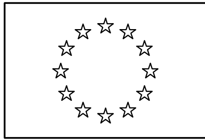

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
SEC(2004) 833 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9
of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Slovakia, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

Slovakia's convergence programme covering the period 2004-2007 was submitted on 14 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the Spring 2004 forecasts and having regard to the Code of Conduct[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> Slovakia submitted its first convergence programme on 14 May 2004. The programme covers the period 2004 to 2007 and, in addition, provides indicative projections until 2010. The document incorporates the measures taken in the budget 2004 and is consistent with the authorities' detailed draft multi-annual budget framework for the years 2005 to 2007. It expresses the authorities' intention to adopt the euro in 2008 or 2009 at the latest.
>
> The programme is very well presented and largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[4]. It compares favourably with the pre-accession

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1 OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.6.2001 endorsed by the ECOFIN Council of 10.7.2001.

3 COM(2002) 668 final, 27.11.2002.

4 Indeed, with a few minor exceptions (a few missing projections for the years 2006 and 2007 in the table on external assumptions and the provision of public consumption only in aggregated form [lines 16 and 17 together] in table 2), the code-of-conduct tables annexed to the programme provide not only the required but also the optional information indicated in the code. In addition, the programme furnishes a broad array of supplementary data. Furthermore, estimated consolidated expenditure- and revenue-to-GDP ratios and disaggregations thereof in line with ESA95 classifications are now available back to 2002, whereas, before that, consolidated expenditure- and revenue-to-GDP ratios are still lacking.

economic programmes 2001 to 2003 in terms of the richness and coherence of the supplied information.

The general government deficit decreased to 3.6% of GDP in 2003, above the 3% of GDP Treaty reference value. The Commission initiated the excessive deficit procedure for Slovakia on 12 May 2004, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on this report on 25 May. On 5 July 2004, the Council is expected, on the basis of Commission recommendations, to decide that an excessive deficit exists in Slovakia and to make recommendations to Slovakia to bring this situation to an end.

The macroeconomic scenario presented in the programme is plausible and broadly in line with the Commission forecast: after a steady increase of the real GDP growth rate from 1.5% in 1999 to 4.2% in 2003, the programme projects real GDP expansion to continue at about this rate in 2004 and 2005, underpinned by an increasingly stronger domestic demand and a weakening external growth contribution. Beyond the Commission forecast horizon, for 2006 and 2007, the programme plausibly predicts an acceleration of growth to almost 5% (i.e. roughly in the range of available estimates for potential growth by that time) -- driven by again strengthening exports as FDI-induced export capacity comes on stream. Throughout the programme period, exports benefit from a projected growth pick-up in Slovakia’s major trading partners until 2005 and their flat but robust growth thereafter. In line with the growth outlook and, since recently, more decisive labour market reforms, unemployment is anticipated to drop gradually to around 14½% by 2007 (from somewhat over 17% in 2003).

Inflation is forecast to fall rapidly after the year 2004 (to below 3% in 2006 and 2007) as increases in administered prices taper off. The inflation projection is realistic under the assumption that second-round effects are strictly contained, notably by counter-acting backward-looking wage setting, in particular in the public sector because of potentially unfavourable demonstration effects. Monetary policy pursues an implicit inflation target, while trying to reduce excessive exchange rate volatility and to offset exchange rate pressures that are deemed inconsistent with economic fundamentals. Policy interest rates have been decreased, triggered by concerns about the strength of the currency, which appreciated by some 10 percent since mid-2002, and supported by the on-going fiscal consolidation efforts. The programme suggests that Slovakia would start participating in ERM II in 2005 or 2006.

The programme aims at a reduction of the general government deficit to 3.0% of GDP by 2007 from 3.6% of GDP in 2003 in order to comply with the Maastricht deficit criterion – with the adjustment path being almost completely in line with the 2003 pre-accession economic programme (up to 2006) and with the following intermediate deficit targets: 4.0% of GDP in 2004, 3.9% of GDP in 2005 and 3.9% of GDP in 2006. Against the backdrop of a far-reaching but expected to be basically revenue-neutral tax reform package, which essentially constitutes a shift of the tax burden from direct to indirect taxation and is effective since the beginning of 2004, the adjustment over the programme period is based on reductions in primary expenditures of 1.5 percentage points of GDP. These reductions are to a large extent underpinned by structural reforms, predominantly in the health and social protection area, which are mostly already enacted and in force.

In particular in an environment of robust growth, the envisaged deficit reduction of a mere 0.6 percentage of GDP over four years does not look very ambitious. In addition, it is back-loaded. However, the following modulating factors need to be taken into account: first, the relatively large deficit reduction from 2002 to 2003 of 2.1 percentage points of GDP, which was partly due to non-recurrent factors; second, the expenditure-based nature of the adjustment; third, the introduction of a funded pension pillar in 2005, which leads to a re-direction of social security contributions and, hence, a revenue decrease for general government, starting with ½ percentage point of GDP in 2005 and amounting to 1 percentage point of GDP by the end of the programme period; and fourth, the increase in public investment over the programme horizon. Contingent on the strict containment of risks on the expenditure side, which would be helped by binding medium-term expenditure ceilings, potentially higher than budgeted tax revenues in 2004 and beyond would provide a welcome opportunity to accelerate the deficit reduction in comparison to what is foreseen in the programme.

The possibility of accelerating the deficit reduction is an especially important consideration. Not only would it allow the general government deficit to be below 3.0% of GDP in 2007, but it would also pave the way to achieve the second major objective expressed in the programme, namely a structural budgetary position of close to balance or in surplus by the end of the decade, and to attain a sufficient safety margin against breaching the 3% of GDP Treaty reference value for the deficit criterion with normal macroeconomic fluctuations. Furthermore, accelerating the deficit reduction whenever the opportunity arises would also create a buffer against potential downside risks. Whereas risks in 2004 are somewhat tilted to the positive side, risks over the whole programme period seem to be broadly balanced. Nevertheless, important downside risks seem to be concentrated on the expenditure side and include in particular delays in the envisaged health care reform and a lack of public sector rationalisation.

The authorities’ structural reform agenda, which is for the most part already enacted and in force, increases the quality of public finances both on the revenue side (tax reform package) and expenditure side (in particular health care and social protection) and is likely to enhance growth, notably by strengthening the incentives to work (including through a better targeting of social transfers) and to create new jobs.

The programme projects an increase in the debt-to-GDP ratio between 2003 and 2005 by 2½ percentage points to 46.4% – broadly in line with the Commission forecast. Thereafter, it plans a reduction to 45.5% by 2007. The role of stock-flow adjustments in determining debt dynamics, which was large before 2003 due to privatisation and other exceptional factors, has substantially diminished. The year 2004 is a notable exception, mainly due to a lower accrual than cash deficit.

On long-term sustainability, the programme projections are contingent on the strict adherence to the fiscal consolidation targets (leading to a budgetary position of close to balance or in surplus by 2010), the full implementation of the envisaged policies (including additional increases in the retirement age after the programme horizon), and the underlying demographic assumptions, in particular potentially too optimistic fertility rates. Under these conditions, the projections suggest that Slovakia would be relatively well placed to meet the budgetary costs of an ageing population. Apart from some additional risks that may emerge in the long run, the main risks to these

projections stem from a lack or a delay in reform implementation or from any backtracking on already implemented reforms.

Table: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP (% change)	**CP**	**4.2**	**4.1**	**4.3**	**5.0**	**4.7**
	COM	4.2	4.0	4.1	n.a.	n.a.
	PEP	*4.0*	*4.1*	*4.4*	*4.8*	*n.a.*
HICP inflation (%)	**CP**	**8.5**	**8.1**	**4.0**	**2.9**	**2.5**
	COM	8.5	8.2	4.5	n.a.	n.a.
	PEP	*8.6*	*8.1*	*4.3*	*3.0*	*n.a.*
General government balance (% of GDP)/1	**CP**	**-3.6**	**-4.0**	**-3.9**	**-3.9**	**-3.0**
	COM	-3.6	-4.1	-3.9	n.a.	n.a.
	PEP	*-5.0*	*-3.9*	*-3.9*	*-3.8*	*n.a.*
Primary balance (% of GDP)/1	**CP**	**-1.2**	**-1.4**	**-1.1**	**-1.2**	**-0.4**
	COM	-1.2	-1.4	-1.0	n.a.	n.a.
	PEP	*-2.1*	*-1.4*	*-1.1*	*-0.6*	*n.a.*
Government gross debt (% of GDP)	**CP**	**42.8**	**45.1**	**46.4**	**46.1**	**45.5**
	COM	42.8	45.1	46.1	n.a.	n.a.
	PEP	*45.0*	*45.7*	*47.4*	*48.5*	*n.a.*

/1 General government balance and primary balance include the revenue-decreasing and hence, *ceteris paribus,* deficit-increasing effect of the introduction of a funded pension pillar in 2005 (estimated at 0.5% of GDP in 2005; 0.9% of GDP in 2006; and 1.0% of GDP in 2007).
Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of Slovakia and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9
of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Slovakia, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July 2004], the Council examined the convergence programme of Slovakia, which covers the period 2004 to 2007 and, in addition, provides indicative projections until 2010. The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".

The budgetary strategy underlying the programme aims at reducing the general government deficit to 3.0% of GDP by 2007 from 3.6% of GDP in 2003 in order to comply with the Maastricht deficit criterion -- with the following intermediate deficit targets: 4.0% of GDP in 2004, 3.9% of GDP in 2005 and 3.9% of GDP in 2006. The reduction of the deficit is expected to occur mainly in 2007. The programme envisages an adjustment based on primary expenditure reductions of 1.5 percentage points of GDP. These reductions are to a large extent underpinned by structural reforms, predominantly in the health care and social protection area, which are mostly already enacted and in force. The reforms on the expenditure side take place against the backdrop of a far-reaching but expected to be basically revenue-neutral tax reform package (effective since the beginning of 2004); the tax reforms essentially constitute a shift of the tax burden from direct to indirect taxation. In addition, a funded pension pillar will be introduced in 2005, which leads to a revenue decrease for general government, starting with an estimated ½ percentage point of GDP in 2005 and amounting to 1 percentage point of GDP by the end of the programme period.

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[5] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

On the basis of currently available information, the macro-economic scenario underlying the programme seems to reflect plausible growth assumptions, i.e. growth of somewhat over 4% in 2004 and 2005 and an acceleration of growth to almost 5% in 2006 and 2007 – due to further strengthening exports on the back of an FDI-induced expansion of export capacity. The anticipated drop in unemployment will require the continued vigorous pursuit of policies which address the deep-seated structural problems in the labour market – given the still very high unemployment rate prevailing in Slovakia. The projection of rapid disinflation after 2004, when administrative price adjustments and indirect tax hikes taper off, is within reach if second-round effects are strictly contained. In particular, wage developments, including in the public sector, should not be guided by past inflation developments.

The programme foresees the general government deficit to be reduced to the 3% of GDP reference value in 2007 and to fall further thereafter. Given the assumption of a very robust growth of the Slovak economy, the size and path of the deficit reduction does not look very ambitious. However, in particular the following modulating factors need to be taken into account: the envisaged reduction in primary expenditures, the revenue decrease resulting from the pension reform, and the, partly one-off, adjustment achieved in 2003. The budgetary stance in the programme seems sufficient to reduce the deficit to the 3% of GDP deficit threshold by the end of the programme period. The risks to the budgetary projections over the overall programme horizon appear broadly balanced. They are tilted to the positive side in 2004, when the deficit is projected to increase marginally. Downside risks seem to be concentrated on the expenditure side and consist mainly in a delay of the proposed further health care reforms and a lack of further public sector rationalisation. The achievement of the deficit targets will depend on the ability of the government to control primary expenditures, which would be helped by binding medium-term expenditure ceilings. Opportunities, in particular in the form of any higher than expected tax revenues, should be seized to accelerate the deficit reduction. In addition to increasing the likelihood of achieving a deficit below 3% of GDP in 2007, this would pave the way to reach the second major fiscal objective expressed in the programme, namely a structural budgetary position of close to balance or in surplus, earlier than by the year 2010 envisaged in the programme, and to attain a sufficient safety margin against breaching the 3% of GDP Treaty reference value for the deficit criterion with normal macroeconomic fluctuations. It would also provide a better basis for dealing with potentially surging capital inflows.

In the programme, the debt ratio is projected to increase between 2003 and 2005 by 2½ percentage points to 46.4% and to fall again to 45.5% by 2007. Slovakia appears relatively well-placed to meet the budgetary cost of an ageing population. Long-term sustainability is contingent on the strict adherence to the fiscal consolidation targets and the full implementation of the envisaged policies. In particular as regards fertility rates, the demographic assumptions underlying the related programme projections may be on the optimistic side. The main risks to long-term sustainability stem from a lack or a delay in reform implementation or from any backtracking on already implemented reforms.

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On [5 July 2004], on the basis of recommendations from the Commission, the Council decided that an excessive deficit existed in Slovakia in accordance with Article 104(6) of the Treaty and made recommendations under Article 104(7) to Slovakia with a view to bringing that situation to an end, in which the Council expresses its policy advice.

Key projections from the convergence programme of Slovakia

	2003	2004	2005	2006	2007
Real GDP growth (%)	4.2	4.1	4.3	5.0	4.7
Employment growth (%)	1.8	0.5	0.6	0.6	0.9
HICP inflation (%)	8.5	8.1	4.0	2.9	2.5
General government balance (% of GDP)	-3.6	-4.0	-3.9	-3.9	-3.0
Government gross debt (% of GDP)	42.8	45.1	46.4	46.1	45.5