with EU Cohesion and Structural Funds is an efficient approach to make sure that the utilisation rate of EU funds is increased. In this respect, the EBRD will focus on the co-financing of larger projects in particular in the water sector.

ANNEX 1: NET CUMULATIVE BUSINESS BY INDUSTRY

(In million EUR as of 31 December 2003)

Sector Business Group (SIC)	Sector Team (SIC)	No. of Projects	Total Project Value	EBRD Finance	Debt	Equity	% Share of Commitments
Energy	Energy Efficiency	1.8	40	12	8	4	1%
	Natural Resources	4.0	625	98	54	44	10%
	Power and Energy	1.7	361	149	148	1	15%
Sub-total Energy		**7.5**	**1,026**	**259**	**210**	**49**	**26%**
Financial Institutions	Bank Equity	9.0	510	148	97	51	15%
	Bank Lending	5.5	110	96	96	0	9%
	Equity Funds	3.1	148	56	0	55	6%
	Non Bank Financial Institutions	0.8	58	72	20	52	7%
Sub-total Financial Institutions		**18.3**	**827**	**372**	**214**	**158**	**37%**
General Industry	General Industry	5.0	561	223	211	12	22%
Sub-total General Industry		**5.0**	**561**	**223**	**211**	**12**	**22%**
Infrastructure	Municipal & Env Inf	0.0	3	1	1	0	0%
	Transport	1.0	42	15	15	0	1%
Sub-total Infrastructure		**1.0**	**44**	**16**	**16**	**0**	**2%**
Specialised Industries	Agribusiness	1.8	35	10	10	0	1%
	Property and Tourism	1.1	174	56	34	23	6%
	Telecoms Informatics & Media	3.1	496	76	50	26	7%
Sub-total Specialised Industries		**6.1**	**706**	**142**	**94**	**48**	**14%**
SLOVAK REPUBLIC TOTAL		**37.9**	**3,164**	**1,012**	**745**	**267**	**100%**

ANNEX 2: BILATERAL ASSISTANCE

Commitment Number	Commitment Name	Fund Short Code	Euro Committed	Euro Disbursed	Fund Approved Date	Commit. Stage Name	Operation Leader	Sector	Business Group
CEI-1995-07-01	Industrial zone development (Phase I)	CEI	19,923	19,923	04/07/95	Closed	Mogull M.	Community/Social Services	Central Europe
TAI-2002-03-09	Close-Out Netting Legislation/Slovakia	TAI	50,000	0	14/03/02	Committed	Chen H.	Community/Social Services	Energy
UKC-1995-12-24	Assistance in developing a secured transactions law	UKC	47,044	47,044	12/12/95	Closed	Dahan F.	Community/Social Services	Specialised Industries
UKE-2001-04-12F	Secured Transactions Legislative Reform and Implementation	UKE	229,067	213,832	04/04/01	Disbursing	Dahan F.	Community/Social Services	Central Europe
UKE-2002-07-08F	Secured Transactions Legislative Reform Phase II	UKE	172,078	113,409	19/07/02	Disbursing	Dahan F.	Community/Social Services	Financial Institutions
AUS-1996-05-02	Energy efficiency project preparation	AUS	212,202	212,202	21/05/96	Closed	Grunig M.	Energy	Financial Institutions
EC-1992-08-35	Danube River Basin Development - industrial waste management	ECP	281,713	281,713	10/08/92	Closed	Bastin J.	Energy	Infrastructure
EC-1992-09-41	Regional Cities Development Programme - Bratislava solid waste management	ECP	47,828	47,828	15/09/92	Closed	Toregas G.	Energy	Infrastructure
ENE-1998-06-01	Extension of the contract with Haskoning for Supervision of Environmental Remediation for ZSNP and Slovalco	ENE	47,193	47,193	15/06/98	Closed	Lecavalier F.	Energy	Infrastructure
FRA-1999-06-02	Kosice geothermal advisory services	FRA	20,827	20,827	07/06/99	Closed	Herman E.	Energy	Central Europe
SPA-2000-06-02	Power Supply Curves for the Period 2000-2020	SPA	39,776	39,776	09/06/00	Closed	Kuno C.	Energy	Financial Institutions
UK-94-04-07PS	Mochovce power project - public participation review	UK9407	46,847	46,847	14/04/94	Closed	Pilloux A.	Energy	Financial Institutions
UK-94-04-08PS	Mochovce power project - financial advice	UK9408	124,438	124,438	14/04/94	Closed	Pilloux A.	Energy	Financial Institutions
UK-94-04-09PS	Mochovce power project - environmental assessment and audit	UK9409	299,818	299,818	14/04/94	Closed	Vitchev D.	Energy	Financial Institutions
UKC-1995-05-13	Mochovce power project - public participation review (extension)	UKC	20,588	20,588	01/05/95	Closed	Murphy T.	Energy	Financial Institutions
UKE-2002-05-07	Power Distribution Privitisation	UKE	28,931	8,060	02/05/02	Committed	Kuno C.	Energy	Financial Institutions
USTD-2002-04-02	Power Distribution Privitisation	USTDA	115,626	115,626	19/04/02	Disbursing	Kuno C.	Energy	Financial Institutions
EC-1993-06-17	Slovak Post-privatisation Fund - feasibility study	ECP	185,400	185,400	20/06/93	Closed	D'Amico A.	Finance, Business	Financial Institutions
EC-1993-12-60	Slovak Post-privatisation Fund - legal feasibility study	ECP	149,984	149,984	29/10/93	Closed	D'Amico A.	Finance, Business	Financial Institutions
EUSPP-2001-09-01F	Slovak Post-privatisation Fund - pre-investment framework contract for investment advisory services (B)	EUSPP	54,480	54,480	17/09/01	Closed	Ankara M.	Finance, Business	Financial Institutions
EUSPP-2001-09-03F	Slovak Post-privatisation Fund - Specialised Advisory Services - individual contracts	EUSPP	1,296,097	953,195	17/09/01	Disbursing	Ankara M.	Finance, Business	Financial Institutions
EUSPP-2001-12-06F	Slovak Post Privatisation Fund - Investment Advisory Services	EUSPP	243,050	122,335	05/12/01	Disbursing	Ankara M.	Finance, Business	Financial Institutions
EUSPP-2001-12-07F	Slovak Post Privatisation Fund - Investment Advisory Services "B"	EUSPP	428,098	359,548	05/12/01	Disbursing	Ankara M.	Finance, Business	Financial Institutions
EUSPP-2003-11-04F	PPF - Slovak PPF -Investment Advis. Servic (Pre & Post Inv)	EUSPP	221,902	0	28/11/03	Committed	Pasian A.	Finance, Business	Financial Institutions
EUSPP-2003-11-05F	Slovak PPF: Investment Advisory Services "A"	EUSPP	356,950	0	28/11/03	Committed	Ankara M.	Finance, Business	Financial Institutions
EUSPP-2003-12-06F	PPF - Slovak PPF - Legal Advisory Services	EUSPP	180,000	0	04/12/03	Committed	Ankara M.	Finance, Business	Financial Institutions
EUSPP-96-09-01	Slovak Post-privatisation Fund - fund manager	EUSPP	2,850,747	2,850,747	18/09/96	Closed	Pilotto R.	Finance, Business	Financial Institutions
EUSPP-96-09-02	Slovak Post-privatisation Fund - pre-investment framework contract for investment advisory services (A)	EUSPP	410,817	410,817	19/09/96	Closed	Ankara M.	Finance, Business	Specialised Industries
EUSPP-96-09-03	Slovak Post-privatisation Fund - pre-investment framework contract for investment advisory services (B)	EUSPP	203,421	203,421	19/09/96	Closed	Ankara M.	Finance, Business	Energy
EUSPP-96-09-04	Slovak Post-privatisation Fund - pre-investment specialised advisory services (procurement agent)	EUSPP	2,213	2,213	19/09/96	Closed	Pilotto R.	Finance, Business	Financial Institutions
EUSPP-96-09-05	Slovak Post-privatisation Fund - pre-investment individual contracts	EUSPP	26,725	26,725	19/09/96	Closed	Ankara M.	Finance, Business	Non-Banking
EUSPP-96-09-06	Slovak Post-privatisation Fund - post-investment framework contract for investment advisory services (A)	EUSPP	118,725	118,725	19/09/96	Closed	Ankara M.	Finance, Business	Central Europe
EUSPP-96-09-07	Slovak Post-privatisation Fund - post-investment framework contract for investment advisory services (B)	EUSPP	6,200	6,200	19/09/96	Closed	Ankara M.	Finance, Business	Financial Institutions
EUSPP-96-09-08	Slovak Post-privatisation Fund - post-investment specialised advisory services (procurement agent)	EUSPP	26,034	26,034	19/09/96	Closed	Pilotto R.	Finance, Business	TurnAround Management Group
EUSPP-96-09-09	Slovak Post-privatisation Fund - post-investment individual contracts	EUSPP	512,975	431,450	19/09/96	Disbursing	Ankara M.	Finance, Business	Central Europe

EUSPP-96-13-10	Slovak Post-privatisation Fund - pre-investment specialised advisory services (procurement agent)	EUSPP	55,957	55,957	19/09/96	Closed	Pilotto R.	Finance, Business	Central Europe
FRA-1994-03-03	Slovak Post-privatisation Fund - TurnAround expert	FRA	60,980	60,980	16/03/94	Closed	D'Amico A.	Finance, Business	Central Europe
GER-1994-02-03	Slovak Post-privatisation Fund - accounting team	GER	155,913	155,913	08/02/94	Closed	D'Amico A.	Finance, Business	Central Europe
JAP-1994-08-30	Development of SPE (export credit insurance) - export financing, refinancing, fund-raising	JAP	88,820	88,820	01/08/94	Closed	Harfield J.	Finance, Business	Central Europe
SWI-1998-07-03	Slovak Post-privatisation Fund - assessment of marketing activity and preparation of restructuring programme for Mopedy sro Kolarovo	SWI	68,734	68,734	28/07/98	Closed	Pilotto R.	Finance, Business	Financial Institutions
UKC-1994-09-08	Development of SPE (export credit insurance) - export financing, refinancing, fund raising - legal advice	UKC	34,923	34,923	12/09/94	Closed	Harfield J.	Finance, Business	Financial Institutions
UKC-1996-10-23	Slovak Post-privatisation Fund - legal feasibility (extension)	UKC	50,501	50,501	23/09/96	Closed	Pilotto R.	Finance, Business	Non-Banking
UKC-1996-02-02	Slovenske Lodenice a.s. - insurance	UKC	20,520	20,520	06/02/96	Closed	Janssens R.	Finance, Business	TurnAround Management Group
AUS-1995-09-02	Slovenske Lodenice a.s and Contexco a.s	AUS	24,585	24,585	01/09/95	Closed	Janssens R.	Manufacturing	Financial Institutions
EC-1994-06-12	ZSNP - Alumina plants study	ECP	139,953	139,953	30/05/94	Closed	Sipos T.	Manufacturing	Infrastructure
GER-95-12-08PS	Monitoring and advisory group of the Zsnp/Slovalco aluminim restructuring project	GE03	101,609	101,609	07/09/95	Closed	Lecavalier F.	Manufacturing	Specialised Industries
GER-1993-08-08	Slovenske Lodenice a.s. and Contexco a.s. legal audit, structuring and contract documentation	GER	132,200	132,200	17/08/93	Closed	Janssens R.	Manufacturing	Central Europe
GRE-2000-11-07F	TurnAround Management Programme (TAM) - Team Coordinator for Slovakia	GRE	46,400	11,600	14/11/00	Disbursing	McPhee J.	Manufacturing	Energy
HOL-1993-07-10	Slovenske Lodenice a.s. and Contexco a.s. - environmental audit	HOL	31,861	31,861	01/07/93	Closed	Janssens R.	Manufacturing	TurnAround Management Group
HOL-1993-11-20	Slovenske Lodenice a.s. and Contexco a.s.- financial audit	HOL	70,407	70,407	19/11/93	Closed	Janssens R.	Manufacturing	Financial Institutions
HOL-1993-12-21	ZSNP soil and groundwater study	HOL	134,371	134,371	24/12/93	Closed	Hussey M.	Manufacturing	Non-Banking
HOL-1994-12-15	Slovenske Lodenice	HOL	37,600	37,600	01/12/94	Closed	Janssens R.	Manufacturing	Financial Institutions
HOL-1995-02-01	Slovenske Lodenice - environmental audit	HOL	9,023	9,023	01/02/95	Closed	Janssens R.	Manufacturing	Central Europe
HOL-1993-12-23	TurnAround Management Programme - Tesla Nove Zamky	HOL	48,781	48,781	24/12/93	Closed	McAlister M.	Manufacturing	Central Europe
HOL-1995-03-03	TurnAround Management Programme - Tesla Nove Zamky (II)	HOL	13,838	13,838	16/03/95	Closed	McAlister M.	Manufacturing	Central Europe
HOL-1994-12-16	Remediation supervisor for ZSNP and Slovalco environmental remediation	HOL	126,012	126,012	14/12/94	Closed	Lecavalier F.	Manufacturing	Central Europe
HOL-1993-12-25	TurnAround Management Programme - Strojsmalt	HOL	44,554	44,554	24/12/93	Closed	McAlister M.	Manufacturing	Financial Institutions
JAP-1992-10-24	Due diligence study - SPB Bank	JAP	75,080	75,080	01/10/92	Closed	Insel B.	Manufacturing	Financial Institutions
NORG-1993-06-03	Slovenske Lodenice a.s. and Contexco a.s. - feasibility report and analytical support	NORG	76,508	76,508	01/06/93	Closed	Janssens R.	Manufacturing	Non-Banking
SWE-2001-01-01	TurnAround Management Programme (TAM) - Tento	SWE	48,400	48,400	15/01/01	Closed	McPhee J.	Manufacturing	Russia & Central Asia
UK-1994-02-01PS	Military conversion project	UK9401	47,710	47,710	08/03/94	Closed	D'Amico A.	Manufacturing	Specialised Industries
UKC-1995-03-04	Slovenska Pol'Nohospodarska Banka a.s. agribusiness SME financing facility	UKC	118,054	118,054	06/03/95	Closed	Weatherseed S.	Manufacturing	Energy
FIN-1996-04-02	Evaluation of tenders for two global systems for mobile communication standard licences	FIN	49,916	49,916	25/04/96	Closed	Lonnen K.	Telecommunications	Non-Banking
ECP99-99-09-16	Slovak Railways - economic recovery and commercialisation programme	ECP	491,493	491,493	07/09/99	Closed	Barrett S.	Transport, Storage	Non-Banking
JAP-1993-11-60	Railways adjustment and pre-investment study	JAP	451,559	451,559	17/11/93	Closed	Smith I.	Transport, Storage	Energy
SLOVAK REPUBLIC									
	Country Total Euro Amount:		**11,933,982**	**10,381,862**					
	Report Total Euro Amount:		**11,933,982**	**10,381,862**					
	No of Commitments:		**65**						

ANNEX 3: POLITICAL AND SOCIAL ASSESSMENT

- **Internal political situation**

  Czechoslovakia was the common state for the Slovaks and the Czechs between 1918 and 1939 and again between 1945 and 1993. The two nations separated peacefully on 1 January 1993, following a vote in the federal assembly in Prague in November 1992. Both pre- and post- independence political scene in Slovakia was for a number of years dominated by Vladimir Meciar, leader of the populist-nationalist Movement for a Democratic Slovakia (HZDS) and three times the country's Prime Minister. Slovakia enjoyed strong economic growth with low inflation between 1995 and 1998, but the country's reputation suffered from Meciar's authoritarian style of governing exemplified in his administration's persistent attacks on President Michal Kovac; its manipulation of the privatisation programme to benefit supporters and its policy aimed at curtailment of Hungarian minority's linguistic and cultural rights. In 1997 this resulted in Slovakia failing to receive an invitation to join NATO and to start negotiations for accession to the EU.

  In March 1998 following the expiry of Kovac's presidential term, Meciar assumed most of the presidential powers. What was widely perceived as a looming threat to the country's constitutional order accelerated the formation of a broad popular front of opposition parties. Meciar's HZDS narrowly emerged as the largest party in the September 1998 elections and he was invited to form a government by the parliament's Speaker, but could not owing to the refusal of other parties to join in. A broadly-based four-party coalition was formed under Mikulas Dzurinda, leader of the Slovak Democratic Coalition (SDKU). The new government enacted a law on minority languages that restored ethnic Hungarian's rights, stripped by Meciar in 1995. Dzurinda's tenure as Prime Minister was marked by political tensions within a coalition made up of centre-left and centre-right parties. He nevertheless managed to keep his unwieldy coalition together. The tensions within the cabinet took their toll mainly on the centre-left parties. The success of Dzurinda's SDKU and the collapse of the left paved the way for the formation of the current centre-right government after Dzurinda's second victory in the parliamentary elections in September 2002. The four parties in it include - apart from Dzurinda's SDKU, the conservative Christian Democrats and the party representing the Hungarian minority - the liberal Alliance of the New Citizen (ANO). The second Dzurinda coalition has proved effective in implementing its reform agenda - passing new legislation for the health and legal systems - in spite of repeated corruption scandals and infighting among the coalition partners over social policy. However, high-profile tensions within the ruling parties have diminished the coalition's strength in the 150-seat parliament from the original 78 to 68. In the first round of the presidential election held on 3 April 2004, the incumbent, President Rudolf Schuster, was eliminated as was Foreign Minister, Eduard Kukan, the nominee of the coalition. In the second round on 17 April 2004 former Prime Minister Vladimir Meciar was defeated by Ivan Gasparovic, a former senior member of Meciar’s party, the HZDS, who now heads a small splinter party. Gasparovic was supported by Smer, the strongest opposition party led by Robert Fico. A non-binding referendum on early parliamentary elections held also on 3 April in response to a public petition, failed because significantly fewer than the required 50 per cent plus voters turned out to vote in the referendum. The government's mandate expires in September 2006.

- **International relations**

  Slovakia's isolation from the West under Meciar has been completely reversed under the two Dzurinda governments. This has been reflected in the invitations to join both NATO and the EU. Slovakia joined NATO in April 2004 and the EU on 1 May 2004. Relations with the neighbouring countries are good. Those with the Czech Republic are close and problem-free. The present predominance of moderate political forces both in Slovakia and Hungary has helped de-fuse conflicts over the position of the 560.000-strong ethnic Hungarian minority. At the end of 2003 an accommodation was reached between Budapest and Bratislava over the application of Hungary's controversial 2001 Status Law aimed at aiding culturally and in other respects the Hungarian diaspora in the neighbouring countries. Initially, Slovakia had strongly objected to the proposed legislation and had vowed to ban its implementation on its territory. The Slovak government approved the opening this year of a Hungarian-language university in Komarno consisting of three faculties - economics, theology and teacher-training. This has been a long-standing demand of the ethnic Hungarian party. In 2003 Dzurinda joined leaders of the three other Visegrad countries (the Czech Republic, Hungary and Poland) in signing a statement of support for the US stance on Iraq. Slovakia has provided military support to the interventions in Afghanistan and Iraq.

- **Labour issues**

  The Constitution provides for the right to form and join trade unions, except in the armed forces. Approximately 45 per cent of the labour force is unionised. The Slovak Trade Union Confederation (KOZ) includes nearly 90 per cent of all trade unions in the country. Unions are independent of the government and political parties. The Constitution specifies two types of strikes: when no agreement is reached while bargaining or to support the demands of other employees on strike (solidarity strike). A strike and the list of members of the strike committee must be announced in advance. Relevant legislation on collective bargaining prohibits the dismissal of workers legally participating in strikes. However, if a strike is not considered official, strikers are not ensured protection. Strikes are rare, but there were several short national strikes during the past year - by customs officers, teachers and railway workers. A controversial new labour law that came into force on 1 April 2002 was criticised both by private-sector employers and by the trade unions on the grounds that it limited workers' rights. The government responded by introducing amendments.

- **Social conditions**

  Slovakia's population in May 2001 was 5,379,455. It had risen by 15 per cent in the 1950s and 13 per cent in the 1960s, but had slowed to 10 per cent in the 1970s and 6.3 per cent in the 1980s. In 2001 the population declined by 0.4 per cent. The birth rate decreased from 28.8 per cent per 1,000 in 1950 to 15.1 per cent per 1,000 in 1990 and 9.5 per cent per 1,000 in 2001. The birth rate in Slovakia is higher than in the Czech Republic.

  In 1996, the last year for which statistics are available, life expectancy was 68.8 years for men and 76.7 years for women - up from 66.7 for men and 75.5 for women in 1990. However, life expectancy is lower than in the West and the Czech Republic. The main causes of lower life expectancy are poor diet, low level of preventive health care, high levels of airborne and water pollutants, and high rates of alcohol and tobacco use. There is a high incidence of cardiovascular disease and smoking-related cancers.

Two separate funds for health and sickness insurance have been established. Provision of benefits comes from a combination of insurance-based components and the previous system of social care. The contribution rate to the health insurance fund is currently 13.7 per cent, with 10 per cent paid by the employers and 3.7 per cent paid by the employee, and the rate for the sickness fund is 4.8 per cent, of which 3.4 per cent is paid by the employer and the remainder by the employee. Low salaries and poor working conditions in the health sector have led to a large exodus of doctors. In March 2003 parliament adopted a controversial healthcare law, which foresees partial coverage of costs by patients via fee-for-service scheme.

The educational level of Slovakia's labour force compares favourably with that in advanced OECD countries and is higher than in most countries of Central and Eastern Europe. The educational system is well developed at all levels. The number of university students rose from 66,900 in 1994 to 94,684 in 2001. Enrolment in secondary technical schools, heavily promoted under the socialist regime, continued to rise until the mid-1990s but has since fallen sharply, from a peak of 46,570 in 1996 to 34,599 in 2001, well below the number of students at schools specialising in economics, management, trade and services, where enrolment stood at 40,205 in 2001. Total enrolment at specialised secondary schools has also fallen from 121,933 in 1996 to 100,791 in 2001. Despite the drop in school-age population, enrolment in grammar schools has remained steady, and was 86239 in 2001. The quality of education and training programmes is generally high. The mobility of labour within the labour market is limited by early occupational specialisation, too narrowly defined.

The majority of the population (85.6 per cent) are ethnic Slovaks. The largest ethnic minority are Hungarians (520,528 , or 10.5 per cent, according to the latest census in 2001). The second largest are Roma, numbering 90,000, or 1.7 per cent, according to the 2001 census. However, according to the US Department of State 2004 Country Report on Human Rights Practices in Slovakia, some experts estimate that Roma may actually number up to 500,000. The same report quotes NGOs as claiming that Roma are reluctant to identify themselves because they fear discrimination. The Roma population is largely concentrated in the eastern parts of the country. According to the State Department report quoted above the Roma minority were victims of societal violence and there continued to be reports of police brutaility against Roma. In March 2004 there were widespread riots (accompanied by looting) by the Roma in a number of towns and villages in eastern Slovakia. The protests were against cuts in social security payments, applying to all citizens but objected to particularly by the Roma population. The cuts were introduced by the government as an inducement to seek employment. There has been a sharp rise in Roma emigration to Western Europe. The third national minority are Czechs (1.1 per cent). Tension between ethnic Slovaks and ethnic Hungarians has eased off since 1998 under the Dzurinda government. The Hungarian minority's cultural and language rights have been broadened to allow the official use of Hungarian in areas where the minority is at least 20 per cent of the population.

The country's first Ombudsman was elected in 2002 to assist in protecting the fundamental rights and freedoms in cases where public administrations bodies have violated the law. The law prohibits all forms of trafficking in persons. There are instances of trafficking of women and girls for prostitution. On 1 September 2002 the Law against Trafficking in Persons was strengthened and implemented, with sentences appreciably increased. Prosecutions for human trafficking are claimed to be on the increase. The Criminal and Financial Police Administration and the International Organisation for Migration report that the country is an origin and transit point for victims of trafficking. The major trafficking routes for Slovak victims are through the Czech Republic or Austria to Western Europe but also to Japan. Another high-risk group includes men and women looking for work abroad, sometimes illegally, and are ill-informed of the potential risks.

ANNEX 4: MACROECONOMIC CONDITIONS

- **Output and employment**: ***continued strong growth despite the slowdown in the EU, but high structural unemployment.***

  Growth remained sustained in 2003, at 4.2 per cent after the 4.4 per cent recorded in 2002, beating expectations and making the Slovak Republic the fastest-growing economy in central Europe. Last year saw a welcome re-balancing of growth, as net exports more than offset the stagnation of total consumption and productive investment caused by the implementation of an austerity plan following the parliamentary elections of September 2002. In the first quarter of 2004, activity accelerated to 5.5 per cent year-on-year fuelled by still sustained net export growth as well as resuming private consumption and investment. In 2002 growth had been fuelled by fast rising household income and public spending, by 4 per cent and over 5 per cent respectively, ahead of the elections. In 2003, despite weak external market conditions, especially in the EU, net exports contributed 6.4 percentage points to growth for a negative contribution of 2.4 points by internal demand, mainly due to falling inventories. Exports grew by 22.6 per cent in real terms, driven by the car industry, while imports increased at a much slower pace of 13.8 per cent, due to anaemic internal demand.

  Strong growth is forecasted for 2004, with a rate of 4.2 per cent, thanks to some resumption of private consumption and a solid export performance, assuming the still slow recovery of the EU economy accelerates. Since the beginning of the year, exports have been experiencing sustained, although somewhat declining, growth compared to last year's performance, as they have increased by 13.1 per cent year-on-year in the first two months, while imports grew by 9 per cent. As for internal demand, the global Indicator of Economic Sentiment published by the statistical office increased by 1.5 percentage points in March, after declining strongly in the previous two months in response to a new but final round of increases in administered price and the unification of the VAT rate. Similar declines, essentially of a temporary nature, happened when regulated prices and excise taxes were raised at the beginning and in mid-2003. More encouragingly perhaps, the confidence indicator in retail trade increased even more strongly, by 11 percentage points, after a temporary trough in the beginning of the year.

  In the medium term, recent announcements of large green-field investments to be operating from 2006 (the Peugeot-Citroën plant in Trnava and that of Hyundai-Kia in Zilina) are likely to raise GDP growth through expanding exports. This potential is already illustrated by the performance of Volkswagen, which increased its production by 25 per cent in 2003. Overall the transport equipment industry now accounts for almost a third of the country's exports. The Ministry of Finance forecasts potential GDP growth to increase from 4.4 per cent in 2004 to close to 5 per cent in 2005-07, under the influence of these investments and as a result of structural reforms.

  Unemployment, as measured according to the ILO definition, declined temporarily to 17.4 per cent of the labour force in 2003 before reaching again 19.3 per cent in the first quarter of 2004, close to the record-high levels of around 20 per cent registered in the last few years following the initiation of structural reforms.

However long-term unemployment represents 60 per cent of total unemployment and almost half of the unemployed are low-skilled workers, with only primary education. This is an indication that unemployment is unlikely to fall far below 15 per cent of the labour force in the near future, even if further measures are taken in order to increase flexibility in the labour market. A revision of the labour code was already adopted in 2003 that increases maximum overtime hours, permits part-time contracts and makes it easier for employers to hire and fire workers. In addition mandatory social contributions were reduced by 3.6 percentage points. Further reduction of the tax burden appears nevertheless necessary since mandatory social contributions still represent 47.8 per cent of total labour cost, one of the highest levels in the OECD.

- **Inflation, monetary and exchange rate policy:** ***last round of administered price increases still fuelling high inflation***.

  As expected, headline inflation increased significantly to 8.5 per cent in 2003, from 3.3 per cent in 2002, due to deferred large increases in administered prices enforced in January 2003 and a raise of excise taxes in the summer. However core inflation, which excludes administered prices, remained low, at around 3 per cent, confirming the absence of demand-led inflationary pressures. In the first three months of this year, CPI inflation has been fluctuating around the level of 8.2 per cent and no significant decline is expected, with a forecast of 7.5 per cent on average for the year. Inflation is expected by the Ministry of Finance to decrease steadily in the coming years and rejoin Maastricht levels by 2006-2007, as 2004 saw the last big increase in indirect taxes and administered prices. Energy and utility prices, in particular, are now considered to have reached market levels. If the absence of second-round effects was to be confirmed, the impact on headline inflation of the increase in administered prices and the VAT-rate unification enforced this year is expected to decline from 4.5 percentage points this year to 1 percentage point over the next two to three years.

  After keeping its key interest rate at 6.50 per cent for almost a year, the National Bank of Slovakia considered that the absence of demand-fed inflationary pressures could warrant cuts in interest rates by a cumulative 150 basis points in the short term. The current level of interest rates is considered by the central bank to be consistent with a strategy that aims at being not too restrictive with regard to the level of core inflation and not too loose as far as headline inflation is concerned. Should the inflationary impact of increases in administered prices die out relatively fast in the near future as expected, the outlook is for further cuts in interest rates in 2004, along with the receding of inflationary pressures.

  The cuts have probably contributed to reduce appreciation pressures on the Slovak koruna, although persistent tensions in the governing coalition certainly also played an important role in that regard. Between the end of 2002 and mid-2003, improved sentiment after the elections of September 2002 and strengthening green-field and privatisation-related FDI inflows had fuelled appreciation pressures on the currency, triggering a one-off 175 basis-point cut in interest rates in November 2002. Since then the Slovak currency has been hovering close to, but above, the psychological level of SKK 40 per euro that was broken only very recently for the first time. While the National Bank of Slovakia has been sending somewhat contradicting signals as regards its exchange rate policy, its main message appears however to be its will to avoid too large fluctuations of the exchange rate with the euro potentially caused by short-term capital flows attracted by large differentials in interest rates. In any case the central bank acknowledges that the Slovak currency has some potential for appreciation of its equilibrium level, although it refuses to quantify this potential.

- **Fiscal Policy**: ***successful implementation of fiscal adjustment and public finance reform.***
  The Ministry of Finance announced a very good fiscal performance, with a general government deficit of 3.6 per cent of GDP in 2003, down from a recently revised 5.7 per cent of GDP in 2002 (according to Eurostat's ESA 95 methodology). This figure shows a strong improvement, as it was originally expected to fall somewhat below 5 per cent of GDP. It is attributed to exceptional elements including 0.6 per cent of GDP of unspent credits, among which are pre-accession funds from the European Union, the use of which has been postponed to 2004. In addition extra non-tax revenues amounted to 0.8 per cent of GDP, consisting of interests on funds held by the Ministry of Finance on a special account with the central bank. These funds consist of privatisation revenues received in 2002, intended to finance the pension reform, and funds for the decommissioning of nuclear plants.

  On the revenue side the Ministry of Finance provided a positive preliminary evaluation of the impact of the fiscal reform enforced from this year, with higher-than-expected receipts. The tax reform mainly consists of the unification of the VAT rate to 19 per cent and the lowering of personal- and corporate-income taxes with the introduction of a single flat rate of 19 per cent. Fears were expressed last year that revenues could decline quite substantially following the implementation of the reform, the impact of which proved relatively difficult to evaluate *ex ante*. The reform of the personal income tax is now thought to result in a significant increase in the taxable base in 2005. On the expenditure side, the wage bill is expected to increase by only a minimal margin in absolute terms and to decrease as a ratio to GDP, as a result of a reduction in the number of civil servants combined with an increase in their salaries.

  Fiscal deficit is now officially targeted at 3.9 per cent of GDP in 2004 and appears to be relatively easily within reach. In its convergence report to be submitted to the European Commission in May this year, the Ministry of Finance forecasts general government deficit to represent 3.9 per cent of GDP in 2005 and 2006 before falling at Maastricht level in 2007. These projections include the impact of the introduction of mandatory pension funds, which will translate into an increase in the general government deficit currently estimated at 0.5 per cent of GDP in 2005 and 0.9 per cent of GDP from 2006. As a matter of fact the State budget will have to compensate the current pay-as-you-go scheme (first pillar) for the portion of workers' contributions that will be channelled to the mandatory pension funds (second pillar).

  The reform of the health care system is also expected to contribute to the consolidation of public finances. The introduction of co-payments by patients along with the initiation of the restructuring of hospitals and the reform of pharmaceutical policy helped to reduce the pace of expansion of the health care sector's debt by around half in 2003. The stock of debt accumulated so far by the health care system, estimated at around 2 ½ per cent of GDP of which almost half is due to entities outside the public sector, is currently being carved out. A new series of legislative amendments, still to be adopted, are designed to halt the accumulation of new debt and stabilise health expenditures at a level of 6 ½ per cent of GDP, of which 5 ½ percentage points will be covered by the social security system.

- <u>**Balance of payments:**</u> ***Very significant correction of external imbalances and strong potential for FDI.***
  In 2002, the current account deficit had remained at the very high level of 8 per cent of GDP for the second year in a row, due to an unsustainable trade deficit that was close to 10 per cent of GDP as a result of fast rising net imports fuelled by sustained domestic demand. In 2003, the austerity plan implemented just after the parliamentary elections of September 2002 combined with a very strong surge in exports to result in a very significant adjustment, as the deficit of the current account decreased to below 1 per cent of GDP and the trade deficit to 2 per cent. Growth of total exports was essentially fuelled by an impressive 68 per cent growth in automobile exports that are essentially dominated by Volkswagen.

  In 2003 both the current account and trade deficits continued to be financed by FDI inflows, which amounted to a net USD 549 million (1.8 per cent of GDP). In any case, this figure is much lower than in 2002, when net FDI had increased to USD 4.2 billion (17 per cent of GDP), driven by large privatisations in the energy sector. However this decline appears accidental in that it is essentially attributable to the absence of major privatisation deals in 2003. Completion of the privatisation of the remaining large state-owned companies this year and next (in the energy sector in particular) will likely result in a much higher figure. In addition the announcements of substantial investment plans by large foreign companies, like Peugeot-Citroën and Hyundai-Kia, will add up to USD 2 billion over the next two years.

- <u>**External debt and foreign exchange reserves**</u>**:** ***large increase in short-term external debt partly attributable to private borrowers.***
  Total external debt increased in nominal terms by more than a third to reach USD 18.3 billion at the end of 2003 (56 per cent of GDP). Half of this increase is estimated to be due to changes in the EUR/USD exchange rate, as most of the Slovak external debt is denominated in euro. A substantial increase in short-term debt also accounts for a large share of the change, as commercial banks and businesses raised their short-term foreign-currency borrowing by USD 1.9 billion. The central bank also resorted heavily to short-term foreign-currency denominated money-market instruments, in an amount of USD 900 million, for exchange rate management purposes. Overall, the nominal debt stock has some potential to increase, excluding exchange rate fluctuations, but should remain relatively stable relative to GDP, as foreign-currency borrowing is cheap relative to local-currency loans and increasingly favoured by the private sector in the absence of any perceived strong exchange risk.

  Public external debt remains low at only USD 5.3 billion (16 per cent of GDP) and the recently-created agency for the management of public debt announced its intention to borrow increasingly in foreign currency, with a preference for euro-denominated bonds in particular. The agency issued a EUR 1 billion bond in May 2004, the largest Slovak sovereign bond issuance ever, to be used for the redemption of issuances coming to maturity later in the year. External debt servicing will be peaking in the next three years, with repayments ranging from EUR 3.8 billion to EUR 4.4 billion. The level of foreign reserves remains sizeable, in an amount of USD 12.2 billion, partly consisting of the funds held by the government on a special account with the central bank to finance the pension reform (privatisation revenues received in 2002) and the decommissioning of nuclear plants.

ANNEX 5: SELECTED ECONOMIC INDICATORS

Slovak Republic

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.2	1.5	2.0	3.8	4.4	4.2	4.5
Private consumption	6.5	3.2	-0.8	4.7	5.3	-0.4	na
Public consumption	12.5	-7.1	1.6	4.6	4.7	2.9	na
Gross fixed investment	11.0	-19.6	-7.2	13.9	-0.9	-1.2	na
Exports of goods and services	12.8	5.0	13.7	6.3	5.5	22.6	na
Imports of goods and services	16.5	-6.7	10.5	11.0	5.2	13.8	na
Industrial gross output	na	-2.0	8.3	7.6	6.7	5.5	na
Agricultural gross output	5.4	0.3	1.9	4.9	-1.6	4.4	na
Employment			*(Percentage change)*				
Labour force (end year)	0.9	0.9	2.0	2.0	0.3	0.4	na
Employment (end year)	-1.0	-1.8	-1.4	-1.0	0.5	0.9	na
			(In per cent of labour force)				
Unemployment (end year)	15.6	19.2	17.9	19.8	17.9	17.4	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	6.7	10.6	12.0	7.1	3.3	8.5	7.5
Consumer prices (end-year)	5.6	14.2	8.4	6.4	3.4	9.3	6.0
Producer prices (annual average)	2.6	4.3	10.8	6.5	2.1	8.3	na
Producer prices (end-year)	1.6	7.7	9.1	2.2	2.3	8.7	na
Gross average monthly earnings in economy	8.4	7.2	6.5	8.2	9.3	6.3	na
Government sector 1/			*(In per cent of GDP)*				
General government balance	-3.8	-7.1	-12.3	-6.0	-5.7	-3.5	-4.0
General government expenditure	42.9	43.3	45.4	47.7	47.4	47.9	na
General government debt	34.0	47.2	49.9	48.7	43.4	42.8	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	4.2	11.4	15.4	11.8	3.4	5.6	na
Domestic credit (end-year)	2.5	3.4	-1.0	-17.0	3.8	12.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	60.5	62.4	65.1	67.3	64.1	62.1	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	8.8	8.8	8.8	8.8	6.5	6.0	na
3-months BRIBOR	18.3	14.3	7.9	7.8	6.0	6.0	na
Deposit rate 2/	10.3	10.5	7.2	5.2	4.6	3.3	na
Lending rate 2/	13.3	11.1	9.8	8.4	8.7	7.6	na
			(Koruna per US dollar)				
Exchange rate (end-year)	36.9	42.3	47.4	48.5	40.0	32.9	na
Exchange rate (annual average)	35.2	41.4	46.2	48.4	45.3	36.8	na
External sector			*(In millions of US dollars)*				
Current account	-1,982	-980	-702	-1,746	-1,924	-280	-1,491
Trade balance	-2,353	-1,092	-904	-2,125	-2,117	-641	-1,894
Merchandise exports	10,720	10,229	11,872	12,645	14,382	21,838	26,205
Merchandise imports	13,073	11,321	12,777	14,770	16,499	22,479	28,099
Foreign direct investment, net	560	799	1,904	1,549	4,118	549	1,500
Gross reserves (end-year), excluding gold	2,869	3,371	4,047	4,139	8,703	11,678	na
External debt stock	11,902	10,518	10,804	11,269	13,188	18,322	na
			(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	2.3	3.1	3.4	3.0	5.9	5.7	na
			(In per cent of current account revenues, excluding transfers)				
Debt service due	11.2	16.5	17.1	19.1	11.5	11.2	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, millions)	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of koruna)	781,437	844,108	934,079	1,009,839	1,096,384	1,195,812	1,343,345
GDP per capita (in US dollars)	4,112	3,780	3,742	3,883	4,497	6,044	na
Share of industry in GDP (in per cent)	24.4	26.2	25.5	25.2	23.7	24.8	na
Share of agriculture in GDP (in per cent)	4.8	4.2	4.2	4.5	4.1	3.7	na
Current account/GDP (in per cent)	-8.9	-4.8	-3.5	-8.4	-8.0	-0.9	-3.6
External Debt - Reserves, in US$ millions	9,035	7,152	6,727	7,080	3,993	6,173	na
External Debt/GDP (in per cent)	55.9	53.4	56.3	56.5	54.5	56.3	na
External Debt/Exports of goods and services (in per	91.8	86.3	76.5	74.5	76.9	72.9	na

1/ General government includes the state, municipalities and extra budgetary funds. General government balance according to ESA 95 methodology from 1999 inclusive

2/ Weighted average over all maturities. Lending rate excludes loans at zero interest rate since 1995.

ANNEX 6: LEGAL TRANSITION

COMPARATIVE ASSESSMENT OF THE SLOVAK REPUBLIC'S COMMERCIAL LAW

According to the annual EBRD Legal Indicator Surveys which have measured the perception of lawyers familiar with Slovak law, the commercial laws in the Slovak Republic have been perceived as relatively stable in the last few years and are approaching generally accepted international standards although there are still issues with respect to the application of the laws by the judiciary.

Based on the 2002 EBRD Legal Indicator Survey, the commercial laws of the Slovak Republic are perceived as being roughly on a par with those of Slovenia, Poland or Latvia. As per local lawyers' perception, they seem however to lag behind those of other accession countries such as the Czech Republic, Hungary, Lithuania and Estonia.

LEGAL SECTOR ASSESSMENT

- **Bankruptcy**

  Bankruptcy and insolvency are governed by the "Bankruptcy and Composition Act of 1991", as amended (the "Insolvency Law"). Based upon the EBRD's 2003 Insolvency Sector Assessment, this law was found to be only in "medium compliance" with international standards. The Slovak Ministry of Justice is currently in the process of drafting a new version of the Insolvency Law which is expected to be submitted to Parliament in September 2004. The new law is expected to, among other things, significantly enhance the role of insolvency administrators.

  The Insolvency Law provides for both bankruptcy (liquidation) and composition (re-organisation). Prior to the 2000 amendments to the Insolvency Law, the time in which the administration of a bankrupt estate could occur was virtually unlimited. The 2000 amendments imposed an 18 month limitation on the insolvency administrator, in which time the assets of the estate have to be liquidated into cash. This period can still be excessive, however, and can also be extended by court order.

  A debtor is considered to be insolvent if it has more than one creditor and is not able to meet its outstanding financial obligations within 30 days after they have become due. In this case creditors, or the debtor itself, may file a bankruptcy petition. Unfortunately, the Insolvency Law also provides that a debtor can be deemed to be insolvent if it has "excessive debts", a term that is not defined in the Insolvency Law. This ambiguity is therefore open to misuse. In addition, a debtor must be insolvent for either liquidation or re-organisation proceedings to be instituted. This makes it difficult for parties to take steps when an insolvency is anticipated (i.e., for the debtor to initiate re-organisation proceedings in advance of a large payment on a term debt becoming due) and makes successful re-organisation more difficult.

  Regional, first-level commercial courts are authorised to handle bankruptcies and compositions. There is no specialised commercial or bankruptcy court capable of dealing with insolvency matters.

Once proceedings have been instituted under the Insolvency Law, a secured creditor does not have recourse to its rights of enforcement under its security agreement. Rather, the insolvency administrator will realise upon the security. Despite this limitation, it appears that the secured creditor will be entitled to the entirety of the proceeds of sale if its secured asset(s), presumably less the cost of the sale itself.

If an application is made to have the debtor declared bankrupt, and the court makes this declaration, an insolvency administrator is appointed and the debtor is liquidated for the general benefit of its creditors.

If the debtor is convinced that it can be re-organised, it may apply for the opening of composition proceedings. Such an application must contain a detailed composition proposal and list of the debtor's assets and liabilities. A composition plan must be approved by both the court and by creditors holding at least 75 per cent of the debt owed by the debtor. Successful re-organisation is made difficult by the unusually high percentage of creditor support required, together with the absence of any provisions for post-filing credit to be provided on a priority basis.

- **Capital Markets**

The primary legislation governing the capital markets include the Act No. 566/2001 "on Securities and Investment Services" as amended, the Act No. 594/2003 "on Collective Investment" as amended, the Act No. 429/2002 "on Stock Exchange" as amended, and the Act No. 530/1990 "on Bonds" as amended.

The Act No. 566/2001 "on Securities and Investment Services" came into force on 1 January 2002 and was amended in 2003 (with changes effective on 1 January 2004). Compared to the old securities law, the Act No. 566/2001, together with recent amendments to the Commercial Code, has significantly improved shareholder rights. It also tightened regulation of securities firms operating in the Slovak market. It is worth mentioning that in early 2002, six so-called "savings and loan" fund companies collapsed as a result of having insufficient liquidity to meet the demands of their clients. They operated on the basis of the Commerial Code and were regulated neither by the Central Bank nor by the Financial Market Authority. The estimate of the total losses from the six companies is said to be more than twenty-three billion Slovak Crowns. The clients of the fund companies are not eligible for the deposit insurance scheme that covers ordinary bank depositors. Before the Act No. 566/2001 "on Securities and Investment Services" was promulgated, the collapsed funds were not legally required to disclose client numbers, how much they had collected in deposits or what they were doing with the deposits. Today, legislation prevents this kind on operation.

According to the Act No. 96/2002 "on Supervision over the Financial Market", the capital markets (and insurance sector) is supervised by the Financial Market Authority ("FMA"), which was established and became operational in November 2000 pursuant to an old law preceding the Act No. 96/2002. While the FMA has improved its cooperation with other regulators since its establishment, it should make further progress in institutional development in order to keep up with the rapid financial sector development. In this regard, it should be noted that under the current legislative framework, the Ministry of Finance continues to be responsible for drafting legislation and regulations applicable to these segments of the financial system, while the authorities of the FMA are limited to enforcing and supervision. However, it should be also noted that the Government has decided to integrate regulations and supervision of all bank and non-bank financial markets under the jurisdiction of the National Bank of Slovakia by 2005.

The Bratislava Stock Exchange ("BSE") was founded on 15 March 1991 as a joint stock company pursuant to a Decree of the Ministry of Finance. The BSE currently performs its activities on the basis of a license from the FMA issued in 2001. Trading on the BSE started on 6 April 1993.

Regarding the insurance sector, the key legislation is the Act No. 95/2002 "on Insurance Industry" as amended. This act came into force in March 2002 and replaced an old act promulgated in 1991 and all subsequent amendments. The new act gave existing new insurance companies a transition period of one year to conform their operations to the new regulatory regime. Some of the provisions, however, are designed to come into force only at the time of EU accession. Pursuant to the Act No. 95/2002, external auditors are required to report to the supervisor factors that could impair the ability of the company to meet its obligations. To a limited extent, this act also strengthens corporate governance of insurance companies.

- **Company Law and Corporate Governance**

The main legislation serving as company law is the Commercial Code (Act No. 513/1991 Coll.), which was initially promulgated in 1 January 1992, with the most recent amendments effective on 1 February 2004.

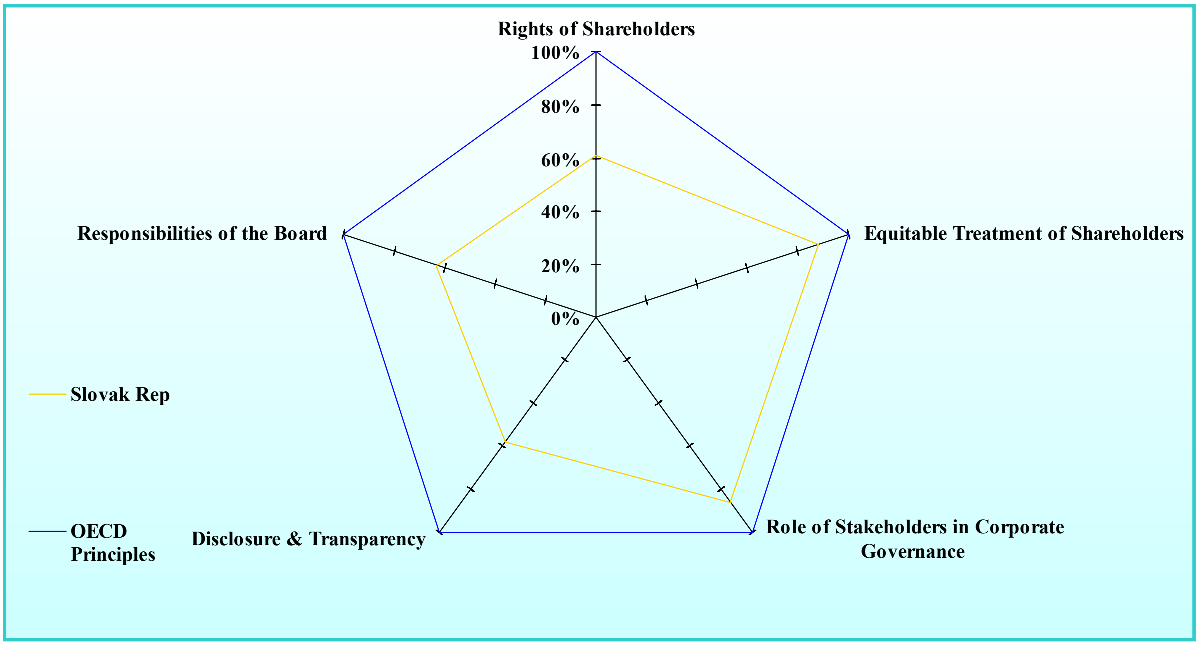
According to the 2003 results of the EBRD's Corporate Governance Sector Assessment, the Slovak Republic is a country whose existing corporate governance related laws (i.e., "law on the books", not how the relevant legislation is being implemented) when compared to the OECD *Principles of Corporate Governance* were rated among "medium compliance" countries. General reform priorities for countries in this category are to improve effective implementation and enforcement of existing legislation, while continuing to reform their existing laws.

A detailed analysis of the results of the EBRD's Corporate Governance Sector Assessment (see chart below) indicates that the corporate governance legal framework would need strengthening on a number of points, including the following, without this list being exhaustive:

- Rights of shareholders: there is a need for clear provisions in the law empowering the shareholders meeting to appoint auditors, approve their remuneration and request additional information regarding their report; the law should also provide for high enough super-majorities of the company's issued and outstanding voting shares for important decisions such as amendments to the company's charter, merger or reorganisation, winding up or voluntary liquidation.

- Responsibilities of the board: the law should give the board responsibility for monitoring and managing potential conflicts of interest of management, board members and shareholders; the board should also be made responsible for monitoring the effectiveness of the corporate governance practices under which it operates; there should be a legal definition of the concept of "board independence".
- Disclosure and transparency: there is no obligation at the moment to prepare financial reports on a quarterly basis (only on a half-yearly basis); the company should be required by law to disclose transactions with related parties of individual board members and key executives; the shareholders should have access to documents such as the list of shareholders owning 1 per cent of more of the company's issued shares, or the list of shareholders who have note fully paid for their shares.

Different aspects of corporate governance legal framework (2003)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD *Principles of Corporate Governance*. The fuller the 'web', the closer the corporate governance laws of the country approximates these principles.
Source: EBRD Corporate Governance Sector Assessment Project, 2003 assessment

It is worth noting that a new Act on Accounting became effective on 1 January 2003 (although subsequently amended in the same year). Also, according to the new Act No. 429/2002 "on Stock Exchange", an issuer of securities from 1 January 2004 is required to prepare financial statements according to International Financial Reporting Standards. Both helped improve the legal framework of the Slovak Republic in the area of corporate governance.

- **Concessions**

Slovakia has recently attempted to modernise its concessions-related legislation. This may, however, lead to a need for further reform. The New Act N° 523/2003 "on Public Procurement" (the "Public Procurement Law"), which contains articles on concessions, entered into force on 1 January 2004, replacing the former Law N°

119/1996 “on Concessions”. The fact that the Concessions Law has been cancelled and relevant rules introduced as part of the general Public Procurement Law makes the latter insufficiently specific to concessions. This undermines concessions as an important type of private sector participation and might limit investors’ options and thus interest.

The Public Procurement Law is not clear in many respects as far as concession related issues are concerned (in particular regarding the content of the project agreement and the determination of the government to promote concessions).

The Public Procurement Law defines concession contracts, but not a concession itself. “A concession contract is a contract of the same type as a works contract except for the fact that the consideration for the works to be carried out is compensated for by the right to exploit the construction for an agreed period, which may be accompanied with payment by the contracting authority.”

A concessionaire is defined as “a natural or legal person or a group formed by several persons with whom a concession contract has been concluded while employing the methods and procedures in accordance with this Act”.

The Public Procurement Law seems to apply to all public contracts including concessions. It applies to all sectors concerned by public works and public services, however, only implicitly and not expressly.

The following other deficiencies of the law should be mentioned: it neither provides for a restrictive list of termination events, nor compensation of the concessionaire. The Public Procurement Law does not deal with such issues as the ownership by the concessionaire of land or project assets nor does it govern issues related to the security interests that a concessionaire could create/assign. The law does not allow parties to negotiate the applicable law and has no “step-in” clause, an issue that is very important to lenders.

Based on the above, it can be seen that Slovak concessions laws need further improvement in order to be in line with the internationally accepted standards of a modern legal framework in the sector.

- **Secured Transactions**

Until recently, the market for secured credit in Slovakia has been limited. Legal procedures for taking security were slow, the chances of a creditor successfully recovering from security were uncertain and the types of assets available as security were restricted to real property and assets which the debtor could hand over to the creditor for the duration of the credit.

Revisions to the Civil Code sponsored by the Office of the Deputy Prime Minister, Economy, and the Ministry of Justice, with support from the EBRD, have dramatically changed this position. The new provisions entered into force on 1 January 2003 when the new charges registry became operative, giving Slovakia one of the most advanced frameworks for secured credit in Europe.

The main strengths of the new law can be summarised as follows:

Any asset: Security can be taken over any asset that is capable of being transferred. The law covers security over real property, movable assets and intangibles (such as rights and receivables). The assets may be identified by general description and may include assets to be acquired by the debtor at a future date. It is possible to take security over a group of assets even where the composition of that group is constantly changing (such as inventory, trade receivables or even an entire enterprise).

Any debt: All types of claims may be secured. The secured debt may be denominated in any currency, may be of a fixed or varying amount and may include claims that will arise in the future. The law is not restricted to bank lending but covers credit given by any person.

Non-possessory: The debtor may retain possession and continue to use the assets taken as security. He can thus use the assets to generate the revenue needed to service and repay the secured debt.

Simple formalities: Creation of security is simple and rapid. The requirements are a written agreement and publication of the security by registration. If the agreement is in notarial form subsequent enforcement of the security is facilitated. The costs of creation are low.

Publicity: Security has to be publicised through registration. Where the assets are already registered (e.g. land or ships) registration is in the existing register. In all other cases, registration is made against the name of the debtor in a new charges registry operated by the Slovak Chamber of Notaries. The new registry is held in a single electronic database and registration may be made instantly via a terminal in any notary's office. The information in the registry is public and can be consulted by anybody for free on the internet.

Priority: The creditor has a first right in the assets taken as security, subject to any prior security given to other creditors. Other persons dealing with the debtor are able to ascertain whether assets are subject to security or not by consulting the register. Normal rules are included to protect ordinary course of business transactions. Tax claims are no longer paid ahead of secured creditors.

Enforcement and realisation: If the debtor fails to pay the secured debt when due, the secured creditor has the right to take possession and to sell the assets given as security and to use the proceeds to repay the debt. Sale may be through a court procedure, or by auction or private sale organised by the creditor. A new law on voluntary private-held auctions also provides the framework for realisation to be achieved rapidly and efficiently through auction.

Contractual flexibility: The new law allows broad scope for debtor and creditor to determine the terms of the security in a way which fits with what they agree between themselves and with the circumstances of their particular commercial transaction.

According to the EBRD New Legal Indicator Survey 2003, which assessed the practical aspects of the enforcement of charges throughout the EBRD countries of operations, a number of qualifying factors where highlighted where further attention will be needed: in particular, the interface of charge enforcement and insolvency regime remains an area of concern. The survey also confirmed that the new law is too recent to have had a full impact and that there was a lack of practical experience in the country (see chart below).

Qualifying factors in the charge enforcement process

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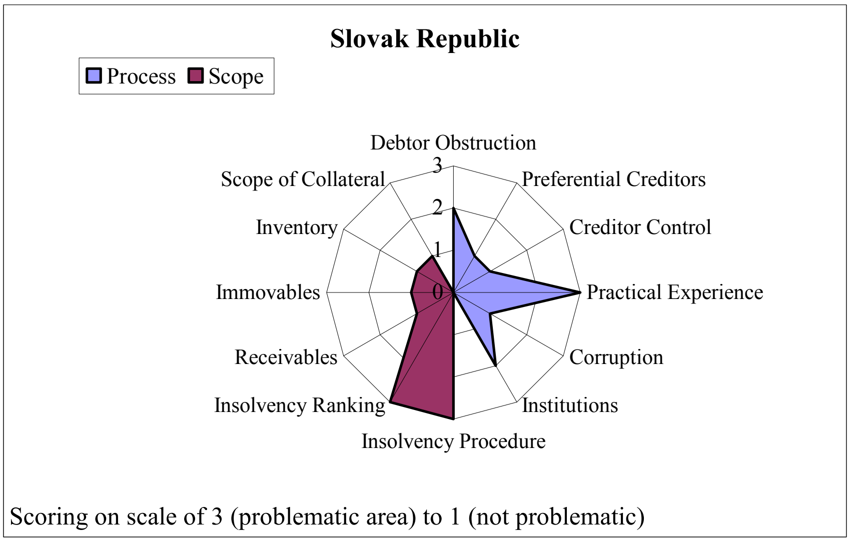

</td>
<td>1 = no significant problems or limitations
2 = relatively minor problems or limitations
3 = major problems or limitations

The fuller the “web” of the graph, the more serious the problems are in each of the respective categories.</td>
</tr>
</table>

Process factors	Scope factors
Debtor obstruction: The possibility for the debtor to prevent, slow down or otherwise obstruct the enforcement proceedings to the detriment of the chargeholder. Legitimate exercise of right of defence or appeal is not included. **Preferential creditors:** The impact of claims of other creditors (other than prior-ranking secured claims) on the satisfaction of the secured creditor’s claim. **Creditor control:** The ability of the creditor to control or influence the conduct of the enforcement procedure. **Institutions:** The reliability of the courts and other institutions necessary to support the enforcement process. ***Practical experience:*** *The general level of practical experience with the enforcement process in the country in question.* **Corruption:** The impact of corruption within the court system on the enforcement process.	**Insolvency procedure:** The impact of the debtor’s insolvency on the enforcement process. **Insolvency ranking:** The priority of the secured creditor’s claim upon insolvency of the debtor. **Receivables:** An assessment of the simplicity and certainty of the enforcement process for a charge over receivables. **Immovables:** An assessment of the simplicity and certainty of the enforcement process for a charge over immovables. **Inventory:** An assessment of the simplicity and certainty of the enforcement process for a charge over inventory.
	Source: EBRD New Legal Indicator Survey 2003

- **Telecommunications**

The telecommunications sector is currently regulated by the Telecommunications Office of the Slovak Republic ('TUSR') and is governed by the Telecommunications Act, 2000 (the "Telecoms Act"), as amended. TUSR is responsible for licensing, type approval of equipment, specifying general conditions for interconnection, tariffing and frequency administration. The Ministry of Transport and Communications is responsible for preparation of telecommunications policy and development activities. Whilst TUSR was created in 1993, responsibilities and independence of the agency were enhanced with the passage of the Telecoms Act.

The Telecoms Act also provides for licensing private networks and non-voice telecommunications, interconnection, universal service and leased lines, together with an arbitration process for disputes among operators and between operators and consumers, together with regulatory arrangements for the liberalised markets. In line with common international practice, a general requirement of the Telecoms Act is that all regulatory decision-making must be carried out using the principles of objectivity, non-discrimination, transparency, and the elimination of anti-competitive behaviour. Current legislation also grants TUSR the power to set tariffs for monopoly or dominant operators where "there is a public interest to protect the users". In regulating tariffs, TUSR must consider the level of price compensation and the need for further investment in the public telecommunications network. Public telecommunications network operators and service providers are currently not permitted to reallocate costs or revenues from other activities or services.

Despite both the Telecoms Act providing for full liberalisation of the Slovak telecommunications market on the 1st January 2003, and the pre-licensing of more than 10 competitive operators, the effective opening of the market to competition was significantly delayed because of the authorities' failure to implement critical interconnection and local loop unbundling measures. Notably, the first interconnection agreement was only signed with a competitive operator in November 2003, almost a year after the formal opening of the market.

In other areas, the Slovak Republic appears to be lagging behind in the effective implementation of a number of essential areas within the regulatory sphere. More particularly, tariff re-balancing has yet to be completed; there seems to be no clear provision with respect to universal service; and, provision for carrier selection/pre-selection and number portability have yet to be fully implemented. Additionally, concern has been expressed about the capacity and independence of the TUSR, with the necessary separation of regulatory and operational functions yet to be fully implemented.

In addition to being a condition of accession to the European Union (EU), full implementation of all EU telecom *acquis* is an essential precursor to the attraction of investment and development of the sector. Accordingly, the authorities should take all necessary steps to ensure that all appropriate regulatory instruments are rapidly implemented and made effective. In particular, as an independent, appropriately financed and adequately staffed regulatory agency is the *sine qua non* of modern sector development, the government should pay specific attention to ensuring that all resources and powers necessary for the TUSR to assert itself as a modern independent regulatory institution are made available to the agency.

LEGAL REFORM PROJECTS

- **SECURED TRANSACTIONS**

The EBRD is still involved in the legal reform project on secured transactions (see description in the "Secured Transactions" section of this Annexe), monitoring the reform's impact on the credit sector and working with the Ministry of Justice in addressing some of the difficulties and bottlenecks that have appeared in practice. It is important that the government remain committed in this process, in order to ensure that the economic benefits which were anticipated, especially for SMEs, are indeed being delivered.

ANNEX 7: ENVIRONMENT

In the latest 'Comprehensive monitoring report on Slovakia's preparations for membership' (November 5, 2003) in Chapter 22: Environment it is stated that:

- In the **air quality** sector**,** legislation is in place and is in line with the *acquis*. Administrative capacities are in place and function adequately. Air quality plans and programmes need to be completed. However, the capacity to establish and implement plans and programmes needs to be enhanced. As regards volatile organic compound emissions from the storage and distribution of petrol, a transitional arrangement until 31 December 2007, with intermediate targets, has been agreed for certain installations in Slovakia.
- In the field of **waste management,** legislation is in place and is in line with the *acquis,* except for an amendment to the Waste Act on PCB/PCT and the recent *acquis* on end-of life vehicles, which need to be transposed by accession. Administrative capacities are in place and function, but more staff is needed at ministerial and regional levels. The establishment of waste collection systems and recovery and disposal facilities needs to continue. Compliance with the *acquis* requirements needs to be ensured in this respect. As regards packaging waste, a transitional arrangement until 31 December 2007, with intermediate targets, has been agreed.
- In the area of **water quality**, legislation is in place and is in line with the *acquis*. Administrative capacities are largely in place and function, but nevertheless require strengthening. The monitoring of drinking water needs to be further enhanced, and programmes for nitrates and dangerous substances need to be adopted by accession. Transitional arrangements until 31 December 2015 for urban waste water and until 31 December 2006 for discharges of certain dangerous substances, with intermediate targets, have been agreed.
- In the field of **nature protection,** legislation is in place and is in line with the *acquis*. Further efforts are needed to finalise the preparation of a list of proposed sites of Community interest and to designate special protection areas by accession, and to apply the relevant protection measures. Close attention needs to be paid to ensuring proper consultation while avoiding delays. Even if technical and institutional capacities, including administrative capacities, have been improved, further strengthening is still required, including in terms of enforcement needs.
- The legislation on **industrial pollution and risk management** is in place and is in line with the *acquis*. While administrative capacities are largely in place and function, enhanced efforts are required to further strengthen the administrative capacity and to ensure that permits are issued and complied with as regards all new installations subject to the rules on integrated pollution and prevention control (IPPC) and that, regarding existing installations, they continue to be issued and complied with until October 2007. Transitional arrangements until 31 December 2011 for IPPC, until 31 December 2007 for certain large combustion plants, and until 31 December 2006 for incineration of waste have been agreed for certain categories of activities and operations at certain installations in Slovakia.
- The legislation concerning **chemicals and genetically modified organisms** (GMOs) is in place and is in line with the *acquis*. Attention must be paid to its

implementation. Administrative capacities are in place and function. Co-ordination between the organisations involved needs to continue to be enhanced.

- Transposition of the *acquis* on **noise** is proceeding according to schedule and the legislation is in line with the *acquis*, except for the recent *acquis* on ambient noise, which needs to be transposed by July 2004 in line with the Directive. Administrative capacities are in place and function adequately.
- As regards **nuclear safety and radiation protection**, legislative alignment has been largely completed and the legislation is in line with the *acquis*. Administrative capacities in this area are largely in place and function adequately.

In Conclusion, Slovakia is essentially meeting the commitments and requirements arising from the accession negotiations and is in a position to implement the *acquis* in the areas of **horizontal legislation**, **air quality**, **waste management**, **water quality, nature protection, industrial risk management, chemicals and genetically modified organisms**, **noise** and **nuclear safety and radiation protection** . Slovakia needs to finalise legal alignment as regards the following areas: horizontal legislation, waste management, water quality, industrial pollution, noise, and nuclear safety and radiation protection. It needs to complete air quality plans and programmes and continue to enhance water quality monitoring. Establishment of waste collection systems and recovery and disposal facilities needs to continue. Moreover, Slovakia must pay particular attention to implementation in the water sector, especially as regards drinking water quality, and must finalise the necessary programmes. In addition, Slovakia must make further efforts to finalise its lists of proposed nature protection sites and special bird protection areas by accession. Close attention needs to be paid to ensuring proper consultation while avoiding delays. Administrative capacity for nature protection, including enforcement, requires further strengthening. Slovakia is partially meeting the commitments and requirements for membership in the area of **industrial pollution**. Enhanced efforts are required to further strengthen the administrative capacity and to ensure that permits are issued and complied with as regards all new IPPC installations and that, regarding existing installations, they continue to be issued and complied with until October 2007.