Ministry of Finance
of the Slovak Republic

CONVERGENCE PROGRAMME FOR THE SLOVAK REPUBLIC

covering the period 2004-2010

May 2004

CONTENT

INTRODUCTION

On 1 May, 2004, the Slovak Republic opened a new chapter in its history by becoming a full member of the European Union (EU). This momentous event presents a win–win outcome for both Slovakia and the other existing members of the Union. Full accession to the EU will provide Slovakia with new opportunities for faster growth and convergence of living standards with Europe's most developed economies. At the same time, Slovakia is now able to participate actively in the shaping of EU's economic policy and thus contribute much more effectively toward joint European efforts to meet the ambitious Lisbon strategy goals.

Upon accession, Slovakia also entered the Economic and Monetary Union (EMU) and thereby assumed a number of obligations that follow from it. Among other things, the Slovak government is now required to prepare an annual Convergence Programme (CP). The first Slovak Convergence Programme is based on Council Regulation (EC) 1466/97 and respects the recommendations of the ECOFIN Council of 10 July 2001, which specify the contents and format of these programmes. Apart from the Convergence Programme, Slovakia – like all other EU members – also prepares an annual progress report on structural reforms of the product, service and capital markets, also known as the Cardiff Report.

The goal of the Convergence Programme is to present a clear picture of the medium- and long-tem objectives of the Slovak economic policy and to provide a comprehensive account of the steps to be taken in attaining convergence in both real and nominal terms. The Convergence Programme contains clearly defined goals of the government through to the year 2010 accompanied by government's strong commitment to meet these goals. The policies until 2007 are presented in a greater detail.

The Convergence Programme has been prepared on the basis of the following documents:

- Programme Declaration of the Government of the Slovak Republic
- Pre-accession Economic Programme for the year 2003
- The Cardiff Report for the year 2003
- Strategy for the Adoption of the Euro in the Slovak Republic
- The 2004 State Budget Act
- General Framework of the General Government Budget for the years 2005 - 2007

The forecasts contained in this document were prepared by 31 March 2004.

The first part of the Convergence Programme sets out the main goals of the economic policy until 2010, followed by a section containing economic assumptions and forecasts. Emphasis is also placed on the analysis of the country's ability to meet the Maastricht criteria. Parts Three to Five deal mostly with public finances: their medium-term development, the impact of structural reforms on public finances, and the long-term sustainability of public finances. Part Six compares the forecasts with the Pre-accession Economic Programme for 2003. Indicative forecasts until 2010 and other tables and charts are presented in the Annex.

The present Convergence Programme has somewhat broader coverage than is typical. Since this is the first Convergence Programme ever prepared by the Slovak government, an attempt was made to present the economic policy goals and practice in a comprehensive manner. As a result, the document provides an exhaustive account of monetary policy and related development. Furthermore, it contains a relatively detailed analysis of the bulky agenda of structural reforms, which should strongly improve the long-term sustainability of public finances. Future CP updates are likely to be narrower in content.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

I.1. Economic Policy Objectives until 2010

The main objective of the economic policy of the Slovak government is to achieve strong and sustainable economic growth, which should translate into accelerated improvement of living standards. Such an objective requires an effective pursuit and coordination of an array of economic policies, including:

- *Fiscal policy*

  Based on three basic principles – transparency, responsibility, and efficiency – the Slovak fiscal policy pursues two main objectives: reduction of the deficit of public finances to 3% of GDP by 2006 (excluding the implementation costs of the fully-funded pillar of the pension system) and achieving long-term sustainability of public finances by 2010. The long-term objective demands stringent interpretation of the Stability and Growth Pact. In practical terms this means that the Slovak Republic should enjoy public finances which are either close to balance (in structural terms) or in a moderate surplus by 2010.

- *Monetary and exchange rate policy*

  The Slovak monetary and exchange rate policy is grounded in the pursuit of price stability. In a small and open economy this also requires a relatively stable exchange rate. Indeed, the small size and very high openness of the Slovak economy are the prime motivations underlying Slovakia's aspirations to accede to the eurozone in the horizon of 2008 - 2009. The architects of the economic policy are persuaded that such step will further accelerate not only nominal, but also the real convergence of Slovakia.

- *Policies targeting the labour market, products and services market and financial markets*

  The main objective of the labour market policy is to reduce the rate of structural registered unemployment below 10% by 2010. In the products and services market the principal goal is to accelerate productivity growth by means of intensified competition, effective regulation, and attractive overall investment climate. With regard to financial markets, the government's policy focuses on supporting their further development via effective regulatory framework and sound market competition.

The Slovak government fully subscribes to the Lisbon strategy and its goals. The key economic policy objectives mentioned above are also in line with the challenges identified in the document „Key structural challenges in the acceding countries[1]." The Slovak government is entirely committed to achieving all of these goals.

I.2. Fiscal Policy

The economic transformation in most economies in Central and Eastern Europe has been accompanied by a high deficit of public finances. For more than a decade, many of these countries were unable to implement critical structural reforms on the side of public expenditures. In 2002, the Slovak government set an ambitious goal for itself: to reduce the deficit of general government finances below 3% of GDP by 2006 (excluding the

[1] Economic Policy Committee (July 2003)

implementation costs of the fully-funded pillar of the pension system[2]). Its attainment is made more challenging by the concurrent reduction of the tax burden, including payroll taxes. The reduction is one of the main feature of the fundamental tax reform and social insurance reform. Consequently, the general government deficit can be sustainably reduced below 3% of GDP only with the implementation of deep structural reforms on the expenditures side. Such reforms should substantially curtail the size of the general government.

Fiscal policy for the period ending 2010 shall be based on three basic principles:

- *Transparency*

  Transparency translates into timely, accurate, complete, and readily available information. The reporting of public finances must also be sufficiently transparent and legible for the public at large. In order to ensure correct quantification and international comparability of the fiscal position, the Slovak authorities have been paying close attention to a full and correct implementation of the ESA 95 methodology.

- *Efficiency*

  The Slovak authorities are focusing on increasing the efficiency of both revenue collection and public spending. On the public spending side, the objective is to maximize the value received for the money spent, including better quality of public services. The reform of public finance management plays a crucial role in this respect. The reform includes the introduction of result-oriented budgeting, in which the budget process is centred around well-defined and measurable goals. Furthermore, efficiency has been also improving thanks to the introduction of a three-year budget, the launch of the State Treasury, and a successful creation of the Debt and Liquidity Management Agency (ARDaL) for the public domain.

- *Responsibility*

  Responsibility means, above all, not passing the fiscal burden to next generations through high and persistent public finance deficits. Responsibility also implies a commitment to fiscal fairness within generations. Such fairness had been further strengthen by a better targeting of public expenses and by a new tax system, which broadly treats all types and amounts of income equally. Responsibility in fiscal forecasting means, among other things, a somewhat conservative attitude, particularly in the case of macroeconomic forecasts and tax revenue outlooks.

The main aim of the Slovak fiscal policy is to ensure and maintain long-term sustainability of public finances. As a result, Slovakia's public finances should be close to balance or showing a moderate surplus by no later than 2010. In this respect the Slovak Republic endorses a strict interpretation of the Stability and Growth Pact. Its basic principles must be observed also in the long run, when the effects of population aging culminate.

Due to a relatively unfavourable starting position, the overall fiscal goal will be pursued in two stages. In the first phase, public finance deficit will be reduced to 3% of GDP by 2006.

[2] The introduction of the fully-funded pension pillar will decrease overall pension liabilities and transform a large part of them from implicit to explicit. It should not have a significant demand impact. As a result, Slovakia will request that these factors be taken into account in the evaluation of the fulfillment of the Maastricht fiscal deficit criterion.

This is the utmost economic priority of the current government. Public finance should then be brought to balance or a moderate surplus in the following four years.

The reduction of deficit is being supported predominantly by structural reforms in such areas where expenses are sensitive to the aging of the population, including the pension system, health care, education system, and social welfare. By implementing these reforms much earlier than some other Member States – relative to the aging rate – Slovakia is strengthening its position for consistent fulfillment of Maastricht criteria and the Stability and Growth Pact in the future.

Further necessary consolidation of public finances should not be to the detriment of public investment. Slovakia is aware of the importance of public investments, particularly in some of the underdeveloped domains, such as productive infrastructure and the environment.

In general, the fiscal policy aims to support the enforcement of monetary policy by improving the efficient functioning of the automatic stabilisers. Although the efforts to consolidate public finances undoubtedly come first, the flexibility of automatic stabilizers is being enhanced, for example, by a number of reform measures in the labour market and the system of social benefits.

I.3. Monetary and Exchange Rate Policy

Since 1st July 2001, in line with Articles 108 and 109 of the Treaty establishing the European Community, the National Bank of Slovakia has had a constitutional status of an independent central bank of the Slovak Republic.

According to the Act on the National Bank of Slovakia (NBS) the primary objective of NBS is to maintain price stability. The maintaining of price stability superseded its previous key objective – monetary stability. Furthermore, a complete implementation of the *acquis communautaire* has ruled out any public sector financing by the central bank.

The practical enforcement of monetary policy is driven by the goal of ensuring price stability. The monetary policy reacts to the risk of inflationary developments diverging from the target values set forth in the Monetary Programme of the National Bank of Slovakia. Due to the relatively strong impact of administrative measures on the inflation rate, especially the price deregulations and changes in indirect taxes, the criterion of price stability has not been explicitly defined yet. The Slovak National Bank publishes its annual Monetary Programme, which contains a forecast for the next year, as well as a medium-term outlook for the upcoming three years. The short-term inflation prediction is the implicit objective of monetary policy.

Since Slovakia is a small open economy, any decision concerning its monetary policy also takes into consideration the development of nominal exchange rate, which plays a significant role in the transmission mechanism of the monetary policy. Exchange rate policy operates in the regime of managed float, whereby NBS usually intervenes on the market only in the case of excessive volatility, or in the case of unsubstantiated short-term pressures on the exchange rate. However, the National Bank of Slovakia normally does not intervene against exchange rate developments that are driven by economic fundamentals.

Other relevant indicators for monetary policy decisions include:

- real effective exchange rate and its impact on the competitiveness of the economy and on import demand

- domestic demand and its impact on inflation and imports
- development in public finances and their impact on the economic cycle
- output gap

Overall, the monetary policy instruments are very similar to those applied by the European Central Bank. The main instrument of the Slovak National Bank are interest rates. Since May 2000 NBS has been setting a limit interest rate for standard two-week REPO tenders. The level of minimum required reserves was gradually decreased. Now it matches the Eurozone level of 2%.

Medium-term objectives of monetary policy

In 2003, the NBS in cooperation with the Ministry of Finance of the Slovak Republic drafted a document „Euro Adoption Strategy in the Slovak Republic". The document concludes that the advantages of membership in the eurozone will outweigh its disadvantages and that the entry into the euro zone will provide a strong additional stimulus to a sound growth of the Slovak economy. The Slovak Republic should therefore adopt the euro swiftly after meeting Maastricht criteria in a sustainable way. The current Slovak government and NBS jointly declared their intention to achieve the necessary prerequisites for the euro adoption in 2008 or 2009 at the latest.

The fulfillment of Maastricht criteria in a sustainable way necessitates close coordination of monetary and fiscal policies. The approval of a clear national timetable for the euro adoption, together with a more substantial reduction of the impacts of administrative measures on the national price level, should enable the NBS to determine an explicit medium-term inflation target corresponding to the level of the Maastricht inflation criterion[3]. The adoption of such a target will depend on the fulfillment of commitments in the area of public finances. An explicitly determined inflation target should provide economic actors with a more transparent and explicit framework for formulating their longer-term business plans, investment and savings decisions, and wage policy.

In the medium-term perspective the managed float exchange rate regime will be replaced by the exchange rate mechanism ERM II. Slovakia's entry to ERM II can be expected to take place in 2005 or one year thereafter.

After the entry to ERM II, the monetary policy will be targeting inflation as well as the exchange rate. Its key objective will remain price stability. ERM II membership of Slovakia should by all means be as short as possible. A fixed band set for exchange rate fluctuation could increase the exchange rate volatility and the vulnerability of the currency, by creating a potentially attractive environment for inflows of speculative capital. Moreover, in a longer period, the price stability objective could become inconsistent with the criterion of exchange rate stability.

While the aim of NBS will be to keep the exchange rate close to central parity, the ongoing process of real convergence, growth of labour productivity, and the related appreciation of the equilibrium real exchange rate may necessitate a more flexible approach within the exchange rate regime. The central parity regime, as well as the evaluation of the fulfillment

[3] While NBS currently prepares inflation outlooks based on the national CPI, the explicit medium-term inflation target should be prepared on the basis of the harmonised index of consumer prices (HICP).

of the exchange rate criterion, should be sufficiently flexible, reflecting and accommodating these exchange rate and monetary effects of real convergence.

I.4. Structural Policies

Labour market

The attainment of the primary objective in the area of the labour market – increased employment and reduction of structural unemployment rate below 10% by 2010 – should be supported by three main factors. First, in July 2003, the government adopted a highly flexible labour code. Second, the available labour supply should be relatively high, also in connection with the adopted reforms in the social insurance and benefits schemes. Third, improving business environment, exemplified in the recent successes in attracting notable foreign direct investments, should continue generating a noticeable increase in labour demand.

The Act on Employment Services, which came into effect in 2004, established a legal framework for the provision of such employment services by integrated Labour, Social, and Family Affairs Offices. The offices are designed to provide prompt and effective support in re-entering the labour market to those unemployed citizens who want to work, are able to work, and seek a job. The assistance should enable the unemployed to improve their social situation by employment, or income-earning activity, in the shortest possible time. Thanks to other legislative improvements, the work of these public entities should be supplemented by job mediation activities of private temporary employment and supported employment agencies. Furthermore, in order to accelerate the implementation of active labour market measures, the Ministry of Labour, Social Affairs and Family of the Slovak Republic has prepared national projects that will be co-financed from the European Social Fund (ESF).

Product markets and capital markets

This area is described in detail in the national Cardiff Report[4], which the Slovak Republic submitted to the European Commission in November 2003. As noted above, the key objective in the products and services market is to increase productivity through intensified competition, effective regulation, strengthened support of small- and medium-size enterprises, and attractive overall investment climate. Financial market policy currently focuses on its further development through an efficient regulatory framework and support of sound market competition.

The Slovak economic policy will strive to create an effective environment for the attainment of all main Lisbon strategy objectives. Upon completion of the main structural reforms required for the consolidation of public finances, the economic policy will refocus its attention to active support of the development of the knowledge-based economy in Slovakia.

Environmental policy

This area is also described in the Cardiff Report. Sustainable development is a key objective.

[4] The update of the national Cardiff Report should be released in November 2004.

II. ECONOMIC OUTLOOK

II. 1. Current Development Trends

The statistical figures describing the current economic development in Slovakia show a positive trend in the economy. The Slovak economy continues to grow at a fast pace – the fastest in Central Europe. In addition, the currently implemented structural reforms are a good prerequisite for an ongoing dynamic and sustainable growth. Slovakia's external balance has been dramatically improving despite the relative underperformance of the Eurozone economy. Positive trends are quite significant on the labour market. The introduction of a flat tax and the across-the-board simplification of the tax system (but also Slovakia's accession to the EU, inexpensive and qualified labour force, improving business environment and the favourable geographical location of the country) are most likely to attract more foreign investment into Slovakia, which, in the medium-term, may further stimulate the growth potential of the economy.

The Slovak economy grew at 4.2% in 2003. GDP growth resulted from a stronger labour productivity and from higher employment. This growth was mainly stimulated by foreign demand. As a result of an increase in regulated prices and indirect taxes, domestic demand has slowed after growing steadily for three years. The reason is a downturn in private consumption and investment. After a two-year growth, household consumption is down 0.6%, while gross fixed capital formation declined by around 1% for the second straight year. The weaker household consumption is a result of the lower purchasing power of households caused by an increase in regulated prices and indirect taxes and, at the same time, by a reduced growth in nominal wages compared to 2002. The reduced growth in nominal wages reflects among other things the strong decline in inflation in 2002. Moreover, the growth of general government consumption also slowed compared to 2002, which was induced by the process of consolidation of public finances. However, the growth of government consumption was temporarily boosted by a surge in payments made by health insurance companies for health care services provided in non-state operated facilities (payment for medicines). Investment into fixed capital has declined, but its negative impact on economic growth was less pronounced. The downturn in investment is probably a result of an increase in production cost factors and of the weaker growth of company profits. There was a strong upswing in foreign demand fuelled by the rising export capacity, in particular in the automotive industry. This is the result of foreign direct investment that arrived over the past few years. Given the stagnation in domestic demand, imports of goods and services are considerably lagging behind the trend in exports.

In 2003, the annual average inflation rate stood at 8.5%, with the average core inflation standing at 2.6%. The difference between these two figures shows that demand-side inflationary pressures are still fairly limited in Slovakia. The considerable increase in price levels was the result of two sets of administrative measures – the release of regulated prices in January and the introduction of higher excise duties in August. On the other hand, the appreciation of the local currency helped to dampen the imported inflation. In 2004, consumer prices are again driven by the ongoing increase in regulated prices and by the now-single 19% VAT rate. In the first half-year, inflation will rise at almost the same rate as in 2003, however, this increase should gradually slow down.

In 2003, the situation continued to improve on the labour market. Foreign direct investment coupled with an improved domestic investment climate started to generate new jobs in larger numbers. In addition, in January 2003, the criteria for the registration of unemployed persons have been modified, which, coupled with the number of new jobs, resulted in an even stronger downward pressure on the average registered unemployment rate, which went from 17.9% in 2002 to 15.2% in 2003. According to the Labour Force Survey, employment rose by 1.8% in 2003 which is the highest increase since 1996.

In 2003, nominal wages grew at a slower pace compared with previous years. This was caused by the fact that, in the private sector, which absorbs around 70% of the employed work force, wages are, for the most part, adjusted based on the inflation posted in the previous year. And the 2002 inflation rate only stood at 3.3%. For the upcoming period, we anticipate a faster growth in the average nominal wage and also a gradual recovery of the real wage.

In 2003, the financial markets saw an upward trend of the SKK exchange rate (the local currency appreciated in average by 2.8% against the Euro and by 18.9% against the US Dollar) and declining interest rates (in September, the key interest rates were down by 0.25 percentage points and in December, they dropped by another 0.25 percentage points). The Slovak Koruna has continued to appreciate in early 2004, where, in the first quarter, it was up 2.9% year-on-year against the Euro and 16.7% year-on-year against the US Dollar. Having regard to the sluggish private consumption, the Central Bank (NBS) cut its key interest rates in March and April by another 100 basis points (to 5.0%).

Slovakia's external balance improved considerably in 2003. Exports of goods grew strongly throughout the year despite the poor economic growth in the countries of the Eurozone. Exports are led by the automotive industry, followed by machinery and metals. The improvement in the trade balance deficit is in part owed to the limited growth of imports. Imports of investment goods are considerably stronger year-on-year, which is a positive trend. On the other hand, the growth of imports of consumer goods is slowing, which has to do with the downturn in private consumption. Given the favourable trade balance result and the improvement in the income and current transfers balance, the current account deficit in 2003 narrowed to 0.9% of GDP (the current account deficit still stood at 8.0% of GDP in 2002). Foreign trade results in the first three months of 2004 underpin the trends started in 2003.

Monetary-policy aspects of the current economic development

At present, the monetary policy is implemented in an environment marked by substantial administrative price interventions and fairly low real interest rates. At the same time, the positive interest rate differential coupled with the favourable development in the fiscal area (lower risk premium) creates an upward pressure on the exchange rate. The inflation development is mainly driven by the upward adjustments of regulated prices. Additional upside pressure on inflation comes from the new rates of indirect taxes introduced by the ongoing tax reform. The role of the monetary policy is to prevent that these administrative measures have excessive secondary impacts on the development of prices. By the same token, the monetary policy must take account of the degree of restriction imposed by the implementation of these measures on the purchase-effective demand. The increase in prices due to upward adjustments of regulated prices or the modification of indirect taxation is therefore not a trigger to modify the parameters of the monetary policy.

In implementing its monetary policy, the National Bank of Slovakia closely monitors the influx of foreign capital. This influx is the result of foreign direct investment (FDI) on one hand and of the influx of speculative capital on the other. As far as the implementation of the monetary policy is concerned, the form of inward capital flows is crucial. In order to prevent excessive volatility of the exchange rate, the NBS is converting the privatization proceeds of the Government from foreign currency to local currency, which increases its foreign exchange reserves.

The local-currency equivalent of the privatization proceeds has been fully sterilized, depending on what these proceeds are used for. As a result, the privatization proceeds increase the sterilization position of the Central Bank, however, they have no impact on the fluctuations of the exchange rate. FDI directed into the private sector may create a certain pressure on the appreciation of the exchange rate, however, by the same token, FDI helps to improve the competitiveness of the economy, increase the potential output, enhance labour productivity and fast-track the process of real convergence. In the medium term, FDI also represents an impetus for the appreciation of the real equilibrium exchange rate.

Having regard to the existing interest rate differential and the "convergence game" being played, the NBS is keeping the impacts of inward speculative capital on the exchange rate volatility under very close scrutiny. Whenever the Slovak Koruna is under significant upward pressure which is irreconcilable with the economic fundamentals, the NBS intervenes on the foreign exchange market or responds to the influx of speculative capital by adjusting key interest rates (e.g. in November 2002, where, due to excessive upward pressure on the Koruna, the NBS had to cut its key interest rates by 1.5 percentage points). Applying interest rate cuts with a view to preventing an unreasonably strong appreciation of the Slovak Koruna is always considered against the backdrop of the prime objective of the NBS, which is price stability. In conclusion, the National Bank of Slovakia resorts to interest rate cuts only in situations where its prime objective is in danger of being thwarted by exchange rate developments.

II.2. The Present and Anticipated Development of External Conditions

In 2003, the sustainability of the recovery in the global economy was still shrouded in doubt. Geopolitical risks undermined the confidence of both investors and consumers and the jittery financial markets brought nothing but discomfort. Throughout the year, however, this signs of a recovery became stronger and the financial markets started to break loose from the bear grip. “Soft indicators", such as the German IFO index of business sentiment, the U.S. ISM index or the OECD leading indicators show that the recovery is gaining the trust of both investors and businesses. Although last year's results were received with mixed feelings, macroeconomic fundamentals should become more solid throughout 2004 to live up to the positive expectations. It is therefore to be assumed, that we will see the global economic recovery go on (even if unevenly) in 2004, which is confirmed in the most recent forecasts by the European Commission and the OECD. The Convergence Programme in the external environment is based on EC and OECD forecasts.

Expected economic growth in selected countries (%)

	2003	2004F	2005F
US	3.1	4.2	3.2
Eurozone	0.4	1.7	2.3
Germany	-0.1	1.5	1.8
France	0.2	1.7	2.4
Japan	2.7	3.4	2.3

Source: European Commission 2004 Spring forecasts

The development in the Eurozone will be driven by the two largest economies – Germany and France, which, after a year of stagnation, are very likely to record in 2004 a year-over-year growth of 1.5% and 1.7% respectively. However, according to the EC structural reforms will have to be put in place in several countries, in order to safeguard sustainable growth for the economies inside the Eurozone.

Despite the relatively weak performance of the world economy, the economic growth in the new Member States will most likely maintain its positive trend in 2004, however, with growth rate varying from country to country. The open nature of these economies suggests that the forecasted recovery in the Eurozone will further boost their growth. In addition, the ongoing reforms in several countries should create an environment that is attractive to investors and thereby speed up the convergence process.

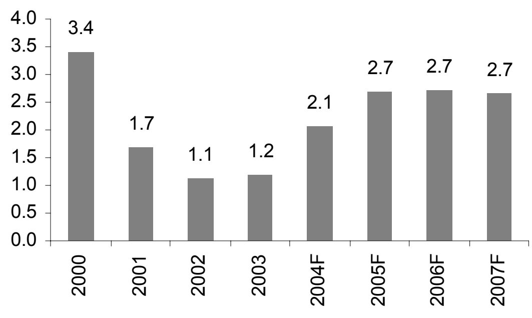
Expected economic growth of Slovakia's major business partners (%)

	2003	2004F	2005F	2006F	2007F
Germany (30.3%)/[1]	-0.1	1.2	2.1	2.2	2.3
Czech Republic (12.7%)	2.9	3.1	3.4	2.9	2.9
Italy (7.4%)	0.4	0.7	1.8	2.1	2.0
Austria (7.3%)	0.7	1.5	2.5	2.5	2.4
USA (6.7%)	3.1	4.5	3.7	3.7	3.3
Hungary (4.8%)	2.9	3.2	3.8	3.9	3.9
Poland (4.7%)	3.7	4.4	4.6	4.6	4.0
SLOVAKIA	**4.2**	**4.3**	**4.8**	**5.2**	**5.3**

[1] In brackets, share on Slovakia's exports in 2003
Source: OECD

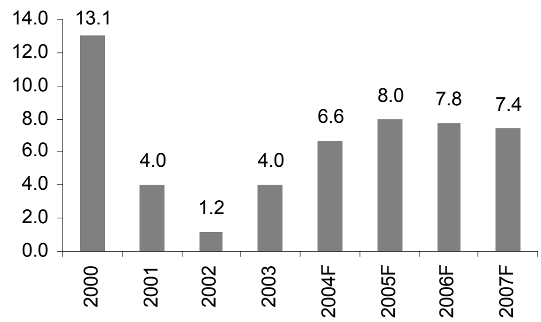
All Slovakia's major business partners are expected to experience an economic recovery. While, during the past three years, the export-weighted real GDP[5] growth slowed considerably, this negative trend should be reversed in the next couple of years and growth should pick up from 1.2% in 2003 to 2.7% in 2005. The acceleration in the economic growth of these countries should translate into a growing appetite on the demand side which, in turn, should drive their imports - and Slovakia's exports. On these grounds, Slovakia has a strong economic growth outlook.

Export-weighted real GDP growth of Slovakia's major business partners (%)



Source: OECD, Ministry of Finance

Export-weighted imports growth of Slovakia's major business partners (%)



Source: OECD, Ministry of Finance

[5] Weighted by country`s share on SR`s exports. In the forecast 2003 weights were used.

II.3. Forecasted Development of the Real Economy and of the Labour Market

The forecasts are based on the following assumptions concerning the internal and external environment:

- growing foreign demand in line with the aforementioned EC and OECD forecasts;
- relative stability of global prices;
- moderate appreciation of the SKK/EUR exchange rate
- existing intentions of the economic policy

The objective was to link, to the extent possible, the forecasts concerning the development of macroeconomic indicators and the forecasts concerning fiscal parameters. In addition, the projection of the indicators represents a conservative/realistic view of the future economic development. This approach is designed to not create any risks for the development of public finances, which risks may result from the macroeconomic forecast. The criterion used in the assessment was the comparisons between the results obtained and the projections made by other forecasting authorities, both domestic (Committee on Macroeconomic Forecasts – c.f. Annex No. 2) and international (EC, OECD, IMF).

Development of the real economy

It is anticipated that, over the forecast period to 2007, the business cycle will enter the next stage – boom. According to estimates, the Slovak economy has the potential to grow at a rate of around 4 to 5% during the upcoming years. More efficient labour market instruments and a far more favourable investment climate in Slovakia should significantly underpin the rise in structural employment. Labour productivity is also expected to improve, in particular in connection with stronger inward foreign-direct and domestic investment.

During the 2004-2007 period, economic growth should be driven by a combination of domestic and foreign demand. In the past, the growth in household consumption – the key driver of domestic consumption – was marked by a significant volatility triggered by irregular administrative price adjustments. Since 2004 is the last year in which significant deregulations take place, the growth of real wages should stabilize over the upcoming period and, in the future, it should be driven exclusively by market factors. As a consequence, the growth in household consumption and its share in GDP growth are also expected to stabilize.

Despite the fact that, in 2004, we still expect a slight real fall or stagnation of the average gross wage, private consumption should be slightly stronger compared with 2003. The main reasons are the ongoing growth in employment, the higher net income that many types of families will earn as a result of the introduction of a flat 19% income tax rate, the new family welfare system, affordable consumer credit facilities and financing possibilities. The cited factors should bring the growth in household consumption to 1.3% in 2004. After 2004, the real growth of the average wage will set in; the development of the average wage should better reflect the growth in labour productivity. Under these conditions, real household consumption may grow at a rate of 4% over the forecast period. We also anticipate a slight increase in the aggregate volume of savings, which were, so far, depleted to compensate for the lower real income.

Government consumption will be restricted by the commitment to meet the declared objectives and fiscal policy measures aimed at bringing the general government deficit below the 3% of GDP reference value by 2006. The direct consequence will be a stagnation of

General government consumption in 2004, followed by a modest growth at 1-1.9% during the 2005-2007 period. The projected development of government consumption will add to the stability of the macroeconomic environment, while indirectly underpinning a balanced growth of the economy.

Present and future investment activities and, in particular, projects implemented by foreign investors or by the Government of the Slovak Republic may be expected to spur the gross fixed capital formation. The negative trend of the past two years should be reversed and the resulting growth should be anywhere between 3.3% and 7%. The growth of investment activities and positive investor sentiment should be spurred by a stable macroeconomic environment with low interest rates, a transparent economic policy of the Government, a business-friendly legal framework, growing profits and Slovakia's overall convergence process.

Exports of goods and services will be, to a large extent, driven by the inward investment going to Slovakia, which increases the existing export capacities, and boosts Slovakia's competitiveness, as well as by the strength of the economic growth inside the EU. In 2003, despite the fairly low economic growth in the EU, Slovak exports were up significantly, mainly on account of the changes to the production range in the automotive industry. However, a similar non-recurring change causing a surge in Slovakia's exports and potential output may be expected to arrive in 2006 and 2007 with the commissioning of two large-scale car plants. Since, at present, several other companies are contemplating locating their investment in Central Europe, the volume of foreign demand may turn out to be a pleasant surprise.

An increase in aggregate demand will create upward pressure on imports. The positive contribution of net foreign demand to the growth of GDP will be rather moderate in 2004. In 2005, there even will be a slight downturn. Throughout, the entire period, the real growth in exports and imports will outweigh the growth in consumption, investment and even GDP. The export performance is most likely to exceed the 100% mark (GDP being the reference value) in 2007 and, according MoF estimates, the degree of openness will reach 223%.

Development on the labour market

During the 2004-2007 period, the positive trend on the labour market will continue. The arrival of new production activities creating new jobs as well as a pro-active labour market policy geared towards incentivising the labour force will increase the growth of employment. By the same token, the unemployment rate will be reduced. This trend should not only spur economic growth, but also reduce the general government deficit. The expected employment growth presented below is well behind the forecasts presented by independent research institutes.

Growing labour productivity, restrictions on administrative price interventions and growing profits of companies (resulting, in part, from the reduced tax burden) will create the necessary conditions for a stable growth of the real average wage. On the other hand, according to forecasts, a prudent wage policy in the public sector and the still relatively high unemployment rate will effectively prevent real wages to grow beyond the labour productivity level. This trend should ensure that the development of wages will keep the growth in the standard of living at a sustainable level.

Growth and associated factors (%, if not stated otherwise)[6]						
	ESA code	**2003**	**2004F**	**2005F**	**2006F**	**2007F**
GDP growth at constant market prices (7+8+9)	B1g	4.2	4.1	4.3	5.0	4.7
GDP level at current market prices, SKK bn	B1g	1,195.8	1,291.3	1,383.6	1,495.9	1,602.6
GDP deflator (y/y growth)		4.7	3.7	2.7	3.0	2.3
CPI (average)		8.5	8.1	4.0	2.9	2.5
Employment growth*		1.8	0.5	0.6	0.6	0.9
Labour productivity growth **		3.4	3.5	3.6	4.3	3.7
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	-0.6	1.3	3.8	4.1	3.8
2. Government consumption expenditure	P3	2.9	-0.1	1.0	1.9	1.5
3. Gross fixed capital formation	P51	-1.2	3.8	7.0	7.0	3.3
4. Change in inventories a net acquisition of valuables as a % of GDP***	P52 + P53	-0.7	1.3	2.5	1.6	1.2
5. Export of goods and services	P6	22.6	9.7	8.7	13.0	8.4
6. Import of goods and services	P7	13.8	9.5	10.0	11.6	6.8
Contribution to GDP growth						
7. Final domestic demand (1 + 2 + 3)		0.1	1.6	3.9	4.2	3.0
8. Change in inventories and net acquisition of valuables (= 4) ***	P52 + P53	-2.3	2.0	1.4	-0.9	-0.3
9. External balance of goods and services	B11	6.4	0.4	-1.0	1.6	1.9

** According to the Labour Force Survey*
*** GDP growth at market prices per person employed at constant prices*
**** Including statistical discrepancy*
Source: Statistical Office, Ministry of Finance

II.4. Cyclical Position

It is expected that, in 2004, potential output will grow at a more moderate rate than real GDP and, as a consequence, the negative output gap should become narrower. All in all, Slovakia's economy will underperform its potential output by 0.1%. The fairly strong economic growth (4.1%) will be driven by the growth of productivity in exporting industries and by the growth of employment. Economic overheating is not an issue in 2004, as the administrative price adjustments will cause the growth of real wages to significantly lag behind the growth of labour productivity.

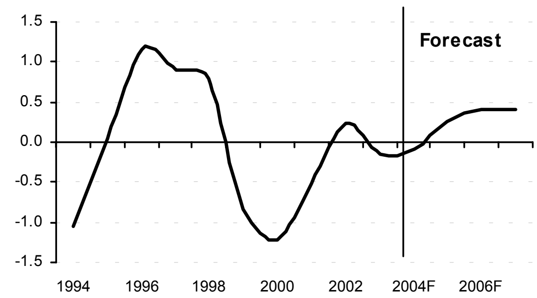
In the following years, we forecast an influx of foreign investment that will considerably increase not only the amount of capital but also its productivity. We also expect Slovakia's accession to the EU to create positive momentum. Significant effects should also arrive with the implementation of the tax, social benefits and labour market reforms. Acting in synergy, these factors will significantly ramp up Slovakia's potential output. With two major car producers soon to launch production and with a rising domestic consumption, the gap will gradually close and, as of 2005, the economy should slightly outperform its potential output.

As far as the new Member States are concerned, computing the output gap is merely an indicative exercise, because the shortness of the time series and the multitude of structural breaks make it difficult to apply standard procedures. The construction of the presented development forecasts concerning the output gap for the upcoming years is similar to the OECD[7] calculations. OECD also forecasts that the growth of productivity during the 2004-

[6] There might be some slight discrepancies in the tables presented in the CP due to rounding.
[7] Economic Survey 2003

2007 will be higher that in the previous period (1998-2002), creating room for the GDP to grow without inflationary pressures and without taking labour costs to unreasonable levels.

Output gap development (% of GDP)



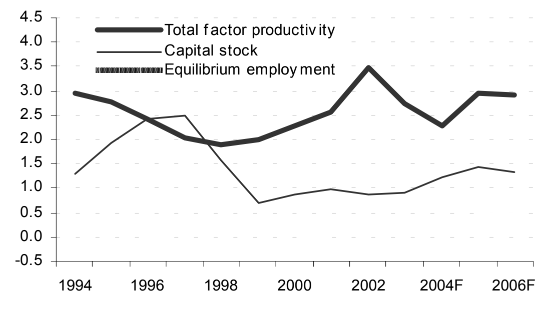
	GDP growth (%)	Potential output growth (%)	Output gap (% of GDP)
2001	3.8	3.1	-0.5
2002	4.4	3.6	0.2
2003	4.2	4.6	-0.2
2004F	4.1	4.0	-0.1
2005F	4.3	3.9	0.2
2006F	5.0	4.8	0.4
2007F	4.7	4.7	0.4

Source: Ministry of Finance

The growth of potential output is driven by two main factors – the total productivity growth and employment growth. Taken in itself, the growth of employment is determined by the growth of the productive-age population and by the rate of participation. According to estimates, total factor productivity (TFP) growth remains at around 2.5% each year. The growth of productivity will be driven, in particular, by inward foreign investment (and the resulting inward technology transfers) and by production as such. According to estimates, inward foreign investment will send TFP growth close to 3.0% annually in 2003 and in 2006-2007. The scale of the impact produced by such investment was estimated based on previous experience with foreign investment of similar magnitude.

The growth of structural employment during the 2005-2007 period is projected to reach around 0.5% annually. Many institutions predict a stronger growth, however, the MoF has chosen a more conservative approach with a view to minimizing fiscal risks. Despite the anticipated positive effects of the ongoing reforms (in particular, the tax, social benefits and labour market[8] reforms), we do not expect the rate of participation to exceed the 70% mark.

Contributions of main factors to potential GDP growth (p.p.)



	Output gap	Capital stock	Equilibrium employment	TFP*
2001	-0.5	0.9	-0.1	2.3
2002	0.2	1.0	0.1	2.6
2003	-0.2	0.9	0.3	3.5
2004F	-0.1	0.9	0.4	2.7
2005F	0.2	1.2	0.4	2.3
2006F	0.4	1.4	0.4	2.9
2007F	0.4	1.3	0.5	2.9

** Total Factor Productivity*
Source: Ministry of Finance

[8] The tax reform should underpin the production-side of the economy (new businesses, self-employment), the pension reform should increase the participation rate (in particular by introducing a higher retirement age) and the labour market reform should stimulate the interest in work and spur employment.

Output Gap Calculation Method

Potential output is an important supply-side indicator; increasing potential output means giving an economy room to grow without triggering inflationary pressures and without running a high external deficit. As far as the new Member States are concerned, it is extremely difficult to correctly assess the impact of foreign direct investment on labour productivity growth. Most recent developments have shown that supply-side shocks will continue to occur quite frequently in Slovakia and, as a result, using statistical methods to determine the potential output appears inappropriate. That is because they do not allow to factor in the effects of future level shifts caused e.g. by the launch of new large-scale production facilities (due in 2006). Notwithstanding the foregoing, the potential output was estimated using two distinct approaches. The first one – the statistical approach – is rather an illustrative exercise based on the Hodrick-Prescott filter, which is widely used in practice. This method takes the observed data and separates the trend component from the cyclical component. The second approach – the one that we prefer – is based on the production function. This method offers the advantage of being able to simulate those economic factors that come to bear in the potential output.

Generally speaking, the production function comes in several distinct functional forms. Given the particularities of the Slovak economy, the Cobb-Douglas function was found to be effective in modelling the potential output:

$$Y_t = A_t \mathrm{K_t}^{1-\alpha} \mathrm{N_t}^{\alpha}$$

where Y_t is the potential output, A_t is the trend component of the total factor productivity, K_t is the capital stock, N_t is the trend component of employment (specified as HP-filtered employment), and the parameter α is the total output elasticity of employment. Subsequently, the output gap is the difference between the actual and the potential GDP value in relation to value of the potential output.

In forecasting potential output growth, it is necessary to correctly assess the impact of future structural changes on the supply-side. As far as Slovakia goes, this change came with the launch of the new VW production line. The calculations assume that this level shift will take productivity to a higher level for the entire period under review. A similar effect is expected with the launch of the PSA Peugeot Citroen and KIA Slovakia facilities scheduled for 2006.

The potential output estimate also takes account of the moderate effect associated with Slovakia's membership in the EU as of May 2004. This effect has been observed in several countries, however, having regard to the fact that, from a historical perspective, it is not demonstrable in all the new Member States, it was treated with lesser weight.

Going forward, it will be necessary to further refine the methodology. However, having regard to the fact that, when it comes to the new Member States, history is not always the best source of information for forecasts, a certain margin of subjective appreciation will always be present in the results. Rather than running exact calculations only to arrive at results that cannot be interpreted, the MoF prefers this approach. For the sake of comparison, we state that according to OECD forecasts (based on similar considerations), the potential growth of the Slovak economy in the upcoming years will be at around 5%.

II.5. Expectations in the Monetary Area

Inflation in the medium-run

The NBS forecast presented in the 2004 Monetary Programme, as well as the forecast by the Ministry of Finance of the Slovak Republic, anticipates a gradual decrease in the year-on-year headline inflation. The impact of administrative price level adjustments should be fading significantly, which should put in place conditions to meet the Maastricht criterion regarding inflation in the period between 2006-2007, and to ensure the sustainable fulfillment of this criterion in the years to come. The consolidation of public finances represents one of the key prerequisites in this regard. Currently, both the NBS and the MoF employ the national consumer price index in preparing their forecasts. Going forward, this index will be complemented with forecasts based on the harmonized index of consumer prices (HICP).

Throughout the entire time horizon, the disinflation will be driven by a gradually diminishing scope of administrative adjustments. The rise in regulated prices will significantly contribute to the price level increase in 2004, whereby, going forward, this influence will gradually fade. By the same token, the secondary cost-related effects of the increase in regulated prices, i.e. the induced increase in market service prices, may be expected to peak in 2004. The adjustment of indirect taxes also constitutes an administrative intervention which may significantly influence the inflation rate. In 2007, the process of harmonizing excise duties according to EU standards should continue, which will be reflected in higher excise duties on tobacco and tobacco products.

Impact of administrative measures on the year-on-year inflation rate (p.p.)

	2004F	2005F	2006F	2007F
Regulated prices contribution	3.6	1.2	0.8	0.5
Contribution of the adjustment in indirect taxes translated into non-regulated prices	1.1	0.0	0.0	0.3
Administrative measures in total	**4.7**	**1.2**	**0.8**	**0.8**

Source: Ministry of Finance

The adoption of the Common Agricultural Policy of the European Union will also have an impact on price developments in 2004-2007. The most pronounced impact on food prices and headline inflation is to be expected in the second half of 2004 (a rise of up to 1 percentage point) and in first half of 2005. The implementation of the Common Agricultural Policy reform, coupled with a step-by-step annual reduction in the intervention prices of commodities until 2007, should counteract the upward pressure on food prices.

In the medium term, mostly the prices of tradables should experience a stable development proportional to the slight price increase across the Eurozone and the anticipated appreciation of the Slovak currency exchange rate. The price development of tradables should also be positively influenced by a continued improvement of Slovakia's competitive environment, stimulated by the accession to the EU. There are also prices in the tradable sector that do not match the average prices in the EU and a faster process of real convergence and higher consumer demand are likely to create moderate inflationary pressures beyond the scope of European price and exchange rate developments.

In 2004, market service prices will be particularly exposed to the secondary cost-related effects resulting from the increase in regulated prices. It is to be assumed that the growth in market service prices will outrun the growth in the prices of tradables, as the former will be influenced by both the secondary effects of the increase in regulated prices and the real convergence process of the Slovak economy.

Inflationary development forecast by the Ministry of Finance (%)				
	2004F	**2005F**	**2006F**	**2007F**
Average CPI growth	8.1	4.0	2.9	2.5

Source: Ministry of Finance

Based on the aforementioned assumptions, estimates and risks, the MoF forecasts an average annual inflation rate at 8.1% for 2004; its end-of-year rate might be as low as 7.6%. In the 2005-2007 period, the MoF expects the inflation rate to gradually drop below 3%, which means that Slovakia should be able to satisfy this Maastricht criterion[9] at the latest by the assessment due in 2007.

Interest rates in the medium-run

The short-term interest rates will develop in line with the objectives of the National Bank of Slovakia; in the medium term, a gradual convergence of their equilibrium level to the interest rates in the Eurozone is expected. Apart from the short-term interest-rate developments, the long-term interest rates will also reflect the perceived risk and liquidity on the market. The MoF anticipates that long-term interest rates will remain close to the interest rates in the Eurozone and that the difference between the two will be gradually reduced.

Long-term interest rates convergence (10Y government bonds, %)							
	2001	**2002**	**2003**	**2004F**	**2005F**	**2006F**	**2007F**
Germany	4.8	4.8	4.1	4.0	4.7	5.0	5.3
SLOVAKIA	**8.2**	**7.0**	**5.1**	**5.2**	**5.4**	**5.5**	**5.7**

Source: OECD, Ministry of Finance

Slovak Koruna in the medium-term horizon and ERM II

By signing the EU Accession Treaty in April 2003, the Slovak Republic made a commitment to join the Economic and Monetary Union and, consequently, to adopt the Euro. The National Bank of Slovakia and the Ministry of Finance of the Slovak Republic have repeatedly declared their support for the earliest possible accession to the monetary union once a "sustainable convergence" with the Maastricht criteria has been reached. The underlying assumption is that the benefits resulting from the integration process cannot be fully harnessed unless the final stage of this process is reached – the monetary union[10]. Following Slovakia's accession to the EU in May 2004, the Government plans to adopt a decision on Slovakia's entry into ERM II in the second half year. By that time, the crucial economic reforms are expected to reach a stage where the country's economic policy will be able to uphold the required economic, financial and monetary stability and to maintain a course of sustainable convergence with the Maastricht criteria after the entry to ERM II.

As mentioned in the chapter on monetary policy, the exchange rate regime will, in the medium term, move away from managed float to embrace the ERM II exchange-rate mechanism (in 2005 at the earliest, or in the following years). In this connection, the

[9] For more information, please refer to II.8, Maastricht criteria
[10] The document „Euro Adoption Strategy in the Slovak Republic" contains a detailed analysis on benefits and disadvantages

exchange rate will also become one of the monetary policy objectives, but it will remain subordinated to the main objective – the explicit inflation target. In order to eliminate a potential conflict between the inflation target and the exchange rate objective, the NBS would prefer Slovakia to remain in the ERM II only for the time necessary to satisfy the exchange rate criterion. Although the National Bank of Slovakia would like to see the exchange rate close to the central parity, the ongoing process of economic convergence may require a certain nominal appreciation[11] corresponding to the development of the real equilibrium exchange rate.

The influx of foreign direct investments (FDI), especially the so-called greenfield investments, will represent a significant impetus for the appreciation of the real equilibrium exchange rate in the medium-term horizon. Even though, from a short-term perspective, inward FDI may give rise to an interim deterioration in the foreign trade balance due to imports of technologies, it will underpin the growth in competitiveness of the Slovak economy in a long-run. The potential appreciation of the exchange rate as a result of inward FDI should not have therefore significant long-term negative impacts on Slovakia's export performance.

The main monetary policy objective with respect to the exchange rate will be to avoid significant fluctuations of the exchange rate away from its equilibrium trajectory. In line with this objective, the NBS will further continue to make use of interventions on both sides of the foreign exchange market in order to eliminate excessive exchange rate volatility. Future privatisation proceeds should still be converted by the central bank; their local-currency equivalent will be fully sterilised.

II.6. External Sector Outlook

The forecast of the foreign trade balance for the period from 2004 to 2007 is based mainly on the assumption of a more significant recovery of the EU economies and their demand on one hand, and on the expected growth of investment and, subsequently, imports to Slovakia on the other. Currently, more than 90% of our exports are placed on markets in EU countries; this figure was 60% before the accession.

The foreign trade results for 2003 confirmed a positive development. Exports grew more than twice as fast as imports. On one hand, the production was growing due to the investment made in the previous years; on the other hand, consumer demand did not put any pressure on the imports. The balance of trade posted the strongest results since 1995, mainly because of car exports.

According to estimates, Slovak exports will be underpinned, in particular, by the automotive industry in the following years. In 2006, two major global car producers are due to launch their operations in Slovakia. These plants are expected to turn out some 300 000 – 500 000 cars per year, which will further increase the share of this industry in the country's total exports. As a result, a more significant acceleration in the growth of exports can be expected as of 2006. However, these investments will also boost the imports of investment goods which will put a slight hamper on the positive development of the trade balance since 2003. A rise in the imports of consumer goods is also expected in 2005, depending on the increase

[11] According to NBS surveys, the equilibrium appreciation of the real exchange rate (base on the PPI) should stand at around 1.5% per year for the 2003 – 2008 period.

in real wages and the final consumption of households. As a result, the foreign trade deficit will widen in 2004 and 2005 with an outlook to improve again over following two years.

The surplus in the balance of services has declined steadily since 2002. The downturn has been mainly caused by a decline in net proceeds from transport services. Between 2005-2007, the balance of services is expected to improve depending on how growth will pick up in the EU. The income and current transfers balance is expected to stay flat during the forecast period.

The deficit on the current account of the balance of payments improved significantly in 2003, which was mainly caused by the reduction of the foreign trade deficit as well as by an improvement in the current transfers balance, as well as, an improvement in the income balance. Last year's current account deficit stood at 0.9% of GDP. In the next two years, the deficit on the current account will widen, which, however, will be safely cushioned by the financial account surplus underpinned, in particular, by the higher influx of foreign direct investments. In 2007, the current account balance might be close to 0% of GDP.

The stronger influx of foreign direct investment in 2004 and 2005 has to do with the construction of two car production plants in Slovakia (PSA and KIA). The FDI volume will also turn on the successful completion of the investment projects currently underway. These include several major foreign investors from the industry sector (in particular mechanical engineering) that expressed their interest to place their investments in Slovakia. Their interest is a positive signal both for the Slovak economy and other potential investments.

Current account development (SKK bn)					
	2003	**2004F**	**2005F**	**2006F**	**2007F**
Trade balance	-23.6	-36.5	-51.7	-36.1	-27.2
Exports	803.0	860.5	929.3	1,058.9	1,175.8
Imports	826.6	897.0	981.0	1,095.0	1,203.0
Balance of services	8.6	5.0	10.6	15.7	17.0
Balance of income	-4.4	-2.1	-3.0	-3.4	-4.0
Current transfers	9.2	7.4	7.4	7.4	7.4
Current Account	**-10.2**	**-26.2**	**-36.8**	**-16.4**	**-6.8**
Current Account (% of GDP)	**-0.9**	**-2.0**	**-2.7**	**-1.1**	**-0.4**

Source: Ministry of Finance

The total foreign exchange reserves of the central bank amounted to USD 12.149 billion at the end of 2003, up by USD 2.953 billion on the year. The year-end amount of the foreign exchange reserves roughly represented the 5.6-fold of the average monthly imports of goods and services to Slovakia in 2003. In 2004, the NBS foreign exchange reserves are expected to grow by USD 1.1 billion, since the government and the central bank revenues (privatisation, loans and interest on NBS reserves) should outweigh expenditures (debt service, guarantees and client payments). Their volume will cover around 4.8 months worth of imports of goods and services. In the following forecast period, the foreign exchange reserves will decrease as loan repayments will outweigh disbursements of new loans and as privatisation proceeds will go lower. The average coverage of the imports of goods and services will drop from 4.4 months in 2005 to 4 months in 2006 and to 3.7 months in 2007.

The total gross foreign debt of the Slovak Republic stood at USD 18.3 billion at the end of December 2003, which represents a USD 5.1 billion increase year-on-year. This resulted mainly from a rise in the total foreign debt of businesses and a stronger influx of short-term liabilities held by commercial banks as well as from the impact of the exchange rate movements. No significant changes in the gross foreign debt are expected in the future.

II.7. Alternative Scenarios of Economic Development and Simulations

The submitted economic forecast laid much emphasis on having all projections and estimates based in reality. The Ministry of Finance tries to use conservative estimates of all factors. Taken in itself, this principle ensures that there is a reserve when it comes to fulfilling major fiscal goals. However, there are certain risks in the development of several factors, which are beyond the Government's control and whose development may cause an unpleasant surprise. Potential risks regarding the fulfillment of the submitted economic forecast may arise from both the internal and the external environment. Nevertheless, sensitivity analyses indicate that their impact should not fundamentally jeopardize the delineated economic growth.

Apart form political uncertainty, another potential risk factor of the internal environment is a potential failure of the projection regarding nominal wage growth. According to the model[12] simulations, if the nominal wage growth is off by 1 percentage point against the base line scenario, economic growth could slow down by 0.3 percentage points from baseline.

Since Slovakia is a very open economy, substantial changes in the external environment and in the volume of inward FDI could have far more significant impacts on its economy. Currently, it is reasonable to consider three particular alternative scenarios in this area: a stronger appreciation of the exchange rate of the Koruna, a lower-than-expected growth in foreign demand, and a higher growth in labour productivity and competitiveness due to the launch of new production facilities by foreign investors in Slovakia. Oddly enough, a few years ago, Slovakia was worried about not being able to attract enough FDI or not being able to sufficiently harness the positive impacts. Currently, such a scenario may be considered less likely to occur and the associated risk is hence lower.

The results of the selected model simulations are presented in two tables herein below; the first is depicting a change in the dynamics of the development (growth) of the monitored variables compared with the original scenario, while the second shows a relative divergence of a variable from the value it reached in the original scenario.

1. simulation: higher nominal appreciation of the Koruna exchange rate

The first simulation of an alternative economic development is based on an assumption of a gradual appreciation of the nominal exchange rate of the Koruna during 2004 to a level 5% stronger than the one projected in the original scenario (an annual average of 2.7% for 2004) and 5% below the original scenario after 2005. It may be expected that, in such a case, the central bank would strongly intervene; however, this is just a model simulation of the effects that would occur if the Koruna were to appreciate for no good reason.
A stronger Koruna should push down inflation, which, in turn, should cause a downturn in short-term interest rates. Lower real interest rates would spur private consumption, which is, to a large extent, served with imports from abroad, since there was no change on the production-side of the economy.

Lower competitiveness and increased consumer imports would widen the current account deficit by almost 1 percentage point in 2005. The weaker performance of the economy would increase unemployment and reduce the growth of nominal wages. Since inflation would continue on its downward tendency, the drop in real wages would be but moderate. Lower interest rates in combination with declining real wages would, at first, have a positive and

[12] The MoF used a proprietary simulation model of the Slovak Economy.

later a negative impact on private consumption. Even if a nominal appreciation of the Koruna were to occur, the gradual fall of the inflation would cause the real exchange rate to rebound to the value of the baseline scenario. Gradually, the economy would revert to its original scenario in real values, however with altered nominal values.

2. simulation: lower-than-expected growth in foreign demand

Exports to Eurozone countries constitute about 60% of Slovakia's total exports, which means that a reduction in the Eurozone's imports from Slovakia by 3% per year would have an adverse impact on the entire economy of the country. This scenario assumes a permanent shock capable of being identified by the central bank immediately. Any shortfall in the export production would increase the current account deficit, thus putting pressure on the depreciation of the Koruna. Concurrently, the GDP would decline, while the potential output would remain at the same level. The resulting output gap would allow for a cut of interest rates. Furthermore, with consumption and investment down against the original scenario, imports would be dragged down to gradually match the reduced volume of exports, forcing the current account deficit (as % of GDP) back to the original scenario. Apart form nominal depreciation, the Koruna would also ease in real terms by 3% towards the end of 2007 as a result of lower inflation. At that point, the unemployment rate would be by 30 basis points higher than in the original scenario, with consumption down 1.1 %, investment down 0.4% and the GDP down 0.6% against the same benchmark (see Table 2).

3. simulation: higher growth of labour productivity

Forecasting productivity growth is extremely difficult; hence a method of extrapolation by which future data are inferred from historical indicators is often used. However, in a small open economy of the likes of Slovakia, non-recurring shocks are able to considerably speed up productivity growth. A good example is the restructuring of the production at Volkswagen Slovakia. Model simulations indicate that a 0.5% increase in the total productivity growth would improve the country's competitiveness and proportionally even the country's potential output. However, it is prudent to assume that productivity will mainly grow in the tradable sector. Given the fact that the tradable sector represents half the value added in Slovakia, this growth would translate into an annual growth of 1% in that sector. With potential output growing faster than GDP, a negative output gap will form. This would allow for a reduction of interest rates, which would ease the nominal exchange rate in the short term, yet lower interest rates would underpin private consumption and investment in the longer term. The improved competitiveness would spur exports, while slightly hurting imports. Even though consumption growth would cause a slight upswing in imports, its overall impact on the balance of payments would be positive, as it would cause the current account deficit to GDP ratio to narrow. The resulting GDP growth would be accompanied by a growth in demand, both for money and goods and services and work force. At the same time, it would mean rising employment and wages, but also a possible increase in interest rates. The exchange rate would respond to the stronger growth of the economy by a real appreciation. The overall real effect of the above shock would be a 0.7% increase in private consumption, a drop in the unemployment rate by 0.4 percentage points.

IMPACT OF CHANGE IN SEVERAL ASSUMPTIONS OF THE FORECAST ON THE DEVELOPMENT OF RELEVANT ECONOMIC INDICATORS

1. Relative change in the growth rate (trend development) of individual variables in comparison with baseline scenario, or change in percentage points (p.p., if not stated otherwise)

	House-hold consump -tion	Gross investments	GDP	Level of unemployment	Average nominal wage	Inflation (CPI)	Short-term interest rates	Nominal rate SKK/EUR (% change)	Real rate SKK/EUR (% change)	Current account (% of GDP)
Scenario No.1: SKK appreciation by 5%										
2003	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2004F	0.1	-0.1	-0.1	0.0	-0.1	-0.2	-0.1	-2.7	-2.5	-0.3
2005F	0.3	-1.4	-0.8	0.2	-1.1	-0.8	-1.1	-5.0	-4.0	-0.9
2006F	0.0	-0.2	-0.2	0.5	-1.6	-1.0	-1.7	-5.0	-3.1	-1.0
2007F	-0.1	1.2	0.3	0.5	-1.4	-1.2	-1.6	-5.0	-2.0	-0.9
Scenario No.2: Eurozone Imports decline by 3%										
2003	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2004F	-0.1	-1.1	-0.6	0.1	-0.3	0.0	-0.4	1.0	1.0	-0.1
2005F	-0.3	-0.9	-0.4	0.5	-1.3	-0.1	-1.2	2.5	2.6	-0.1
2006F	-0.4	1.0	0.3	0.5	-0.5	-0.4	-0.9	2.1	2.6	-0.1
2007F	-0.3	0.6	0.1	0.3	-0.8	-0.4	-0.8	2.1	3.0	0.0
Scenario No.3: Acceleration of productivity growth by 0.5 % p.a.										
2003	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2004F	0.0	0.1	0.1	0.0	0.0	0.0	-0.1	0.3	0.3	0.0
2005F	0.2	0.5	0.3	-0.1	0.3	0.1	0.0	0.3	0.2	0.1
2006F	0.2	0.6	0.3	-0.3	0.4	0.1	0.1	0.1	-0.1	0.1
2007F	0.3	0.4	0.3	-0.4	0.7	0.3	0.3	0.1	-0.4	0.2

Source: Ministry of Finance

IMPACT OF CHANGE IN SEVERAL ASSUMPTIONS OF THE FORECAST ON THE DEVELOPMENT OF RELEVANT ECONOMIC INDICATORS

2. Relative change in the value of the variable against baseline scenario

	2003	2004F	2005F	2006F	2007F
Scenario No.1: SKK appreciation by 5%					
Household consumption	0.0	0.1	0.4	0.4	0.3
Gross investments	0.0	-0.1	-1.4	-1.6	-0.5
GDP	0.0	-0.1	-0.9	-1.1	-0.8
Scenario No.2: Eurozone Imports decline by 3%					
Household consumption	0.0	-0.1	-0.4	-0.8	-1.1
Gross investments	0.0	-1.1	-1.9	-1.0	-0.4
GDP	0.0	-0.6	-1.0	-0.7	-0.6
Scenario No.3: Acceleration of productivity growth by 0.5 % p.a.					
Household consumption	0.0	0.0	0.2	0.4	0.7
Gross investments	0.0	0.1	0.6	1.2	1.6
GDP	0.0	0.1	0.4	0.7	1.0

Source: Ministry of Finance

II.8. Evaluation of Convergence with the Maastricht Criteria

The Maastricht criterion concerning price stability prescribes that the inflation rate must not exceed the average inflation rate (measured on the basis of the HICP) of the three best performing member countries, plus 1.5 percentage points; average for the last 12 months before the assessment.

Although Slovakia has not satisfied the criteria so far, the goal is realistic given the slow-down in the price deregulation process in 2006-2007. The demand-side pressure has been limited and both the core and net inflation have been approaching the values based on the above criteria. The CPI development, as well as the development of Slovakia's harmonised index of consumer prices (HICP) has approached the target value as early as in 2002. In 2002, the average headline inflation posted 3.3% year-on-year. That happened despite some adjustments in regulated prices in the same year. The net inflation – i.e. a measure of inflation disregarding the impacts of administrative price regulations and movements of food prices – averaged only 2.3% in 2002, which is well below the then reference value. All of the above creates the necessary prerequisites for Slovakia to meet the inflation criterion once the price deregulation process has been completed.

Maastricht criterion on inflation (%)

	1996	1997	1998	1999	2000	2001	2002	2003
HICP	5.8	6.0	6.7	10.4	12.2	7.0	3.3	8.8
CPI	5.8	6.1	6.7	10.6	12.0	7.3	3.3	8.5
Reference value	2.5	2.7	2.2	2.1	2.8	3.3	2.9	2.7

Source: Eurostat, Statistical Office

Turning to the price development in both tradable and non-tradable sectors, it appears that Slovakia's fulfillment of the inflation criterion will remain largely unaffected by the so-called Balassa-Samuelson effect (B-S effect), which occurs with disparities between the labour productivity development and the price growth of tradables and non-tradables. In 2002, the development of consumer prices was marked by a slow-down in the deregulation process. The so-called dual inflation (the difference between the growth rate of market service prices and tradables excluding food) also fell substantially, from 6.7% in 2001 to -0.3% in 2002. This indicates, that the dual inflation in 1999-2001 and 2003 was, for the most part, not caused by the Balassa-Samuelson effect, instead it was caused by the fact that the secondary effects of increased input costs (not wage-related costs) were billed-through to market service consumer prices. At present, the impact of the Balassa-Samuelson effect on consumer prices does not materialise in any considerable manner in Slovakia (it is estimated at about 1 percentage point).

Price development in tradable and non-tradable sector (%)

	1999	2000	2001	2002	2003
Tradable sector					
Food prices	1.3	6.0	3.7	-0.2	2.6
Other tradable goods	7.8	2.6	1.0	2.8	1.2
Non-tradable sector					
Regulated prices	38.2	20.7	17.2	6.0	18.7
Prices for market services	14.6	7.5	7.7	2.5	7.0
Dual inflation	**6.8**	**4.9**	**6.7**	**-0.3**	**5.8**

Source: NBS

Naturally, the B-S effect could pick up slightly in future, but, under optimum conditions, the process of disinflation could also be accelerated by a slight nominal appreciation of the exchange rate, if accompanied by a non-inflationary wage policy and strict fiscal policy. The right mix of monetary and fiscal policies should allow to further reduce headline inflation despite a stronger growth in consumer demand.

The fulfillment of the Maastricht criterion will turn on how inflation develops in the Eurozone countries and, in particular, in the countries with a low inflation rate, as it will be these countries that will ultimately influence the reference value. The enlargement of the Union will increase the number of countries involved in the determination of the reference value, which poses a certain risk. The development of inflation will also be determined by the phase of the business cycle that the remaining EU member states will be in, the external shocks they will be exposed to and the extent to which the impact of such shocks on inflation is comparable among the individual EU countries.

Possible risks of inflation development

Pro-inflation	Anti-inflation
• Global price shocks (notably crude oil prices increase) • Commitments related to EU entry (potential change of minimal rates for excise taxes, custom duties and import quotas; commitments to the Common Agriculture Policy) • Health and educational system reforms • EUR/USD exchange rate • Higher B-S effect • Inflationary expectations	• Appreciation of SKK exchange rate • Reform of the Common Agriculture Policy • Lower-than-expected price growth in the Eurozone • Strong competitive environment

Source: Ministry of Finance

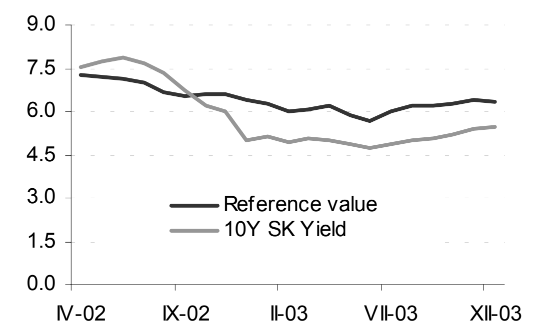
In the medium term, inadequate inflationary pressures may be addressed by deploying the right combination of monetary, wage and, of course, fiscal policy instruments. However, the development of the net inflation has so far indicated that the fulfillment of the Maastricht inflation criterion by 2007 is a realistic goal.

The Maastricht criterion for long-term interest rates prescribes that the interest rate must not exceed the average interest rate of the 3 EU member states with the lowest inflation, plus 2 percentage points, whereby the yield-to-maturity of 10-year government bonds is used as the indicator for tracking long-term interest rates.

Slovakia has only had a limited number of 10-year government bond issues and their history is fairly short. The first-ever issue of 10-year bonds was out as late as in August 2000, with an average yield of 8.42%. Since then, the yield-to-maturity declined to an average of 5.1% in 2003. As for yield-to-maturity, the bonds hit their historic low of 4.65% in June 2003. The development of long-term interest rates has partly reflected the development of short-term interest rates, taking into account the anticipated macroeconomic conditions, both at home and abroad. Long-term interest rates have a tendency to contour with the yields of European bonds, mainly the German 'bunds'.

It will be the development in the Eurozone countries with the lowest inflation that will determine the reference value of the Maastricht criterion. While that reference value stood at 6.9% in 2002, it dropped to some 6.1% in 2003. Slovakia would have fulfilled the criterion already last year. Slovakia should have no problems with this particular criterion of the nominal convergence. With a stronger outlook for an economic recovery in the Eurozone, we may go with the assumption that the yield on European long-term bonds will slightly increase and lift the reference value to a higher level. The yields of 10-year German bunds are estimated to grow from 4.1% in 2003 to 5.3% in 2007.

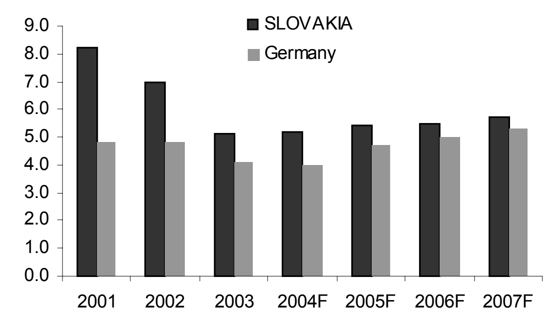
Reference level (%)



Source: Eurostat, Reuters

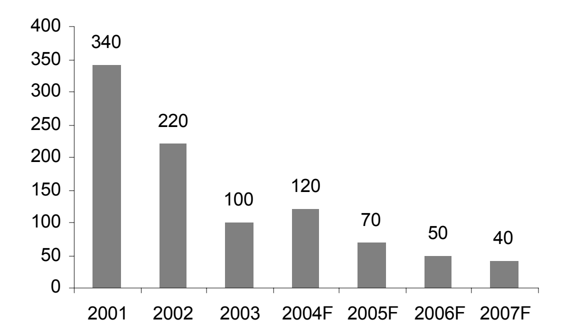
It can be assumed that the continuous convergence of short-term interest rates will, by 2007, reduce the difference between the Slovak (SKK) and German (EUR) bonds. From that moment on, any difference will be the result of risk premium and liquidity. Just for the sake of comparison, spreads of the Slovak Eurobonds – compared with the bunds (evidence of the cost of risk) – are currently at about 20 basis points. The liquidity should improve with the reform of public finance management, which has already seen the launch of the ARDaL.

Yields of 10Y SK government bonds (%)



Source: OECD, Reuters, Ministry of Finance

Spreads 10Y DE vs SK bonds



Source: OECD, Reuters, Ministry of Finance

Only a substantial divergence from the draft macroeconomic scenario could cause Slovakia's failure to comply with the criterion on interest rates – and that is rather unlikely.

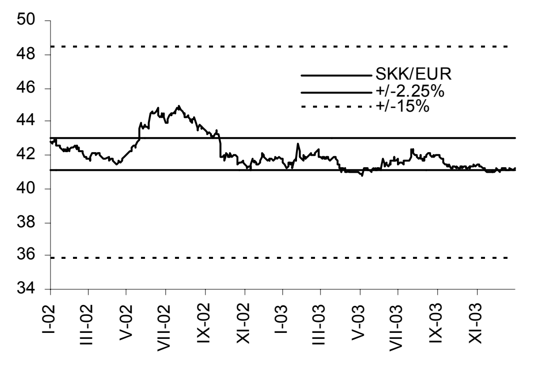
To meet the Maastricht criterion for exchange rate stability, a country must be a member of the ERM II mechanism for at least two years and respect the fluctuation margins (+/- 15%). The central parity cannot be devaluated. The exchange rate stability is assessed on the EU level.

Nevertheless, the value of the exchange rate parity on the date of Slovakia's entry into the ERM II system need not necessarily be an irreversible conversion rate, at which the Koruna will be pegged to the Euro at the end of the convergence process. It is very likely that the real equilibrium exchange rate will appreciate in the process of the convergence and therefore it may very well happen that the exchange rate parity will have to revalue after the accession to the ERM II or by the entry to the Eurozone. The determination of the exchange rate parity will also reflect opinions and economic interests of other member countries of the European Union.

Since the Slovak currency is not yet subject to the ERM II and since no central parity has been assigned yet, it is possible to use the mid-rate of exchange to assess its current stability (*purely indicative approach*). Based on that, we find that, from early 2002 through the end of

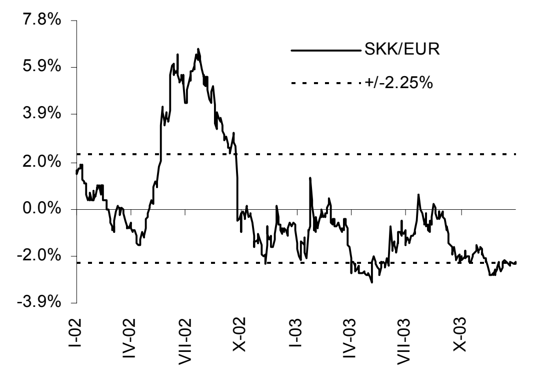
2003, the exchange rate remained well within the broad fluctuation margins. Moreover, during that period, even the extreme values of the SKK/EUR exchange rate did not test the limits of the aforementioned margins. The highest depreciation of the exchange rate was 6.62% against the mid-rate, while the highest appreciation was 3.06%.

SKK/EUR exchange rate development



Source: NBS

SKK/EUR exchange rate changes



Source: NBS

On the other hand, as regards compliance with the narrow fluctuation margins (i.e. +/- 2.25%), the assessment of the SKK/EUR exchange rate development shows that, at some point, the extreme values exceeded the prescribed margins. The SKK/EUR rate depreciated excessively in 2002[13]. In the following year it appreciated by more than 2.25%. This shows that, last year, the exchange rate of the Koruna remained fairly stable vis-à-vis the Euro despite the theoretically narrow fluctuation margins of the ERM II.

In order to determine the right timing for Slovakia to join the ERM II and to adopt the single currency, it will be necessary to take into account the situation in the neighbouring countries. Any delay in joining the monetary union compared with the neighbouring countries would result in a competitive disadvantage for Slovakia in terms of a continued exchange rate risk; it would also send a negative signal to the financial markets and to investors, which could hurt the influx of foreign direct investment into Slovakia.

Having regard to all relevant considerations and possibilities, Slovakia has four alternatives for joining the ERM II.

1. With the budget consolidation and deficit reduction underway, Slovakia is expected to join the ERM II in 2005 provided that the examination of compliance with the Maastricht criteria will not find Slovakia's fiscal deficit influenced by the pension reform costs.

2. If that is the case, i.e. if, at the examination of compliance with the criteria, the costs of the second pillar of the pension reform are included in the general government deficit, reaching the necessary fiscal convergence will require further consolidation taking approximately another year. Thus, the Slovak Republic would most likely join the ERM II in 2006.

3. There is also the alternative that Slovakia would join the ERM II as early as in 2005, although the process of the budget consolidation would proceed until 2007. The feasibility of this alternative as well as the pros and cons of an earlier accession to the ERM II will be subject to discussion in the second half of 2004. The completion of structural reforms will be a prerequisite.

[13] There was a short-term fluctuation triggered by the parliamentary elections

4. The fourth scenario is a considerable divergence of the line of the economic policy from the current intentions, which would endanger the consolidation of the public finances. In such a case, the entry to the ERM II could be substantially delayed.

Risks

Given the relatively stable development of the Koruna so far, it is reasonable to assume that Slovakia will have no serious problems meeting this particular criterion. Notwithstanding the foregoing, there are many factors – in particular external factors, such as various geopolitical risks, speculative capital, downturns on world markets, unforeseen developments in the region and, last but not least, a change of course in the single monetary policy of the Eurozone – that may come to bear.

The greatest risk is clearly a maladapted central parity and/or a parity that is unsustainable in the long run and that results in devaluation pressures during the ERM II stage. A bad central parity may hurt a country even inside the monetary union. On these grounds, the latest equilibrium exchange rate of the Slovak Koruna should be used as the central parity.

The stable development of the Koruna exchange rate could theoretically be undermined by a sluggish fiscal consolidation, however the reforms already put in place to streamline public finances show the resolve to live up to the objectives of macroeconomic stability and the earliest possible accession to the Eurozone. Of course, short term fluctuations may be triggered by the political situation, however, in the long term, the exchange rate should be clearly driven by economic fundamentals.

To meet the Maastricht criterion for a sustainable fiscal position, a country must keep its general government deficit below 3% of its GDP or show a substantial and continuous decline to a level below the reference value.

A more detailed analysis of the expected development in the area of fiscal deficit and the gross debt is included in the following chapter, and therefore the following paragraphs provide only a brief outline. The main goal of the government is to reduce the general government deficit by 2006 to a level of 3% of GDP, excluding the impact of the implementation of the second pillar of the pension reform, and to 3% of GDP in 2007 including that impact. These goals are both ambitious and realistic. The deficit based on ESA 95 was 3.6 % of GDP in 2003. The substantial reduction against 2002 was influenced mainly by structural reforms and hard budgetary contraints.

The gross general government debt should not exceed 60% of GDP or a clearly declining trend must be shown.

Having regard to the amount of gross debt in 2003 (42.8% of GDP) and the general government deficit targets for the coming years, the fulfillment of this criterion is realistic despite certain risks[14] .

[14] More information in the next chapter.

III. GENERAL GOVERNMENT BALANCE AND DEBT

III.1. Medium-Term Fiscal Framework

The medium-term fiscal framework is determined by the government's principal fiscal goal, which is general government finances consolidation. This should allow to reduce, by 2007, and in a sustainable way, the general government deficit to 3% of GDP (including the negative effects of introducing the second pillar of the pensions reform), thus putting conditions in place for meeting the Maastricht criteria and subsequently joining the Eurozone. This consolidation is also a prerequisite for the stabilisation and gradual reduction of net public debt as a percentage of GDP.

Balance of general government revenues and expenditures (% of GDP, ESA 95)

	2003E	2004B	2005F	2006F	2007F
Total revenues	**37.4**	**37.4**	**38.4**	**37.8**	**37.6**
Taxes	18.2	17.9	17.6	17.3	17.0
Social security contributions	13.9	13.1	13.7	13.6	13.6
Non-tax revenues	5.3	5.0	5.2	4.9	4.7
Grants and transfers	0.0	1.4	1.9	2.0	2.3
Total expenditures	**40.9**	**41.5**	**41.8**	**40.9**	**39.6**
Current expenditures	37.8	37.6	37.5	36.7	35.6
- Wages	8.4	8.4	8.1	7.8	7.5
- Goods and services	6.6	6.3	6.3	6.2	6.0
- Subsidies and transfers	20.4	20.3	20.3	20.0	19.6
- Interest	2.4	2.6	2.8	2.7	2.6
Capital expenditures	3.2	3.9	4.2	4.2	4.0
Primary balance	-1.2	-1.5	-0.6	-0.3	0.6
Net borrowing (-)/lending(+)	**-3.6**	**-4.0**	**-3.4**	**-3.0**	**-2.0**
Pay-as-you-go pillar revenues shortfall	0.0	0.0	-0.5	-0.9	-1.0
Net borrowing (-)/lending(+) including PAYG shortfall	**-3.6**	**-4.0**	**-3.9**	**-3.9**	**-3.0**

Source: Ministry of Finance

The fiscal framework is based on the macroeconomic forecast presented in the preceding section of the document. The presented macroeconomic development will become one of the sources of general government budget consolidation. Gradually accelerating growth will impact positively on the revenue and expenditure sides of general government finances by way of taxes and social spending. A stable macroeconomic environment and continuing disinflation will probably be reflected as well in lower debt service expenditures in 2006 and 2007.

Structural reforms on the revenue and expenditure sides will be another important source of consolidation. Not only will it contribute to financial consolidation but it will render general government finances more efficient. The fact that most key reforms have already been launched is significant in terms of actually attaining the fiscal targets. The last phase of health care and tertiary education reforms is expected to clear the approval process in mid-2004. The tax reform was designed in a way that would moderately diminish the overall tax burden (by 0.3 percentage points of GDP). However, it is expected to have a positive effect on budget revenues in the medium term. Health care and pension reforms are particularly important as they generate savings in the medium to long-term run owing to greater efficiency in the system. Moreover, they impact positively on the long-term sustainability of public finances by reducing implicit government debt. The reforms of the social benefits and social assistance systems should also contribute to the consolidation, in particular arrangements designed to prevent system misuse. These arrangements, however, must not undermine efforts to secure basic living conditions. The same philosophy was used to draft the sickness benefit and unemployment benefit reforms.

The government's fiscal goals are also ambitious in view of the factors that make their attainment much more difficult. Despite the fact that the European Union accession is expected to have a positive impact on economic development, its net effect on general government finances will be negative in the medium term, contrary to the country's net financial position. EU accession will, on the one hand, increase budget revenues and expenditures and, on the other hand, it will alter the government's expenditure policy. Similarly, the revenue shortfall resulting from the introduction of the 2nd pillar (fully-funded) of the pension reform as reflected in the fiscal framework deficits presented will have a negative impact on the public sector balance. The tables that follow give an overview of the net effect of EU membership on Slovakia as a whole and on general government finances.

Net position of Slovakia vis-á-vis EU (% of GDP)				
	2004F	**2005F**	**2006F**	**2007F**
SK revenues	**2.1**	**2.7**	**2.7**	**2.8**
Pre-accession assistance	0.6	0.5	0.3	0.1
Post-accession assistance	1.6	2.2	2.3	2.7
SK expenditures	**0.8**	**1.1**	**1.1**	**1.0**
Slovakia net position vis-à-vis EU	**1.3**	**1.6**	**1.6**	**1.7**

Source: Ministry of Finance

The net impact on general government finances (% of GDP, ESA 95)				
	2004F	**2005F**	**2006F**	**2007F**
EU accession	**-0.8**	**-1.4**	**-1.3**	**-1.4**
- Contributions to EU budget incl. rev. shortfall	-0.8	-1.1	-1.0	-1.0
- Co-financing from the state budget	-0.5	-0.7	-0.6	-0.6
- Reserve for EU funds and EU contributions	-0.1	-0.2	-0.1	-0.1
- Special compensatory payment	0.2	0.0	0.0	0.0
- Savings in agriculture	0.4	0.4	0.3	0.3
Launching 2nd pillar of pension reform	**0.0**	**-0.5**	**-0.9**	**-1.0**
TOTAL	**-0.8**	**-2.0**	**-2.3**	**-2.4**

Source: Ministry of Finance

Various general government subsectors will each be contributing to the overall deficit in its own way. The consolidation effort will be most visible at the central government level. The bulk of the deficit will be concentrated in the state budget, giving the government additional control over targets and stabilisation measures and ensuring greater transparency.

Social security reforms were designed to ensure that the funds are managed so as to have balanced budgets in the long run. However, the transition costs of the pensions reform will have to be addressed by transfers from the central government and state financial assets. If it were not for the revenue shortfall due to the introduction of the 2nd pillar of the pensions reform, the Social Insurance Agency would generate substantial long-term surpluses, as the retirement age increases.

Although the government has no direct control over the management of municipal budgets, the latter are projected to be broadly balanced. There is after all a method of exercising indirect control in the form of rules (including those provided for in the law) that municipalities must comply with if they want to avoid forced administration. There are two rules that are important in terms of fiscal discipline:

- Total debt may not exceed 60% of the actual current revenues in the previous year.
- The sum of annual loan payments is capped at 25% of the actual current revenues in the previous year.

The outturn in 2003 suggests that the debt of municipalities is in fact not growing. This has been due to the fact that large cities are reporting high values of these ratios and, therefore, are tending to reduce rather than increase their debts.

Furthermore, preparations are under way for a fiscal decentralisation project that is likely to shift some of the taxes to the local level.

Net borrowing (-)/lending (+) at different levels of general government (% of GDP, ESA 95)

	2003E	2004B	2005F	2006F	2007F
Central government	-4.2	-4.3	-4.1	-3.6	-2.7
Municipalities	-0.2	0.0	0.0	0.0	0.0
Social security funds	0.8	0.3	0.7	0.5	0.7
General government, total	**-3.6**	**-4.0**	**-3.4**	**-3.0**	**-2.0**
Pay-as-you-go pillar revenues shortfall	0.0	0.0	0.5	0.9	1.0
General government deficit including PAYG shortfall	**-3.6**	**-4.0**	**-3.9**	**-3.9**	**-3.0**

Source: Ministry of Finance

III.2. General Government Revenues

In 2003 to 2007 consolidated total general government revenues are projected to grow from 37.4% of GDP to 37.6% of GDP. Net of EU funding, revenues are expected to decline by 2.1 percentage points.

Tax revenues

In January 2004 Slovakia launched a fundamental tax reform[15]. The principal feature of the reform was the introduction of a flat income tax rate, making uniform the taxation rate applicable to individuals and legal entities. The philosophy behind the introduction of single rate tax was to improve the production capacity of the economy through the inflow of foreign investment, better incentives for work and business. The reform eliminated a host of exemptions and tax breaks, broadening the tax base, enabling lower rates of taxation and making the entire system simpler and more transparent. The elimination of a tax on dividends did away with the double taxation of profit. Furthermore, the gift tax and inheritance tax were revoked and in 2005 property transfer tax will be rescinded.

The tax reform was conceived to take account of the medium-term economic objectives. A significant positive impact on tax revenues is not expected until the production capacity of the economy improves. Flat rate tax has significantly reduced the progressive nature of income taxation. To take account of the medium-term fiscal consolidation objective, the single tax rate was set at 19% (the tax allowance of individuals was increased to 19.2 times the official subsistence level), while the shortfall of direct tax revenues was compensated by introducing a single VAT tax levied at 19% and increasing the rates of some excise duties

[15] for details, see the Cardiff Report for 2003

(those levied on beer, tobacco and mineral oils). As a result, a substantial portion of the tax burden was shifted from direct to indirect taxes.

On a consolidated basis, total tax revenues as a percentage of GDP are expected to decline in 2003 to 2007 by 1.2 percentage points (conservative scenario).

Social security contributions

As part of the drive to transform the social security system, several laws came into effect as of 1January 2004, amending the scope and extent of welfare provided under social insurance. An essential part of the change was the modification of the insurance element providing for a closer link between contributions and benefits.

The overall rate of social security contributions (net of accident insurance) declined as of 2004 by 3.0 percentage points and employers are now paying 3.6 percentage points less. Furthermore, the rate of old-age pension insurance contributions paid by one of the parents was reduced by 0.5 percentage point per each dependent child. At the same time, the minimum and maximum assessment bases were elevated and linked to the minimum and average wages in the economy.

Social security contributions (% of gross wages)

	2002	2003	2004F	2005F	2006F	2007F
Paid by employer	**38.2**	**38.2**	**35.2**	**35.2**	**35.2**	**35.2**
Pension insurance	21.60	21.60	19.00	17.00	17.00	17.00
- old age insurance*	-	-	16.00	14.00	14.00	14.00
- disability insurance	-	-	3.00	3.00	3.00	3.00
Sickness insurance	3.40	3.40	1.40	1.40	1.40	1.40
Unemployment insurance	2.75	2.75	1.00	1.00	1.00	1.00
Guarantee insurance	0.25	0.25	0.25	0.25	0.25	0.25
Accident insurance**	0.20	0.20	0.80	0.80	0.80	0.80
Reserve fund	-	-	2.75	4.75	4.75	4.75
Health insurance	10.00	10.00	10.00	10.00	10.00	10.00
Paid by employee	**12.8**	**12.8**	**13.4**	**13.4**	**13.4**	**13.4**
Pension insurance	6.40	6.40	7.00	7.00	7.00	7.00
- old age insurance*	-	-	4.00	4.00	4.00	4.00
- disability insurance	-	-	3.00	3.00	3.00	3.00
Sickness insurance	1.40	1.40	1.40	1.40	1.40	1.40
Unemployment insurance	1.00	1.00	1.00	1.00	1.00	1.00
Health insurance	4.00	4.00	4.00	4.00	4.00	4.00

**The employer is required to pay only 5% to PAYG on behalf of employees who join funded pillar and the remaining 9% will flow to 2nd pillar.*
*** Accident insurance rates will, as of 2007, be differentiated depending on the degree of risk associated with the job.*
It is assumed that the weighted average rate will remain at 0.8%
Source: Ministry of Finance

The health insurance system is undergoing deep reform and new bills will be submitted to the legislation approval process in the first half of 2004. The proposed change will tighten budgetary constraints and strengthen funding from sources other than the public ones. The change will introduce the same minimum and maximum assessment bases as in the social insurance system. Contributions paid from the state budget for and on behalf of the economically non-active part of the population will be mandatory and linked to the evolution of average wages in the preceding period. By the same token, non-systemic transfers from the Social Insurance Agency will be discontinued.

By 2007 the social security contributions burden should diminish by 0.3 percentage point to 13.6% of GDP.

As regards overall insurance rates, the government envisages further reduction of the contributions burden in the future (beyond 2007). The pace at which insurance rates decline will primarily depend on the outcome of the tax reform in the context of continued consolidation of general government finances.

Tax quotas I and II (% of GDP, ESA 95)

	2003E	2004F	2005F	2006F	2007F
Tax quota I (taxes)	18.2	17.9	17.6	17.3	17.0
Tax quota II (taxes and social contributions)	32.1	31.0	31.3	30.9	30.6

Source: Ministry of Finance

Non-tax revenues

Non-tax revenues (generated by leased-out land and buildings, administrative and other fees, receipts from the sale of surplus fixed assets, royalties for mining mineral resources) are not amenable to projections on the basis of macroeconomic indicators. For this reason, only a moderate nominal increase is anticipated in non-tax revenues. Their share of GDP will thus decline from 5.3% to 4.7%.

Non-tax revenues are to a large extent affected by *dividends* paid out by companies in which the government holds an equity stake. Dividends are projected to grow again moderately in 2004 and beyond. *Interest income* is another important component of non-tax revenues. Interest accrued on the credit balance of government funds in the State Treasury single account will grow compared to 2003. In addition, interest income is due from the time deposit of funds that have been set aside for the pension reform. After the 2nd pillar of the pension reform is launched in 2005, this income will be gradually eroded as the funds in the account are used to offset the revenue shortfall in the Social Insurance Agency.

Grants and transfers

After the Slovak Republic's accession to the European Union, general government revenues will increase by the amount of payments from the EU general budget. Those will grow from 1.4% of GDP in 2004 to the 2.3% GDP target in 2007. Since those funds are primarily earmarked for project finance and support of the agricultural sector, they will not, after all, impact the general government balance as the money is spent and recorded as expenditures.

III.3. General Government Expenditures

According to MoF estimates, general government expenditures are projected to decline in 2003 to 2007 by 1.3 percentage points to 39.6% of GDP.

Current expenditures

In the years to come expenditures on wages, salaries, service pay and other personnel-related payments are not projected to decline in real terms[16]. This notwithstanding, the constituent

[16] In an effort to improve data comparability, these items were reclassified in 2003 from transfers to estimated wages and salaries in subsidised organisations

components of general government are encouraged to manage employment and wage policy on their own. Given the level of overemployment in some areas of public administration, a moderate nominal increase in the payroll package may, if combined with shedding some labour, generate room for a substantial increase in real wages (e.g. in the MoF, the percentage of the real wage increase was in double digits). Personnel-related spending as a percentage of GDP is thus set to diminish by 0.9 percentage point in 2007 compared to 2003.

More spending on goods and services will primarily result from the anticipated increase in producer prices, which should not be substantial. With this arrangement to adjust spending in place, rapid economic growth would result in these expenditures (as a percentage of GDP) declining by 0.6 percentage point in 2003 to 2007.

By 2007 subsidies and transfers are projected to decline by 0.8 percentage point. The constituent components are described below.

There will be a special approach to agriculture. On EU accession in 2004, the Slovak Republic will assume the obligations ensuing from the Common Agricultural Policy. The MoF envisages that in 2004-2007 direct payments will be accompanied by payments from the state budget to the tune of 52.5/40/45/50% of the EU average respectively.[17] Direct payments will also see the reallocation from the EAGGF Guarantee Section of 20% of funds earmarked for rural development (including co-financing from the state budget).

The reimbursement of expenses incurred while rendering road and railway transport services in the public interest represents the second largest subsidies item. At present those subsidies account for 0.7% of GDP.

The fact that, since 2003, the system of health insurance companies has been running a balanced budget is to the result of enhanced allocation efficiency at the micro level and of cuts in the scope of services reimbursed under solidarity-based health insurance schemes. In 2003, the introduction of differentiated patient co-payments for health care services was a major policy change. The aim was to ensure an equilibrium of the systems at 6.5% of GDP. Eliminating the deficit and stabilising the debt may put conditions in place for reducing the burden of insurance contributions in the future.

Sickness insurance benefits have also undergone a systemic change. Income compensation payments by the employer during the first ten calendar days of the employee's temporary inability to work are an entirely new feature of the system. Employees will not be entitled to sickness pay from public sources until day eleven of their temporary inability to work. This arrangement is expected to result in an abrupt reduction of the system being misused.

Following the reform of the pay-as-you-go pillar of the pension system, substantial changes were introduced on 1.1.2004 concerning eligibility to various kinds of pension benefits. The reform transformed a defined benefit system into a contribution defined one while the calculation of old-age pension benefits (within the pay-as-you-go pillar) was switched to a score-based mechanism. The reform also includes a gradual increase in the retirement age to 62 years, which should considerably relieve the burden on the expenditures side of the Social Insurance Agency budget during the next few years. Also, the rule was introduced to automatically increase pensions to the tune of the sum of 50% of the change in year-on-year inflation and 50% of the increase in wages in the national economy in the previous year.

[17] Actual amounts will be subject to future political discussions.

At present, certain groups of public sector employees (police officers, military personnel etc.) are enjoying a special social security regime provided for in a separate law. A new bill currently in the pipeline will include these employee categories in the general social security system.
Spending on old-age and disability pensions, including widow, widower and orphan benefits, will remain static at 7.5% of GDP. Any decline will be precluded, among other things, by a transition period intended to protect low-income groups in the first place.

The reform of the social insurance system has had implications for passive labour market policy. The year 2003 already saw changes tightening registration rules applicable to job seekers. In 2004, the period was extended during which insurance contributions must be paid to ensure unemployment benefits eligibility. On the other hand, the level of benefits paid reflects the income level on which insurance contributions are paid. These factors, along with improvements in the labour market, will by 2007 generate savings to the tune of approximately 0.1% of GDP.

The philosophy of paying social benefits out of the state budget is being overhauled. These benefits are being made more targeted as an incentive for beneficiaries to start receiving or to increase their earned income, while keeping the objectives of social inclusion intact. Rapid GDP growth and declining numbers of beneficiaries along with a moderate nominal increase in benefit funding allocations will by 2007 generate savings of 0.5% of GDP.

Transfers of the Slovak Republic to the EU budget will, as of 2004, be an item adding to the expenditure side of the budget. Whereas in 2004 transfers to the EU accounted for 0.7% of GDP, in 2005 they will amount to 1% of GDP. However, given the rapid economic growth envisaged in 2006 to 2007, the share of Slovak Republic transfers to the EU is projected to decline to 0.9% of GDP.

Until 2007 the interest expense of public debt service is projected to rise on 2003 by 0.2 percentage point despite the likely decline in short-term interest rates. The high cash balance deficit of the state budget in 2004 as well as the anticipated moderate increase in long-term interest rates are the main reasons for that projection.

Capital expenditures

The government's economic policy and the structural reforms already implemented are aiming to render the use of public funds more efficient. Current expenditures are therefore being managed in a restrictive fashion. On the other hand, the focus of economic policy objectives is on financing capital expenditures (development programs, infrastructure projects etc.) and, even given a restrictive policy stance designed to meet the general government deficit targets, the share of such spending should increase above 4.0% of GDP. Capital expenditures have been quantified with a view to the assumed needs of the budget chapters. At the same time it is envisaged that 60% of funds originating in the European Communities will be used in the form of capital expenditures. Capital expenditures should also be topped up from the government reserve earmarked for priority projects and proposed to be set at SK 11 billion in 2005. The government will decide on how the reserve will be applied during the subsequent stages of drafting the budget. It is projected that in 2005 SKK 5.6 billion out of that reserve will be used for capital expenditures.

General government revenues and expenditures in 2003-2007 (% of GDP, ESA 95, consolidated)	2003E	2004B	2005F	2006F	2007F
TOTAL REVENUES	**37.4**	**37.4**	**38.4**	**37.8**	**37.6**
Tax revenues	**18.2**	**17.9**	**17.6**	**17.3**	**17.0**
Personal income tax	3.3	2.1	2.2	2.2	2.2
of which: dependent activity	3.0	1.8	1.9	1.9	1.9
- paid into state budget	2.3	1.1	1.9	1.9	1.9
- paid into municipalities	0.7	0.7	0.0	0.0	0.0
Business activity	0.3	0.3	0.3	0.3	0.3
Corporate income tax	2.7	1.8	2.0	2.1	2.1
- paid into state budget	2.5	1.7	2.0	2.1	2.1
- paid into municipalities	0.1	0.1	0.0	0.0	0.0
Withholding income tax	0.8	0.9	0.6	0.6	0.6
Property tax	0.4	0.4	0.4	0.3	0.3
- paid into state budget	0.1	0.1	0.0	0.0	0.0
- paid into municipalities	0.3	0.3	0.4	0.3	0.3
Value-added tax	6.7	8.8	8.7	8.6	8.4
Excise taxes	3.4	3.3	3.2	3.1	3.0
Road tax	0.2	0.2	0.2	0.2	0.2
- paid into state budget	0.1	0.1	0.2	0.2	0.2
- paid into municipalities	0.1	0.1	0.0	0.0	0.0
Taxes on international trade and transactions	0.3	0.1	0.0	0.0	0.0
Local taxes (paid into municipalities)	0.3	0.2	0.2	0.2	0.2
Social security contributions	**13.9**	**13.1**	**13.7**	**13.6**	**13.6**
Non-tax revenues	**5.3**	**5.0**	**5.2**	**4.9**	**4.7**
of which: interest	0.8	0.5	0.6	0.6	0.5
Grants and transfers	**0.0**	**1.4**	**1.9**	**2.0**	**2.3**
of which: from EU	0.0	1.4	1.9	2.0	2.3
TOTAL EXPENDITURES	**40.9**	**41.5**	**41.8**	**40.9**	**39.6**
CURRENT EXPENDITURES	**37.8**	**37.6**	**37.5**	**36.7**	**35.6**
Gross wages	8.4	8.4	8.1	7.8	7.5
- Wages	6.2	6.3	6.1	5.9	5.6
- Employer social security contributions	2.2	2.1	2.0	1.9	1.8
Goods and services	6.6	6.3	6.3	6.2	6.0
Subsidies and transfers	20.4	20.3	20.3	20.0	19.6
- Agriculture subsidies	0.7	1.0	1.1	1.1	1.2
- Transport subsidies	0.7	0.7	0.7	0.6	0.6
- Health insurance companies	4.8	4.7	4.6	4.8	4.7
- Sickness benefits	0.8	0.4	0.4	0.4	0.4
- Old-age and disability pensions	7.5	7.5	7.6	7.6	7.5
- Unemployment benefits	0.3	0.2	0.2	0.2	0.2
- State support and social assistance benefits	2.6	2.5	2.4	2.2	2.1
- Soc.security contrib. on behalf of certain groups	2.0	1.8	1.9	1.9	1.8
- Transfers to EU budget	0.0	0.7	1.0	0.9	0.9
- Other subsidies and transfers	0.9	0.8	0.3	0.2	0.2
Interest payments	2.4	2.6	2.8	2.7	2.6
Capital expenditures	**3.2**	**3.9**	**4.2**	**4.2**	**4.0**
NET BORROWING (-)/LENDING (+)	**-3.6**	**-4.0**	**-3.4**	**-3.0**	**-2.0**
Pay-as-you-go pillar revenues shortfall	0.0	0.0	-0.5	-0.9	-1.0
NET BORROWING (-)/LENDING (+) including PAYG shortfall	**-3.6**	**-4.0**	**-3.9**	**-3.9**	**-3.0**

Source: Ministry of Finance

III.4. Cyclically Adjusted Balance

Estimates of a cyclically adjusted deficit indicate whether public budgets are facing structural difficulties. The ongoing fiscal consolidation will bring about a substantial reduction of the structural deficit in Slovakia. This will be primarily achieved by measures on the expenditures side that will more than offset the continuing decline in tax revenues as a percentage of GDP. Expenditure reforms will be implemented in an environment of accelerated growth. Unlike in the previous years, now fiscal policy would not run counter to the economic cycle, which should increase the odds of successfully consolidating public finances. The current fiscal policy priority is the consolidation of general government finances in order to put conditions in place for long-term sustainable growth accompanied by low inflation, low interest rates, a stable exchange rate and stable expectations of business entities with regard to future economic policy. Only a reduction of the structural deficit will set the stage for the unrestrained effects of automatic fiscal stabilisers in the medium term.

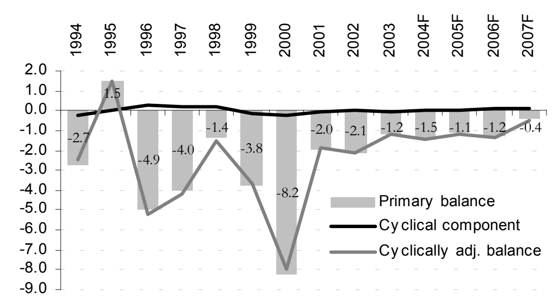
Cyclical developments (% of GDP)

	ESA code	2003	2004F	2005F	2006F	2007F
1. GDP growth, constant prices	B1g	4.2	4.1	4.3	5.0	4.7
2. Net borrowing (-)/lending (+)	B9	-3.6	-4.0	-3.9	-3.9	-3.0
3. Interest payments	D41	2.4	2.6	2.8	2.7	2.6
4. Potential GDP growth		4.6	4.0	3.9	4.8	4.7
5. Output gap		-0.2	-0.1	0.2	0.4	0.4
6. Cyclical budgetary component		0.0	0.0	0.0	0.1	0.1
7. Cyclically adjusted balance (2 - 6)		-3.5	-4.0	-3.9	-4.1	-3.1
8. Cyclically adjusted primary balance (7-3)		-1.2	-1.5	-1.1	-1.4	-0.5

Source: Ministry of Finance

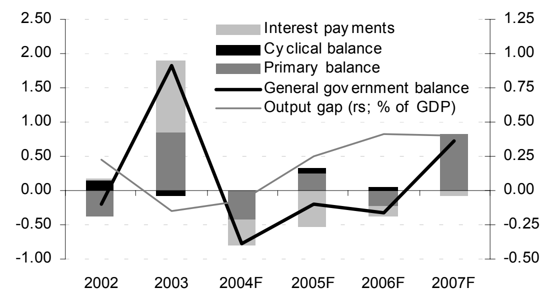
The first chart below illustrates the long-term structural problems of general government finances and the government's consolidation plans in the period ahead. However, deficits assessed according to ESA 95 have been overshadowed by the characteristic non-recurring effects of a transition economy such as privatisation and bank restructuring, which reduces their analytical and predictive value. This deficiency is overcome in the second chart that shows the crucial contribution made by the primary balance to budget consolidation, one that should be conducive to the future reduction of public debt as a percentage of GDP. The visible synchronisation of the curves reflecting changes in the balance of general government finances and output gap as of 2004 also documents the fact that the consolidation effort of the government will not produce an counter-cyclical effect on the economy.

Cyclically adjusted balance of general government finances (% of GDP)



Source: Statistical Office, Ministry of Finance

Annual changes of budgetary position of general government finances and contrib. of primary, cyclical balance and interest to deficit (p.p.)



Source: Statistical Office, Ministry of Finance

Method for calculating cyclically adjusted general government balance

To estimate the structural components of the general government balance, it is necessary to identify general government revenues and expenditures sensitive to cyclical developments in the economy. In Slovakia, those include corporate income tax, personal income tax levied on dependent activities and business income, value-added tax, excise duties, social security contributions and spending on the unemployed.

Given frequent changes in legislation and the profound structural transformation of the economy, it would be problematic to directly derive tax elasticity values. The following approach was used to tackle the problem. Regression analysis was used to estimate the elasticity of different tax bases as a function of GDP. Macroeconomic bases were chosen such as household consumption to deal with VAT and excise duties as well as the number of persons employed in the economy to address personal income tax and social security contributions. Elasticity values were estimated using seasonally adjusted quarterly data.

While the estimated elasticity of the number of employed persons was consistent with the standard values observed in other countries, the elasticity of household consumption to GDP proved extremely low. This observation is due to the nature of economic growth in the previous period, in which exports and productivity growth were the prevailing contributors. The Slovak economy has already put most of the transition process behind it and household consumption is expected to gradually stabilise as a percentage of GDP. For this reason, estimates of the cyclically adjusted general government balance were conducted with the elasticity of household consumption set at 0.9. The correlation between a macroeconomic base and the relevant tax was secured assuming the unit elasticity of tax vis-à-vis the base, which is consistent with the structure of calculating tax liability. The cyclical revenue component of the general government balance is a sum of the cyclical components of the relevant taxes.

The cyclical expenditure component was calculated using the mean values of unemployment benefits and the numbers of the employed or unemployed persons generated by the economic cycle. The sum of the revenue and expenditure cyclical components then constitutes the general government balance.

III.5. Sensitivity Analysis and Risks Confronting Public Finances

Three simulations of economic developments were presented in the section of the CP dealing with the macroeconomic outlook. The following table illustrates their implications on the balance of general government finances.

The scenario that envisages the SKK/EUR exchange rate appreciating by 5% would result in a moderate improvement of the fiscal position notwithstanding declining GDP and growing unemployment. Along with diminishing inflation, this should lead to lower tax revenues; however, this decline would be partially offset by the rising real consumption of households. Lower inflation would be furthermore translated into lower government spending on social transfers (envisaged indexation to price indices) as well as goods and services (price effect). Lower inflation would also moderately reduce the government’s interest expense as interest rates are cut.

The implications of diminishing imports in the Eurozone countries by 3% (versus the baseline scenario) will be negligible. Expenditure savings resulting from lower interest rates will be almost completely offset by decreasing revenues, as employment, wages and household consumption decline.

The scenario of productivity growth by 0.5% annually would have positive implications for general government finances. Expenditures would decrease due to lower unemployment and lower interest rates, as revenues grow in line with rising employment, wages and consumption.

Gen.government finances-table of differentials (% of change vs baseline scenario if not stated otherwise)

	SKK/EUR exchange rate - 5% in 2004			Productivity growth +0.5% pa			Eurozone imports -3%		
	Revenues	Expenditures	Balance (% of GDP)	Revenues	Expenditures	Balance (% of GDP)	Revenues	Expenditures	Balance (% of GDP)
2003	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2004F	-0.1	-0.2	0.0	0.0	-0.1	0.1	-0.4	-0.4	0.0
2005F	-1.2	-1.6	0.2	0.3	0.0	0.1	-1.5	-1.5	0.0
2006F	-2.6	-3.1	0.2	0.9	0.3	0.2	-2.1	-1.7	-0.2
2007F	-3.8	-4.0	0.1	1.6	0.8	0.3	-2.7	-2.2	-0.2

Source: Ministry of Finance

Other risks

The accuracy of estimates of tax reform implications on public revenues remains a relatively significant risk. In addition to adjusting tax rates, the reform has brought about major systemic changes that are difficult to quantify. Furthermore, in 2004 there will be a shortfall of VAT and excise tax revenues attributable to EU accession. Any substantial tax revenue shortfall would have to be offset by government measures that might significantly modify the macroeconomic and fiscal scenarios. However, given the fact the tax revenue estimate of the MoF is the lowest amongst all estimates made by institutions (including the IMF) that have looked in detail at the reform implications, the risk of a major shortfall appears to be low (first quarter date were better-than-expected). A moderate shortfall could be offset in the course of the year by measures on the expenditures side. The entire impact of the tax reform will not be obvious until 2005 and 2006. Following that, it will be possible to appraise whether the tax parameters have been set appropriately.
Another risk is the introduction of a fully funded pillar as part of the pensions reform. The uncertainty is primarily due to the fact that it is extremely difficult to predict how many people will choose to join the multi-pillar system.
Similar problems in quantifying the impact of reform could be encountered on the expenditures side. However, the risk there, except in the pensions reform, is lower since the projections are not so much effected by behavioural aspects.

III.6. General Government Debt Development

Gross general government debt (including central government and local government debts as well as the debts of social insurance and health insurance funds) will increase during the period in nominal terms from SKK 511.3 billion to SKK 729.8 billion. In view of a growing nominal GDP, however, its share in GDP will remain roughly stable at 45.5% in 2007. This level of debt would be fully compatible with the Maastricht criterion. In 2007 net public debt will be 36.6 % of GDP.

Debt growth will be largely generated by the central government, whereas the other general government components will have a surplus, which will not be used, however, to retire the debt of other general government subsectors. Following the transition to a multi-pillar scheme of funding pension insurance, part of the implicit debt inherent in the previous system will become explicit.

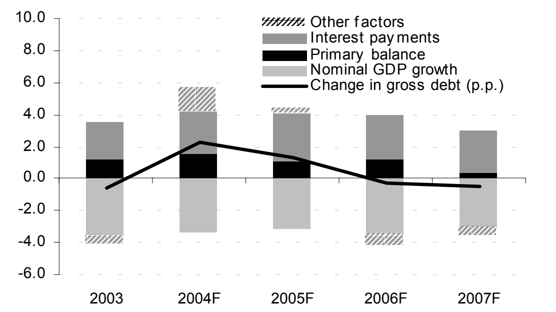
Public debt indicators

	2003	2004F	2005F	2006F	2007F
Net debt (in SKK mn.)	348,387	429,668	480,930	532,185	586,210
Net debt (% of GDP)	29.1	33.3	34.8	35.6	36.6
Gross debt (in SKK mn)	511,336	581,776	641,505	689,380	729,849
of which: government guarantees	63,089	42,251	41,746	33,509	21,617
Gross debt (% of GDP)	42.8	45.1	46.4	46.1	45.5
Changes in gross debt (p.p.)	-0.6	2.3	1.3	-0.3	-0.5
nominal GDP growth	-3.6	-3.3	-3.1	-3.5	-3.0
primary balance	1.2	1.5	1.1	1.2	0.4
interest payments	2.3	2.7	2.9	2.7	2.6
other factors	-0.6	1.5	0.4	-0.8	-0.5
p.m. implicit interest rate (%)	6.0	6.4	6.7	6.3	6.0

Source: Ministry of Finance

Of all the factors that trigger changes in gross debt, the contribution of interest payments will be broadly stable in 2004-2007. The impact of the primary balance will gradually diminish, as state budget deficits dwindle. It is projected that in 2007 the primary general government balance (net of the costs associated with launching the second pillar of the pensions reform) will become positive and commence to help reduce public debt. GDP growth will contribute positively to debt reduction by means of two mechanisms as the base of calculating public debt-to-GDP ratio and, indirectly, as the catalysator for general government balance improvement.

Contrib. to change of gross public debt (p.p.)



Source: Ministry of Finance

The substantial pro-growth effect of other factors on gross debt in 2004 is primarily associated with the one-off cash shortfall of tax revenues. On the other hand, state financial assets will be used in 2006 and 2007 to finance the deficit arising as a result of the second pillar of the pension reform being introduced. Thus the gap between gross and net debt will become less significant.

The general government finance reform saw the establishment of the Debt and Liquidity Management Agency (*ARDaL* in Slovak notation), whose responsibility will be to "*ensure transition to active state debt management, streamline the costs of financing state debt, minimise risks associated with financial assets and liabilities and open market positions of the state.*" Less efficient loan-based financing will be phased out and substituted by bonds. Given the limited absorption capacity of the domestic capital market, especially during the first part of the envisaged period, and in view of the anticipated introduction of the euro currency and the associated need for communicating with institutional investors in the Eurozone, it is envisaged that part of the debt issued annually will be denominated in EUR. Assuming a stable or moderately appreciating SKK/EUR exchange rate and a small existing foreign debt (about 30%), this move should not represent a major increase in foreign exchange risk. Transparent rules have been implemented to regulate the issuance of government guarantees for loans that are compliant with European Union legislation. These rules should prevent the replacement of government loans by government guarantees that ultimately prove more costly.

As net debt is more important from an economic standpoint, the table also features net debt values where growth is more consistent with the total general government deficit development.

In this instance net debt has been defined conservatively as gross debt less cash balances in the accounts of general government subcomponents. A relatively substantial increase in gross debt in 2004 will be primarily due to the one-off shortfall of tax revenues attributable to Slovakia's accession to the European Union. As the collection of some taxes (VAT and excise duties) is taken over by the tax administration from the customs, this is likely to lead to several weeks' delay in cash flows (estimated at SKK 17.7 billion).

The future evolution of debt is associated with the following risks:

- Litigation. In particular, this applies to the government's dispute with *ČSOB* and to the bills of exchange issued by *Slovenský plynárensky priemysel*.
- Debt relief in the health sector. Following systemic changes, this sector should be given debt relief. The sector's liabilities vis-à-vis the private sector are estimated at 1% of GDP.

The future positive growth of gross debt could be positively affected by the following opportunities:

- Privatisation proceeds. The government has decided to use its privatisation proceeds exclusively to reduce debt, which may translate into future gross debt reductions. Further to the anticipated balance or even surpluses in the primary balance, this decision might result in a reverse snowball effect.
- Other state assets. Net debt projections only included cash balances in bank accounts; however, the government is holding other fairly liquid assets as well as loans granted by the State Housing Fund totalling 1.5% of GDP.

Sensitivity analysis

According to MoF forecasts, the interest expense attributable to general government debt will be positively impacted by a stable macroeconomic environment. The table that follows compares the interest expense under the baseline scenario presented in the Convergence Programme and a scenario envisaging negative interest rate and exchange rate developments.

It should be emphasised that the baseline scenario has been formulated using conservative assumptions. The exchange rate used was 5% less favourable and interest rates were slightly higher than in the macroeconomic forecast developed by the MoF.

The risk scenario was defined as one envisaging 5% depreciation of the local currency and an increase in interest rates by 1 percentage point above the baseline scenario level in each year of the forecast. A 1 percentage point risk margin was chosen for short-term interest rates applicable to treasury bills. As the maturity of securities increased, the margin was gradually reduced, with the lower limit of 0.2 percentage point set for 15-year treasury bonds and 10-year eurobonds. The overall general government risk fluctuates slightly above 0.1 % of GDP and should be adequately covered by the conservative approach used in baseline scenario quantifications.

General government interest payments (% of GDP)

	2005F	2006F	2007F
Baseline scenario	2.82	2.72	2.60
Higher scenario	2.94	2.84	2.73
difference	0.11	0.12	0.13

Source: Ministry of Finance

IV. STRUCTURAL ISSUES AFFECTING PUBLIC FINANCES

Slovakia has recently adopted a number of laws that overhaul the philosophy of systems on the expenditure side of public finances. These necessary structural reforms are expected to yield considerable savings over a medium- to long-term horizon. This part of the document reviews the most demanding areas in terms of financing. All the figures presented in the preceding section correspond to the calculations presented below. *However, the calculations presented in this section do not take account of a reserve set aside in the budgetary assumptions for the years 2005 to 2007 (SKK 11 billion; 14.7 billion; 13.1 billion)*. This reserve will be distributed at the behest of the cabinet in line with the political priorities set out in the Government's Programme Declaration. Many of the areas featured below are therefore likely to benefit from additional resources (*education* and *road infrastructure* are among key priorities).

IV.1. Social Assistance and Support

The main reform steps in the field of social assistance and support focus on changing the way in which support is delivered to the needy (large emphasis is put on the precise targeting of benefits and their activating dimension). Since the new system was put in operation in January 2004, its main features are not likely to change any considerably in the years to come.

Benefits in material need

The new law on social assistance to those in material need is based on the philosophy of motivating and giving new prospects to the needy individuals and their families. A needy citizen and members of his household are entitled to a basic subsistence benefit plus certain additional benefits. These benefits include: health-care benefit, activation benefit, housing allowance, protection allowance[18]. Eligibility for individual types of benefits is tested against a set of criteria listed in the Act on Assistance in Material Need. The 'activation requirement', which is a pre-condition of eligibility for the activation benefit, is of particular importance.

[18] For those, where activation is not expected (e.g. pensioners)

Compared with the previous system, the total amount of the material need benefit plus additional benefits is lower only in the case of bigger families with children (to avoid benefit growth driven by the number of children). For other categories, the absolute amount of the benefit is roughly the same, although its structure and the eligibility criteria have changed. The new system can be characterised as one that motivates its beneficiaries to seek employment because, as a consequence of other social and tax measures, the disparity between the amount of the benefit and the net wage income (even at the minimum-wage level) has grown.

The calculations of the 2004-2007 budgetary expenditures are based on the assumption that the share of those on benefits in material need would remain about the same, i.e. approximately 62% of all registered unemployed. The benefits and additional allowances have been adjusted for inflation always as of September to maintain their real value.

Estimated expenditures on benefits to those in material need (in SKK mn)

	2004F	2005F	2006F	2007F
Material Need Benefits	10,091	10,274	10,258	10,156

Source: Ministry of Finance

Family support

According to the law valid thus far, the child allowance was paid at the rate of SKK 270 per month and child regardless of the household income and age of the child. Depending on the level of family income and the age of the dependent child, an addition of SKK 210 to 620 per month was paid on top of the basic rate of allowance. Under the new law, the child allowance is paid at a flat rate of SKK 500 per month and dependent child regardless of the age of the child and the level of family income. The new system is designed to support dependent children in families and ensure that parents use child allowances for proper purposes, particularly in connection with proper care for children and their school attendance. The allowance, being paid across the board regardless of the level of income, has a stronger motivating effect. The estimate of budgetary outlays is based on the medium variant of demographic projections.

Support to families (in SKK mn)

	2004F	2005F	2006F	2007F
Direct support through budgetary outlays	15,032	15,633	16,087	16,489
Indirect form of support	6,339	6,408	6,488	6,569
- tax bonus	5,600	5,631	5,666	5,701
- lower pension-system contribution rate	739	777	822	868

Source: Ministry of Finance

The other forms of state support to families include the tax bonus (SKK 400 per month) and a reduced rate of mandatory pension insurance contributions (by 0.5 percentage point) granted to one of the parents for each dependent child.

Compensations to persons with severe disability

The persons with severe disabilities receive financial compensations from the state for the consequences of their impaired health. The projections are based on the legislative framework valid from February 2004 and the available relevant historical data.

Compensations paid to persons with severe disabilities (in SKK mn)				
	2004F	2005F	2006F	2007F
Compensations	5,348	5,562	5,723	5,866

Source: Ministry of Finance

IV.2. Social Insurance and Pension Saving Schemes

The new Act on Social Insurance entered into force as of 1 January 2004. The purpose of the new legislation is to put the amount of benefits paid from the system in better correlation to the amount of insurance contributions collected. The new system also entails certain institutional changes aimed at making it more efficient and improving its mechanisms of control.

The new social insurance system introduces other significant changes. The law redefines the system of social insurance, which, apart from the sickness, pension and accident insurance, also comprises the unemployment insurance. Unlike under the previous law, the unemployment insurance system is administered by the Social Insurance Agency (National Labour Office has been abolished). In order to enhance the transparency of financing, the pension insurance scheme has two components: old-age pension insurance and disability pension insurance. The *retirement age is being gradually increased* (9 months per year) and unified to bring the eligibility threshold for pension to 62 years for both men (between 2004 and 2006) and women (between 2004 and 2013), which will make the entire pension system sustainable in the long-run from the perspective of public finances. So far, the retirement age has been 60 year for men and 53 to 57 year for women depending on the number of children. The possibility of voluntary pension insurance has also been expanded. In the interest of ensuring balanced public finances, the law has reduced the pool of individuals on whose behalf the pension insurance contributions must be paid by the state.

The system for the provision of sickness benefits has been overhauled to prevent abusive claims and eliminate undesirable pressure upon public finances. *In the first ten days of sickness, the sickness benefits are paid by the employer*.

In response to the challenges of the aging society, the new law makes it possible to receive retirement pension and, at the same time, earn income from a gainful activity from which the pensioner pays mandatory insurance contributions into the system, which is then reflected in assessment of the pension amount. A new indexation mechanism for the indexation of pensions has been introduced (50% CPI-based inflation and 50% growth of nominal wage in the national economy).

The Act on the Retirement Pension Saving Scheme represents another important step in the pension system reform: from the year 2005, the law establishes a strong 2nd pillar (with contributions representing *9% of the gross wage*) of the pension system – retirement pension saving scheme – the purpose of which is to secure long-term financial stability of the pension system, diversify the risks entailed in individual methods of financing, and broaden the margin for the increase of old-age pensions. Participation in the pension saving scheme will be mandatory for those who were not insured by the Social Insurance Agency before 1 January 2005. The persons insured by the Social Insurance Agency prior to 1 January 2005 will have to decide – between 1 January 2005 and 30 June 2006 – as to whether they want to enter the pension saving scheme or remain only in the pay-as-you-go system. The uncertainty regarding the number of persons entering the new system poses a risk to public finances. This uncertainty will be eliminated only after the first half of 2006.

Balance of social insurance in the current year (in SKK mn)				
	2004F	2005F	2006F	2007F
Revenues in the current year	**114,027**	**123,395**	**133,609**	**143,498**
Sickness contributions	8,299	9,055	9,854	10,593
Pension contributions	85,017	91,951	99,640	107,064
- old age pension contributions	66,142	71,535	77,522	83,299
- disability pension contributions	18,875	20,416	22,118	23,766
Accident contributions	2,108	2,377	2,546	2,713
Guarantee contributions	640	689	748	802
Unemployment contributions	7,189	7,099	7,633	8,128
Reserve fund	7,427	8,843	9,651	10,397
Administration fund	3,347	3,382	3,537	3,801
Expenditures in the current year	**109,931**	**118,157**	**127,139**	**133,937**
Sickness benefits	5,580	5,414	5,630	5,827
Pension benefits	97,299	105,356	113,673	119,702
- old age pension benefits	72,210	79,404	85,317	89,862
- disability pension benefits	25,088	25,951	28,356	29,840
Accident benefits	700	760	820	880
Guarantee benefits	150	150	150	150
Unemployment benefits	2,856	3,096	3,328	3,577
Reserve fund	0	0	0	0
Administration fund	3,347	3,382	3,537	3,801
Balance (revenues – expenditures)	**4,096**	**5,238**	**6,470**	**9,560**
Sickness insurance	2,719	3,641	4,224	4,765
Pension insurance	-12,282	-13,404	-14,034	-12,637
- old-age pension insurance	-6,068	-7,869	-7,795	-6,564
- disability pension insurance	-6,214	-5,535	-6,238	-6,074
Accident insurance	1,408	1,617	1,726	1,833
Guarantee insurance	490	539	598	652
Unemployment insurance	4,333	4,003	4,305	4,551
Reserve fund	7,427	8,843	9,651	10,397
Administration fund	0	0	0	0

Source: Social Insurance Agency

The Ministry of Labour, Social Affairs and Family is currently drafting the Act on Supplementary Pension Savings Scheme, the purpose of which is to reform the system of supplementary pension insurance.

The table presented above shows the anticipated balance of the social insurance system without taking into account the introduction of the second pillar, which is quantified in the first part of the preceding chapter. The calculation of the spillover of funds to the second pillar assumes the rates of participation of particular age groups in the second pillar in line with the estimations prepared by the World Bank based on opinion polls and empirical experience. It is assumed that approximately 70% of the population below age 45 will enter the multi-pillar system.

IV.3. Active Labour Market Policy

A new legislative framework has been put in place to improve the quality and delivery of the employment services in line with the goals and objectives of the European Employment Strategy. The main goal of the reform measures is to make the labour market more flexible and increase the motivation of the jobless to get employment as soon as possible and improve their social situation through work.

Funds for the Active Labour Market Policy (in SKK mn)				
	2004F	2005F	2006F	2007F
EU Funds	1,273	2,251	2,491	3,784
Co-financing	482	831	920	1,398
State budget funds - national ALMP programmes	1,519	1,569	1,405	602
Total funds	**3,273**	**4,651**	**4,816**	**5,784**
Number of unemployed (thousands)	426	418	404	394

Source: Ministry of Financer

Given the anticipated decline in the rate of registered unemployment, the total amount of funds budgeted for the Active Labour Market Policy in 2005-2007 will dynamically increase from year to year. The European Social Fund, which will provide significantly more funds than in 2004, will also play an important role.

IV.4. Education

Regional school system

Although the number of students attending primary and secondary schools has declined significantly over the past decade, the capacities of the regional school system remained unchanged. The decline in the number of students has not yet resulted in the reduction or optimisation of the school network, nor has it caused any significant layoffs of teachers and other employees from the system. The law, which entered into force in 2004, addresses this issue by introducing the concept of standardised allocations per student ("normative"). The indexation mechanism of the standardized allocation is bound to the number of students and the rate of inflation.

Regional school system					
	Unit	2004F	2005F	2006F	2007F
Number of students at primary and secondary schools*	persons	931,541	899,955	872,823	843,216
Volume of funds for the regional school system	SKK mn	39,683	39,874	39,793	39,404
Volume of funds per student through MoE budget line	SKK	42,600	44,307	45,591	46,731
Change in the amount of expenditures per student, year-on-year	%	-	4.0	2.9	2.5
Anticipated headline inflation rate	%	8.1	4.0	2.9	2.5

** the calculation of expenditures per student takes into account only the number of students attending primary and secondary schools and do not include those attending special schools, kindergartens and extracurricular establishments.*
Source: Ministry of Finance

The total state-budget allocation in 2005 is expected to reach SKK 39.9 billion. In comparison with 2004, these expenditures will increase by 2.6% despite the declining number of students. The 2006 and 2007 allocations should reach SKK 39.8 billion and SKK 39.4 billion, respectively.

Tertiary education

The draft 2005 budget assumptions envisage transfers for 20 public universities in the amount of SKK 10 billion, which is 5.5% more than in 2004. The transfers in the 2005 and 2007 budgets should amount to SKK 10.5 billion and SKK 11.0 billion, respectively. The state budget expenditures for universities will thus increase at a steady annual rate of 5%. The proposed package of expenditures on public universities also includes funds earmarked to support their research and development activities; in addition, universities may apply for R&D grants financed from EU funds or the Science and Technology Support Agency.

The funds provided to state universities from the budget chapters of the Ministry of Defence, Ministry of the Interior, Ministry of Health and Ministry of Justice should reach approximately SKK 1.2 billion in 2005.

In 2005, all types of schools and educational establishment may bid for the financing of their projects from the EU structural funds in the budget chapter of the Ministry of Education (SKK 800 million, including co-financing). The amount of both the EU structural funds and the national co-financing is expected to increase progressively. Universities may also bid for grants from the EU within the framework of 'internal measures' in the amount of SKK 1.5 billion in 2005 to SKK 2.7 billion in 2007. It is realistic to assume that universities will absorb at least SKK 500 million from the EU funds in 2005.

The total public expenditures on universities from the general government budget in 2005 will reach SKK 11.7 billion (assuming that the EU component will reach SKK 500 million). The proposed volume of public expenditures on university education in 2005 accounts for 0.85% of GDP.

The strategic [and the most demanding] goal in the sector of tertiary education is to create conditions conducive to the efficient functioning of the system so that the high-quality university education, meeting the international standards, becomes accessible in a matter of several years to all those who qualify for successful study. However, this goal can only be achieved if and when the provision of adequate funding to universities is secured. The system of multi-source funding will be supported in this connection. The proposed new system also introduces students' contribution towards the cost of tuition, both in full-time and part-time courses of study. At the same time, specific attention will be paid to improving the system of social support to students. The objective is to create and put in place an efficient system of student loans and expand the system of welfare grants. Nonetheless, the 2005-2007 budgetary assumptions do not take account of these student loans.

IV.5. Healthcare Sector

During the relevant period, the state of public finances will be determined by the reform of the health-care system. The goal of the reform is to balance the revenues and expenditures of the sector by enhancing efficiency of the system (on the supply side), mobilising additional revenue sources, by increasing the participation of patients' co-payment element (on the revenue side), and adjusting the citizens' expectations (on the demand side). The objective is to bring the system in balance at the level of 6.5% of GDP, with public funds representing 5.2% of GDP. The current system of financing – with revenues accounting for 6.1% of GDP and expenditures far above – has accumulated a debt of SKK 26.6 billion, which can only be redeemed through *ad hoc* transfers from outside the system. Moreover, the reformed system will be capable of absorbing the negative fiscal impacts resulting from a shift in the disease prevalence (non-communicable and chronic diseases prevail) and population aging. The reform will be implemented in three stages:

1. Stabilisation measures aimed at bringing the debt growth to a halt.
2. Systemic measures aimed at making the health-insurance scheme more efficient.
3. Network measures aimed at enhancing the quality and efficiency of health care providers.

The first stage of the reform, launched in 2003, resulted in the reduction of expenditures by 0.4%. It included specification of the term "health care" and the related services, introduction of a fee for seeing a doctor, prescription fee, and fees for the provision of related services.

The objective behind the introduction of these fees was more micro-economic than fiscal – to reduce excessive consumption of drugs and excessive provision of health-care services. The next steps included changes in the drug policy and categorisation of drugs. The drugs have been categorised in a new manner based on the presence of active substances. The third important change included the restructuring of the network of the state-run health care facilities.

The new architecture of the system, based on the criteria of equality (vertical and horizontal) and universality, similarly as the old system, is financed from public funds that are collected and redistributed based on the principle of solidarity.

The rate of the mandatory insurance contributions payable by all economically active persons is flat and becomes degressive when the highest assessment base – three times the average wage – is exceeded. The proposed increase of the maximum assessment base for the calculation of mandatory insurance contributions by 30% will affect about 5.4% of the workforce. Although this will slightly increase the cost of labour, it is unlikely to have any impact upon employment – those affected are mostly managers or professionals-specialists. Unlike the current *ad hoc* system, the contributions paid from the state budget on behalf of the economically inactive population and vulnerable groups (including the persons formerly insured by the National Labour Office and Social Insurance Agency) will be mandatory at a rate of 4% of the average monthly wage for the previous two calendar years. The proposed solution will increase the transparency and predictability of revenues and relate them to the real economic indicators. After the system change in 2004, the revenues should largely correspond to the nominal-wage increase. The non-systemic transfers from the Social Insurance Agency will be abolished.

In determining the scope of health-care services paid for from the public health insurance, a proper account has been taken of the shift in the structure of diseases, unfavourable demographic development, technological progress in the health sector in general and in the pharmaceutical industry in particular, and, to a certain degree, the excessive expectations of citizens, availability of funds, and the requirement to keep the system in balance. In contrast to the implicit rationing of health care services at the micro-level under the original system, the reformed system uses the concept of explicit rationing, i.e. specification of clear, transparent and quantifiable rules and respect for the applicable medical, ethical and economic criteria. This approach eliminates the occurrence of irresolvable ethical dilemmas on the part of health-care providers and narrows the margin for corruption. The proposed coverage of the solidarity package maximizes the improvement of public health and quality of life within the given financial constraints. During the period under review, the capital expenditures from the central government budget are expected to diminish overtime (by approximately SKK 0.5 billion per year) as the responsibility for capital investments shifts gradually to health insurance companies. Gradual introduction of differentiated patients' co-payments for health care services represents a significant change. The share of expenditures from public funds should consolidate at a level of 5.2% of GDP. The mandatory insurance contributions will, nevertheless, remain a substantial source of revenues – approximately 2/3 of total revenues at the end of the period.

Revenues of the health-insurance system (SKK bn)					
	2003E	**2004F**	**2005F**	**2006F**	**2007F**
Public insurance	58.2	61.3	70.9	75.3	79.8
Contributions	40.8	43.3	50.0	53.0	56.1
Employees and employers	37.5	39.9	45.4	48.3	51.4
- employees	10.8	11.5	13.0	13.9	14.8
- employers	26.7	28.5	32.3	34.4	36.7
Self-employed persons	2.0	2.8	4.0	4.0	4.0
Other	0.3	0.5	0.7	0.7	0.7
Penalties, sanctions, overdue contributions	0.2	0.2	0.2	0.1	0.1
State budget contributions	16.1	18.1	20.8	22.2	23.7
National Labour Office contributions	0.6	0.0	0.0	0.0	0.0
Social Insurance Agency contributions	0.7	0.0	0.0	0.0	0.0
Expenditures from the budget line of the Ministry of Health (excluding state budget contributions) including outlays of other ministries and public authorities + research expenditures + capital expenditures	4.8	5.5	3.4	3.2	3.2
PUBLIC FUNDS	**63.0**	**66.8**	**74.3**	**78.5**	**83.0**
PRIVATE FUNDS	**10.5**	**14.0**	**16.0**	**19.0**	**21.0**
TOTAL FUNDS (public and private)	**73.5**	**80.8**	**90.3**	**97.4**	**104.0**
GDP	1195.8	1291.3	1383.6	1495.9	1602.6
Funds/GDP	6.1%	6.3%	6.5%	6.5%	6.5%
Public funds/GDP	5.3%	5.2%	5.4%	5.2%	5.2%

Source: Ministry of Finance

The table indicates a significant increase in the amount of available funds between 2005 and 2004. However, on the other hand, the system will no longer be generating new debts. In addition to the public health insurance, individuals will have an option to buy private health insurance policies covering health-care services above the basic package covered by the public health insurance system. While under the previous system, the health insurance companies were public-service institutions with obligatorily balance budgets, the reform contemplates the existence of health insurance companies as commercial operators – joint stock companies. These companies may produce profit or loss, are subject to severe budgetary restrictions, must have transparent financial links and must keep standard accounts and have such accounts audited. The purpose is to apply the rules of market economy, subject to certain regulated conditions, also to the field of health care. The supervision over the health insurance companies and health care providers will be performed by the National Health Care Supervision Authority. The supervision over the insurers offering private health-insurance schemes will be performed by the Financial Market Authority.

IV.6. Other Significant Areas

Agriculture

Slovakia's accession to the European Union (EU) is accompanied by significant changes in the financing of the agricultural sector. These trends are connected with the Common Agricultural Policy (CAP), which, in view of the negotiated position of the Slovak Republic, narrows the margin of manoeuvre for budgetary expenditures. The EU funds will account for almost 70% of total expenditures from the agricultural line of budget in 2005. In line with the increased inflow of EU funds into the system, the national budget will have to make increased allocations to co-finance projects funded from the rural development, structural and pre-accession funds. With a view to these trends, the overall expenditures for agriculture will continue to increase in the years to come.

Funds in the budget line of the Ministry of Agriculture (in SKK mn)				
	2004F*	2005F	2006F	2007F
State budget funds **	8,100	6,100	6,100	6,200
EU funds	10,600	14,200	15,600	17,000
Total	18,700	20,300	21,700	23,200

** Total of state budget own expenditures and expenditures for co-financing*
*** In the year 2004, the expenditures do not include funds for water management in the amount of SKK 0.5 billion*
Source: Ministry of Finance

The budgetary assumptions for 2005 and 2007 show a considerable increase in the inflow of EU funds. Their volume in 2005 will increase by 34% compared with 2004. The rate of increase in the following years will be more moderate.

Environment

Environment is one of the areas with the largest anticipated influx of EU funds between 2005 and 2007. This fact will be reflected in the significant increase of expenditures from this budget chapter, most of which will be bound to specific projects. In the year 2005 alone, the expenditures (including pre-accession funds) will rise by almost 66% compared with the previous year. In the subsequent years, the average rate of increase will stabilize at 17%. The increased inflow of EU funds has been taken into account in the budget assumptions by increasing their co-financing component.

Funds in the budget line of the Ministry of Environment (in SKK mn)					
	2003	2004F*	2005F	2006F	2007F
State budget funds **	3,300	3,500	3,900	4,300	4,400
EU funds	1,100	1,700	4,700	6,200	7,300
Total	4,400	5,200	8,600	10,500	11,700

** Total of state budget expenditures for co-financing*
*** In 2004, expenditures of the Ministry of the Environment also take account of the transfer of funds for water managemant*
Source: Ministry of Finance

Infrastructure

The outlays from the state budget for railways are designed to finance railway services performed in public interest and the upgrading of railway links.

Expenditures on infrastructure (in SKK mn)				
	2004F	2005F	2006F	2007F
Subsidies for railway service in public interest	6,630	6,900	6,900	6,900
Railways – investment expenditures	4,881	5,271	5,078	5,180
Railways – total	11,511	12,171	11,978	12,080
Roads – maintenance*	1,387	1,415.0	1,443	1,472
Roads – investment expenditures **	11,411	11,130	11,353	11,580
Roads – total	12,799	12,545	12,796	13,052
Railways and roads – total	24,310	24,716	24,774	25,132

** takes account of decentralisation to Higher Territorial Units (SKK 1,200 million)*
*** takes account of decentralisation to Higher Territorial Units (SKK 100 million)*
Source: Ministry of Finance

The proposed budgetary outlays for services performed in public interest for the years 2005, 2006 and 2007 amount to SKK 6.9 billion, which is 4% more than in 2004.

The upgrading of the railway transport links in 2005 will be exclusively financed from the EU structural funds, the Cohesion Fund and pre-accession funds, which total SKK 5.3 billion (including co-financing from the national budget). This represents an 8% increase in expenditures compared with 2004. In 2006 and 2007, the expenditures should slightly decline (compared with 2005) as a consequence of a lower support from EU funds.

The budgetary chapter of the Ministry of Transport, Posts and Telecommunication plans to spend SKK 11.1 billion for the construction and reconstruction of the road network (the construction and maintenance of the 2nd and 3rd class roads has been transferred under the responsibility of the Higher Territorial Units) and the construction of motorways, of which SKK 4.7 will be contributed from the Cohesion Fund, ISPA and PHARE (including co-financing). Compared with 2004, the expenditures on road infrastructure will increased by SKK 0.2 billion. The plan for 2006 and 2007 is SKK 11.4 billion and SKK 11.6 billion, respectively.

IV.7. Public Finance Management Reform

Apart from structural reforms, also proper management is exceptionally important to making the processes within the public finance framework more efficient.

In order to achieve a sustainable development of public finances and fulfill the convergence criteria, the public finance management reform continues to be implemented. The steps taken in 2003 focused particularly on:

- development of a methodology for the compilation of a medium-term fiscal outlook and Pre-accession Economic Programme in line with the EU requirements,
- further implementation of the ESA95 methodology
- elimination of the potential for local governments and social security funds to run into uncontrolled deficits,
- improved conceptual approach to budgeting by enhancing the importance of the underlying assumptions,
- implementation of a pilot project introducing the so-called (results-oriented) programme budgeting.

In April 2003, the government approved a paper entitled the "*Public Finance Management Reform Strategy*". Based on the strategy, the public finance management reform focuses on three inter-dependent areas:

- enhanced transparency of public finances,
- enhanced role of the strategic planning in the allocation of funds and transition towards the result-oriented budgeting,
- development of a system for setting up a medium-term framework for public finances.

The *transparency* component entails further steps towards meeting the standards and adhering to the principles of fiscal transparency. The objective here is to identify potential sources of hidden debts in the economy and, subsequently, quantify the inherent risks for public finances. It is equally important for the same principles of transparency to apply to all components of the public budget and for the deficit and debt in the sector of general government to remain fully under control of the government and parliament. The intention behind the effort is to strengthen the accrual principle of accounts maintained by the bodies of public administration. In the year 2003, all public budgets were already prepared under the ESA95 methodology.

One of the key trends in a modern approach to budgeting is to strengthen strategic planning and management via the (results-oriented) *programme budgeting*. The programme budgeting was introduced through a pilot project covering four chapters in the 2002 budget, which was then expanded to nine chapters in the 2003 budget. The 2004 budget was fully prepared in a wholly programme-based structure. From 2005 onward, the programme structure will be used as a primary structure for the allocation of budgetary expenditures. The rationalisation of expenditures through a shift from capacity financing to output financing will also be strengthened by the analysis of budgetary expenditures. The first step was taken back in May 2003 when a technical IMF mission analysed the public finance "macro-structure".

In the interest of strengthening the medium-term public finance framework the government intends to develop a system of macro-economic projecting, which will provide reliable and conservative estimates of future macroeconomic developments, and design and put in place a methodology for multi-annual budgeting, including a transparent mechanism for making decision on the future government activities and the related expenditures. A system of macroeconomic modelling, designed in 2003, was put in full operation in 2004. The methodology of multi-annual budgeting should be fully applied starting from the 2005 budget.

The establishment of the *State Treasury* and the *Debt and Liquidity Management Agency* represents an important step in the public finance reform. The role of the Debt and Liquidity Management Agency is make the management of the state debt professional, facilitate the government securities market, and minimise the cost of debt service. The role of the State Treasury is to make the cash flows in the public finance sector as efficient as possible. Both institutions are operational since 1 January 2004.

V. LONG-TERM SUSTAINABLITY OF PUBLIC FINANCES

For the purposes of the Convergence Programme, the long-term sustainability has been defined as the ability to maintain the general government deficit below 3% of GDP and the net debt below 60% of GDP, both before and after the culmination of demographic problems in around 2055. The main purpose of this part is to briefly describe the efforts of the Slovak government to reform the system of public finances and identify their impact upon long-term sustainability. One of the main goals is to bring the public finance deficit to 3% of GDP by 2007. This ambitious goal can only be achieved through in-depth and far-reaching reforms in a number of areas of public finances. Another milestone is the year 2010, by which time the long-term sustainability of public finances should be achieved.

V.1. Assumptions

The projection is based on the legislative changes, either already approved or under preparation, which affect the key pillars of the public finance reform:

- Tax reform – particularly its impact on productivity: introduction of a flat tax rate (19%) and abolition of most exemptions from tax liability; unification of VAT rates at 19%; abolition of the tax on dividends, inheritance, transfer and assignment of real estate, and the gift tax;
- Pension system reform – impact on public expenditures and participation rate: gradual increase of the retirement age to 62 years; direct link between the contributions paid and pensions received; introduction of the second fully-funded pillar with 9% of the gross wage transferred under the pay-as-you-go and 9% under the second pillar;
- Health care reform – impact on public expenditures: introduction of patients' co-payments and reduction of the basic package of services covered by the public health insurance scheme;
- Labour market and provision of social assistance – impact on unemployment rate: restructured social assistance benefits and stricter conditions of eligibility; introduction of a tax bonus per child (motivation for the working population) and the uniform rate of child allowance irrespective of the parents' level of income;
- Education reform: introduction of students' contributions towards the cost of tuition at universities;

In most cases, the calculations are based on a methodology similar to that presented in the publication „Budgetary challenges posed by ageing populations" (2001), written by the Ageing Working Group of the Economic Policy Committee (EPC). The projection includes the expenditures of the pension system, health care system, education system, child allowances, and the child tax bonus. The calculations cover the period until 2080, with the demographic cycle expected to peak at around 2055.

The calculations show that government reforms represent a giant leap towards achieving the long-term sustainability of public finances. The reduction of the public finance deficit to 3% of GDP by 2007 is not sufficient to cope with the problem of population ageing. In spite of this, long-term sustainability is achievable between 2008 and 2010 also without additional substantial structural reforms.

V.2. Demography

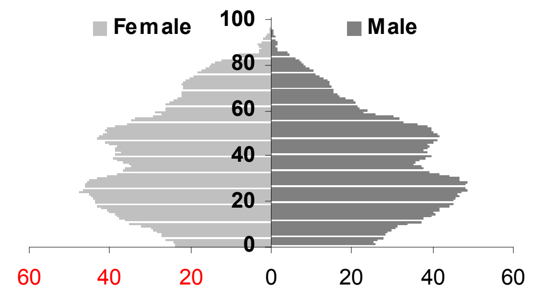
For the purposes of the Convergence Programme, the Ministry of Finance performed an internal population simulation, which is based on the 2001 population census. For the sake of comparison, the table also shows the assumptions used by the World Bank in preparing the population prognosis.

Demographic assumptions

	Slovak Republic							EU average	
Baseline scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2080**	**2000**	**2050**
Population ('000)	**5,381**	**5,404**	**5,447**	**5,405**	**5,237**	**5,031**	**4,379**		
aged 0-14	941	810	812	751	662	664	594		
aged 15-64	3,817	3,919	3,735	3,518	3,308	2,904	2,506		
aged 65 +	622	674	900	1,136	1,267	1,463	1,279		
Life expectancy (M)	70.2	71.3	73.3	74.9	76.0	77.1	81.0	75.0	80.0
Life expectancy (F)	78.0	79.0	80.8	82.2	83.0	84.0	87.7	81.3	85.5
Fertility rate	1.17	1.28	1.46	1.58	1.64	1.70	1.70	1.50	1.70
Migration balance ('000)	1.4	2.4	4.2	5.9	7.7	9.5	15.0		
Net migration (% pop.)	0.03	0.05	0.08	0.11	0.15	0.19	0.34		
World Bank assumptions									
Fertility rate	1.40	1.40	1.70	2.00	2.10	2.10	2.10		
Life expectancy	73.3	75.1	76.6	78.0	79.5	81.1	84.3		
Low scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**	**2070**	**2080**
Population ('000)	5,381	5,402	5,399	5,270	5,005	4,657	4,261	3,842	3,464
Fertility rate	1.17	1.22	1.34	1.42	1.46	1.50	1.50	1.50	1.50
Migration balance ('000)	1.4	0.7	1.6	2.3	2.8	3.4	3.9	4.5	5.0
High scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**	**2070**	**2080**
Population ('000)	5,381	5,407	5,507	5,570	5,531	5,470	5,396	5,328	5,337
Fertility rate	1.17	1.38	1.66	1.82	1.86	1.90	1.90	1.90	1.90
Migration balance ('000)	1.4	4.3	8.1	11.2	13.7	16.1	18.6	21.0	23.5

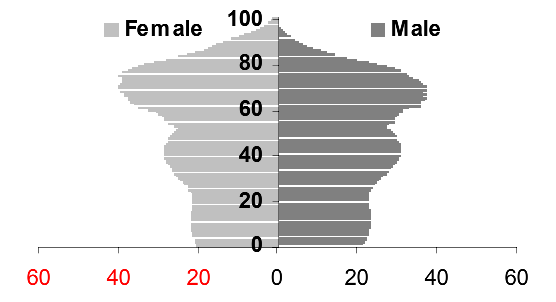
Source: Ministry of Finance

Structure of population in 2004 ('000 persons)



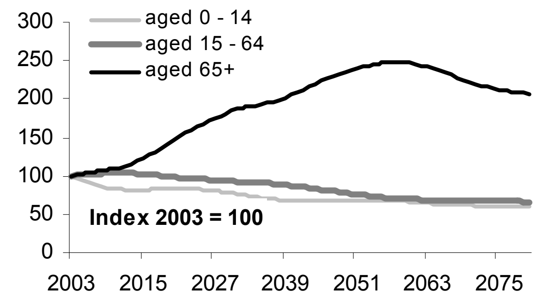
Source: Ministry of Finance

Structure of population in 2055 ('000 persons)



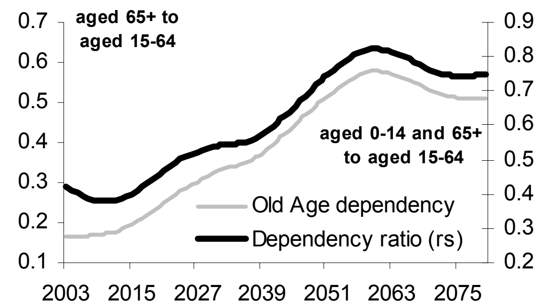
Source: Ministry of Finance:

Trends in age groups



Source: Ministry of Finance

Demography – indicators



Source: Ministry of Finance

The Slovak Republic is currently among the EU countries with the lowest fertility rates (Italy, Spain, Luxembourg). We nevertheless expect the fertility rate in the nearest future to rise and reach the average of the former EU-15 by the year 2050. The life expectancy of men and women will increase by 2050 by more than 7 and 6 years, respectively.

At such parameters, the most critical demographic structure is likely to occur around 2060 when the share of citizens older than 65 in the working population (15 – 64) will reach almost 58%. This relationship can be illustrated by the "old age dependency ratio", which shows that the population ageing problem in Slovakia is not as acute as in the European Union. In spite of this, the demographic development in Slovakia will turn around shortly and this indicator will stop growing in 2060.

Demography – indicators

	Slovak Republic							EU average	
	2002	2010	2020	2030	2040	2050	2080	2000	2050
Old Age Dependency ratio (inv.)	6.14	5.81	4.15	3.10	2.61	1.99	1.96	4.17	2.04
2002 index	*1.00*	*0.95*	*0.68*	*0.50*	*0.43*	*0.32*	*0.32*	*1.00*	*0.49*

Source: Ministry of Finance

V.3. Economic Growth and Employment

Apart from the legislation already enacted, the calculations take also into account other legislative changes that are still in the pipeline of the pension system reform. These include, in particular, the progressive increase in the retirement age from the approved 62 to 65 years of age starting from 2013. Since the upward adjustment of the retirement age concerns mainly those aged 55 – 64, the rate of participation within this age category has significantly increased. The increase among the remaining age categories has so far been moderate. After 2020, when the retirement age will have reached its target level, the rates of participation will increase linearly as the average life expectancy is expected to grow.

The combination of the medium variant of the demographic prognosis and the expected rate of participation results in a fairly considerable labour force contraction between 2015 and 2060 (by more than 25%), which is probably a conservative scenario. In fact, the Ministry of Finance anticipates higher participation rates and migration figures than those appearing in the baseline scenario. We believe the main reasons are as follows:

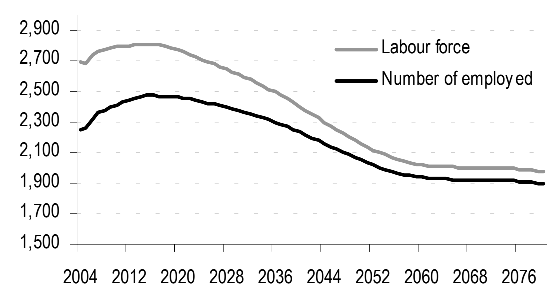
- high percentage of citizens with secondary education by European standards
- the current participation rate of women aged 25-49 is more than 10 percentage points above the EU average
- Slovakia is on the easternmost border of the EU, which is a favourable geographical location in terms of immigration
- possibility to work and, at the same time, receive old-age pension
- the proportion of part-time jobs in the economy is currently very low
- catching up with the EU economic level will escalate demand for labour.

The level of unemployment is largely influenced by the difference between the number of people entering and exiting the labour market. The *unemployment rate* assumptions took these facts into account and, also for the reason given in the last indent, unemployment should drop to 13.8% by 2010 (very conservative scenario), 11% by 2020 and 9% by 2030.

During 2050 – 2060, when the demographic problems will culminate and the supply of labour shrink considerably, the estimates oscillate around 4-5%.

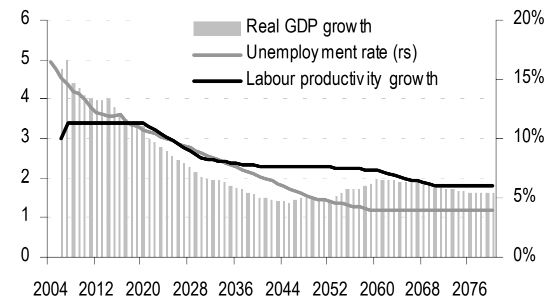
The *productivity of labour* is expected to gradually near the EU-15 average. In spite of this, we may expect a relatively strong convergence in the nearest 20 to 30 years and a considerably higher growth in the productivity of labour compared with the developed countries.

Labour market development ('000)



Source: Ministry of Finance

Macroeconomic assumptions



Source: Ministry of Finance

Labour market and macroeconomic assumptions (%)

	Slovak Republic							EU average	
	2002	2010	2020	2030	2040	2050	2080	2000	2050
Participation rate (male)									
15 – 54	80.9	83.4	86.3	84.9	84.4	85.3	85.8	85.1	84.6
55 – 64	42.1	49.8	52.0	56.9	57.7	59.4	68.6	52.6	56.0
65 +	5.1	5.2	5.5	6.3	7.3	8.1	10.9	5.0	3.9
Participation rate (female)									
15 – 54	71.7	73.7	77.0	76.4	75.4	76.3	77.4	67.0	77.1
55 – 64	10.7	20.0	31.9	37.5	41.5	45.9	60.8	29.9	46.7
65 +	1.8	1.9	2.1	2.8	3.6	4.3	6.5	1.9	1.7
Unemployment rate	18.5	13.8	11.0	9.0	7.0	5.0	4.0	7.8	8.0
Labour productivity growth	4.3	3.4	3.4	2.5	2.3	2.3	1.8	1.8	1.8
Real GDP growth	4.4	4.1	3.3	2.0	1.5	1.5	1.6		
Inflation rate	3.3	3.8	3.5	2.8	2.5	2.3	2.0		

Source: Ministry of Finance

V.4. Expenditure Analysis

Pension expenditures

In order to estimate the expenditures of the pension system, the MoF used the World Bank's "PROST"(Pension Reform Option Simulation Toolkit) model in order to simulate the impacts of ongoing pension reform and the introduction of the 2nd fully-funded pillar. This model allows to track old-age and disability benefits as well as survivor benefits payable to widows, widowers and orphans.

All these groups were defined as a percentage of the population and the individual benefit types were computed using the average replacement rate (i.e. the average amount payable in benefits after retirement was determined as a function of the average wage).

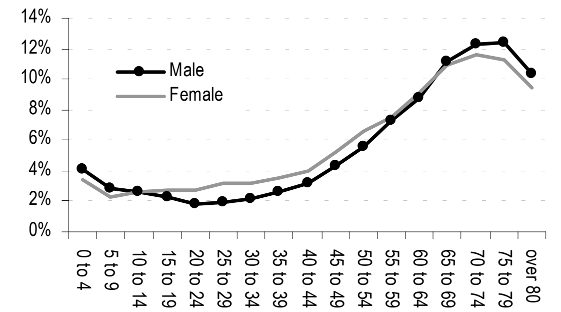
Apart from the aforementioned change in the retirement age (now 65 years of age), the simulation includes the parameters of the existing pension reform, while taking account of additional anticipated changes, such as the change in the indexation mechanism applicable to benefits awarded under the pay-as-you-go system. The existing method will remain in place until 2009 and as of 2010, pensions will only be adjusted according to the inflation.

According to estimates, the public pension system expenditures (as a percentage of GDP) will only increase by 0.2 percentage points until 2050. This relatively small increase is explained by the launch of the second pillar of the pension reform. Regard must be had to the revenue shortfall from the pay-as-you-go pillar, which is not part of the public revenues and which will certainly influence the gross debt level.

Health insurance companies expenditures

The forecast concerning expenditures on health care services was based on the age structure of the population and on the spending within each category. Long-term care is financed through social programmes; however, so far, there are no relevant data to calculate the expenditures in this category. On the other hand, this category is not very large, which means that disregarding these expenditures will not significantly distort the results of the calculation. For the following two years, the proposals of the Ministry of Health regarding the reform of the heath care system were taken into consideration. These proposals should become effective during the year 2004. The following graph shows the health care expenditures by age group (as % of the per-capita GDP).

Average health care expenditure per head expressed as a share of GDP per capita



Source: Ministry of Health

Education expenditures

Spending on education currently stands at 3.9% of the GDP. As far as the following years are concerned, the expenditures should reflect the decrease in the number of students caused by demographic changes. As a result, spending will go down to 3.5% of GDP[19]. For this period, we fixed expenditures at the 2007 level despite the fact that we expect another significant decrease in the number of students in the regional education system. In the medium-term, the Slovak Republic is looking to support investment into human capital. This objective should be supported by unlocking private funding for tertiary education.

Child allowances and tax bonus

Along with the numerous changes introduced in the social area and the launch of the tax reform as of January 1st, 2004, a new welfare system for parents and dependents was put in

[19] In reality it will be higher because of expected allocation from the government reserve for priorities.

place. Under the new system, an allowance of SKK 500 for each child is awarded irrespective of the income of the parents.

Also, the new tax system allows working parents to apply a tax bonus and deduct SKK 400 from their tax liability for each dependent child. Other types of assistance (e.g. one-off allowances payable after the birth of a child) were not contemplated in the calculations. In both cases, it was assumed that adjustments will be made according to the nominal wage.

V.5. Results

The following table summarizes the results of the projection:

Expected development of the public finances through 2080 – baseline scenario (% of GDP)

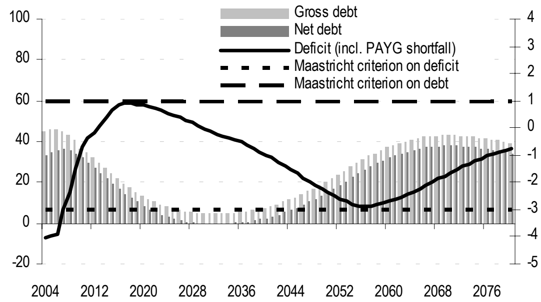
	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050	2060	2070	2080
Tax revenues	17.9	17.6	17.3	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0
Tax bonus	*-0.4*	*-0.4*	*-0.4*	*-0.4*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*
Social security contributions	13.1	13.7	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6	13.6
2nd pillar contributions	*0.0*	*0.5*	*0.9*	*1.0*	*1.2*	*1.3*	*1.3*	*1.5*	*1.7*	*1.9*	*2.0*	*2.0*	*2.1*	*2.1*
Other revenues	6.4	7.1	6.9	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Total revenues	**37.4**	**38.4**	**37.8**	**37.6**	**37.6**	**37.6**	**37.6**	**37.6**	**37.6**	**37.6**	**37.6**	**37.6**	**37.6**	**37.6**
Current expenditures	**37.6**	**37.4**	**36.6**	**35.5**	**34.6**	**33.7**	**32.9**	**31.1**	**31.8**	**32.6**	**33.9**	**34.2**	**33.1**	**32.3**
Pension system	7.2	7.3	7.2	7.1	7.0	6.8	6.6	5.8	6.7	7.1	7.4	6.8	5.5	4.9
Health care	4.7	4.6	4.8	4.7	4.8	4.8	4.9	5.3	5.7	6.1	6.3	6.4	6.2	6.2
Unemployment benefits	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
School system	3.9	3.9	3.7	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Child allowances	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.5	0.4	0.4
Other expenditures	20.9	20.7	20.1	19.3	18.6	17.8	17.2	15.9	15.4	15.5	16.1	17.0	17.4	17.3
wages	*8.4*	*8.1*	*7.8*	*7.5*	*7.3*	*7.1*	*7.0*	*7.0*	*7.0*	*7.0*	*7.0*	*7.0*	*7.0*	*7.0*
goods and services	*6.3*	*6.3*	*6.2*	*6.0*	*5.8*	*5.5*	*5.2*	*5.2*	*5.2*	*5.2*	*5.2*	*5.2*	*5.2*	*5.2*
interest	*2.6*	*2.8*	*2.7*	*2.6*	*2.3*	*2.2*	*2.1*	*0.8*	*0.3*	*0.4*	*1.0*	*1.9*	*2.3*	*2.1*
other	*3.7*	*3.6*	*3.4*	*3.4*	*3.2*	*3.1*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*	*3.0*
Capital expenditures	**3.9**	**4.2**	**4.2**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**
Total expenditures	**41.5**	**41.8**	**40.9**	**39.6**	**38.8**	**37.9**	**37.0**	**35.2**	**35.9**	**36.7**	**38.0**	**38.3**	**37.2**	**36.3**
DEFICIT	**-4.0**	**-3.4**	**-3.0**	**-2.0**	**-1.1**	**-0.2**	**0.6**							
DEFICIT (including PAYG pillar shortfall)	-4.0	-3.9	-3.9	-3.0	-2.4	-1.5	-0.7	0.8	0.0	-1.0	-2.4	-2.7	-1.6	-0.8
Primary balance	*-1.5*	*-1.1*	*-1.2*	*-0.4*	*0.0*	*0.7*	*1.4*	*1.6*	*0.2*	*-0.6*	*-1.4*	*-0.8*	*0.6*	*1.3*
GROSS DEBT	**45.1**	**46.4**	**46.1**	**45.5**	**43.6**	**40.6**	**37.0**	**13.7**	**5.0**	**7.8**	**20.4**	**37.2**	**43.1**	**39.3**
NET DEBT	**33.3**	**34.8**	**35.6**	**36.6**	**36.0**	**34.2**	**31.9**	**8.6**	**-0.1**	**2.7**	**15.3**	**32.1**	**38.0**	**34.2**

Source: Ministry of Finance

Remarks:
1) beyond 2007 GDP growth is equal to potential output growth
2) wages indexed by headline inflation + 2% (2008 - 2010)
3) goods and services indexed by 3% a year (2008 - 2010)
4) other expenditures indexed by headline inflation
5) gross debt is calculated as deficit (ESA95) + PAYG pillar shortfall (since 2011)
6) net debt is calculated as gross debt + net change of the cash deposit on accounts (debt increases due to the decrease of deposit in NBS)
7) deficit due to the introduction of the 2nd pillar is financed by privatisation revenues until 2010 (deposit in NBS)
8) average interest rate for the calculation of interest cost (debt service) was set at 5.5%

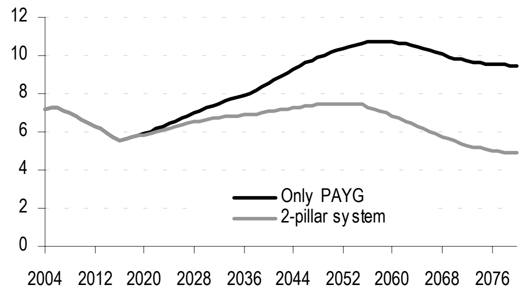
As we can see from the results, the following consolidation of public finances in the 2008-2010 period will ensure the long-term sustainability of public finances (as a result of the adjustment of the expenditures shown below the table). Without any further changes, Slovakia's public finances are ready to resist the pressures resulting from the aging of our population. The key element to achieve this development is reaching a budget position of "close to balance or in surplus" by the end of this or at the beginning of the next decade, which is a fundamental prerequisite for effective debt reduction.

Debt and deficit development (% of GDP)



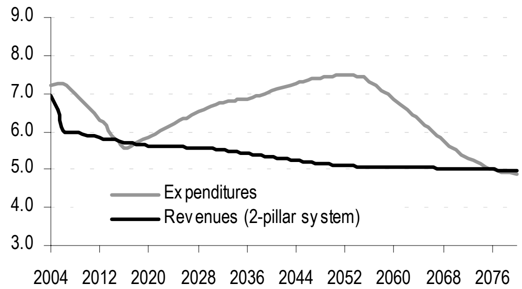
Source: Ministry of Finance

Expenditures on old-age benefits (% of GDP)



Source: Ministry of Finance

Revenues and expenditures of the Social Insurance Agency (% of GDP)

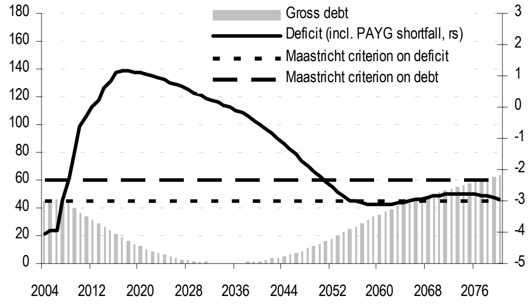


Source: Ministry of Finance

V.6. Simulations

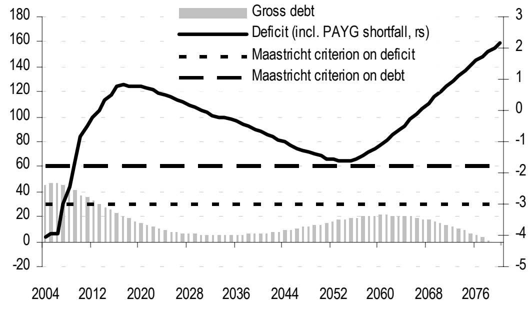
In addition to a medium variant, the MoF also formulated additional scenarios of demographic development: the low variant and the high variant (with both variant relying on the assumption of further consolidation in the 2008-2010 period). The following graphs demonstrate how the impact on public finances differs from scenario to scenario. Moreover, the following two graphs show the hypothetical development in deficit and debt without further consolidation starting in 2004 and 2007, respectively. Both graphs rely on the medium variant of our demographic forecast and of other macroeconomic indicators. Finally, there is a hypothetical scenario, the only difference being labour productivity, here up by 0.5 percentage points compared to the original scenario.

Demographic impact–low scenario (% of GDP)



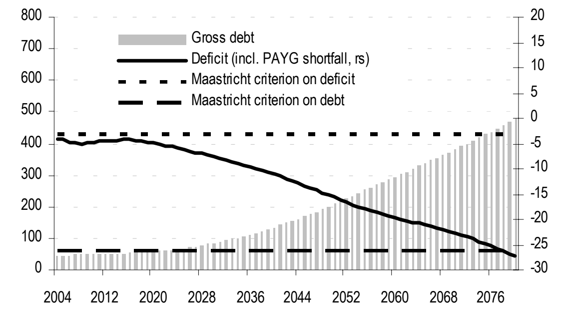
Source: Ministry of Finance

Demographic impact–high scenario (% of GDP)



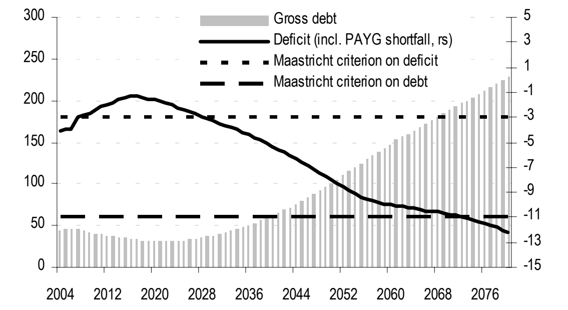
Source: Ministry of Finance

Development with fixation in 2004 (% of GDP)



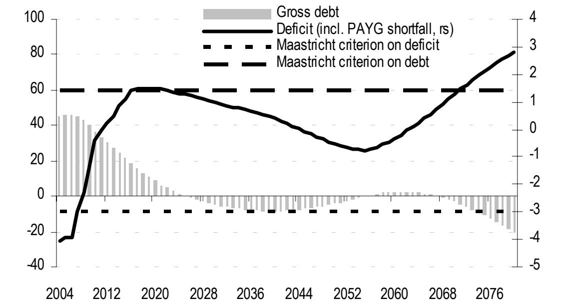
Source: Ministry of Finance

Development with fixation in 2007 (% of GDP)



Source: Ministry of Finance

Labour productivity up by 0.5 %



Source: Ministry of Finance

V.6. Fiscal Gaps

The fiscal gap is a very practical indicator in our effort to meet the criteria set out in the Stability and Growth Pact. The fiscal gap is the amount by which the primary balance should be adjusted in order to reach the pursued objective within a pre-defined period.

The MoF chose the years 2030 and 2055 (the latter being the most critical year in terms of demographic development and pressure on the public finances). Gross and net debt (60% of GDP reference value) and a public finance deficit below the 3% of GDP reference value (including the shortfall resulting from the introduction of the 2nd pillar of the pension reform) have been among the economic indicators used to monitor the condition of the economy. However, since according to the Stability and Growth Pact, the public finances should be kept "close to balance", the MoF calculated the fiscal gap even in the present conditions.

The following table shows the fiscal gap in a situation without further consolidation starting in 2004 and 2007 and also the baseline scenario with further consolidation until 2010. All calculations relied on the medium variant of demographic development.

Fiscal gap (% of GDP)

		Gross debt 60.0	Net debt 60.0	Deficit -3.0	Deficit 0.0
2030	2004	1.0	0.8	2.1	3.5
	2007	-1.0	-1.2	0.1	1.6
	2010	-2.9	-3.1	-1.5	0.0
2055	2004	3.0	2.9	3.5	4.2
	2007	1.1	1.0	1.6	2.3
	2010	-0.5	-0.6	0.0	0.7

Source: Ministry of Finance

The above results show that, in the absence of further consolidation (starting in 2004), the gap will widen and, in order to meet the criteria, revenues will have to be increased (or spending cut) by as much as 4.1 percentage points by 2055. It is also apparent that the present assumptions for the 2005-2007 general government budget create favourable conditions to attain long-term sustainability as early as in 2010.

VI. COMPARISON WITH PEP 2003

The Convergence Programme confirms the growth trend of the Slovak economy presented in PEP 2003. The current forecast of real GDP growth in 2003 and 2004 is in line with the initial forecast and the variances in 2005 and 2006 are negligible. As a matter of fact, they may be interpreted as a signal that, in 2006, we may expect even more positive effects resulting from the newly-launched export-oriented production facilities.

As far as the public finance deficit is concerned, the most significant variance is seen in 2003, which has to do, in particular, with the non-recurring positive effect resulting from an excess balance on various off-budget accounts. As far as the following years are concerned, the targets (disregarding the impact of the 2nd pillar of the pension reform) remain by and large the same as in PEP 2003.

As regards gross debt, there has been an adjustment on account of the repayment of certain guarantees from privatization proceeds.

Divergence from previous update (PEP 2003)						
	ESA code	2003E	2004F	2005F	2006F	2007F
GDP growth (%)						
Previous update	B1g	4.0	4.1	4.4	4.8	
Latest update	B1g	4.2	4.1	4.3	5.0	4.7
Difference		0.2	0.0	-0.1	0.2	
Actual budget balance (% of GDP)						
Previous update	B9	-5.0	-3.9	-3.4	-2.9	
Latest update	B9	-3.6	-4.0	-3.4	-3.0	-2.0
Difference		1.4	-0.1	0.0	-0.1	
General government gross debt (% of GDP)						
Previous update		43.9	44.8	46.4	47.6	
Latest update		42.8	45.1	46.4	46.1	45.5
Difference		-1.1	0.3	0.0	-1.5	

Source: Ministry of Finance

ANNEXES

ANNEX No. 1 – Indicative forecast until 2010

Forecast until 2010	Unit	2003	2004F	2005F	2006F	2007F	Average 2008F–2010F
GDP, constant prices 1995	%	4.2	4.1	4.3	5.0	4.7	4.3
Final household consumption	%	-0.6	1.3	3.8	4.1	3.8	3.5
General government final consumption	%	2.9	-0.1	1.0	1.9	1.5	1.1
Gross fixed capital formation	%	-1.2	3.8	7.0	7.0	3.3	4.3
Exports of goods and services	%	22.6	9.7	8.7	13.0	8.4	9.5
Imports of goods and services	%	13.8	9.5	10.0	11.6	6.8	9.2
Average annual inflation rate	%	8.5	8.1	4.0	2.9	2.5	3.5
Current Account Balance (BoP)	% of GDP	-0.9	-2.0	-2.7	-1.1	-0.4	-0.5
Average number of workers (as per Labour Force Survey)	%	1.8	0.5	0.6	0.6	0.9	0.7
Average unemployment rate (as per Labour Force Survey)	%	17.4	16.4	15.9	15.2	14.6	13.5
Average real monthly wage of a worker	%	-2.0	-0.3	3.0	2.7	3.0	2.8
Average SKK/EUR exchange rate	SKK	41.5	40.2	39.4	39.0	39.0	39.0
General Government Revenues (ESA 95) *	% of GDP	37.4	37.4	38.4	37.8	37.6	37.6
General Government Expenditures (ESA 95) *	% of GDP	40.9	41.5	41.8	40.9	39.6	37.9
General Government Balance (ESA 95) *	% of GDP	-3.6	-4.0	-3.4	-3.0	-2.0	-0.3

** disregarding the impact of the 2nd pillar*
Source: Ministry of Finance

ANNEX No.2 – Committee on Macroeconomic Forecasts

In an effort to enhance transparency and harness all available information and relevant experience in macroeconomic forecasting, the MoF approached seven organizations that achieved a certain level of excellence in this field and founded the Committee on Macroeconomic Forecasts.

The Committee meets twice per year: before the assumptions are formulated and before the State Budget Bill is finalized. The objective is to discuss the preliminary forecasts of the MoF, which may be subsequently modified according to prevailing opinion among the members of the Committee. The members have a very important role - to assess the forecasts produced by the MoF.

The MoF's medium-term forecast, which is the basis for the formulation of the assumptions for the 2005-2007 multi-annual budget, was rated by the members of the Committee as follows:

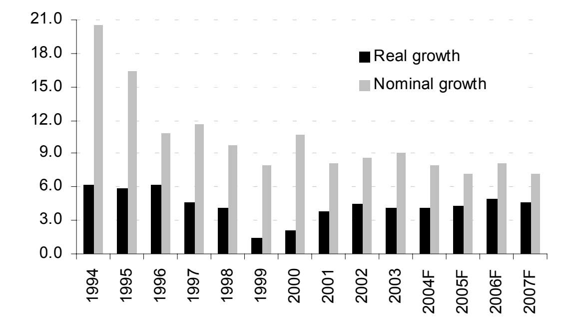
- conservative (ING Bank)
- conservative (Tatra banka)
- slightly conservative (SLSP)
- realistic (Infostat)
- realistic (VÚB)
- predominantly realistic (SAV)
- optimistic (NBS)

Committee on Macroeconomic Forecasts (average, 7 organizations)	Unit	2003	2004F	2005F	2006F	2007F
GDP at current prices	SKK bn	1,184.6	1,289.2	1,394.6	1,509.0	1,630.8
Real GDP growth	%	4.0	4.4	4.8	5.0	4.8
Final household consumption, real growth	%	0.0	2.1	4.1	4.6	3.9
Final household consumption, nominal growth	%	6.7	7.7	7.6	7.7	6.7
Average monthly wage in the whole economy (nominal growth)	%	6.8	8.1	7.5	7.2	6.4
Average employment growth as per Labour Force Survey	%	2.0	1.1	1.1	1.2	1.0
Average employment growth according to the number of unemployment claims	%	1.0	0.9	0.8	0.9	0.8
Consumer price index (average growth)	%	8.5	7.8	3.7	3.2	2.8
Producer Price Index (average growth)	%	8.3	3.9	2.9	2.6	2.4
Current Account Deficit (% of GDP)	%	-0.9	-1.7	-2.4	-1.9	-1.6
General government final consumption (real growth)	%	-0.3	1.6	2.2	3.1	1.5
Gross fixed capital formation (real growth)	%	-0.5	7.3	7.8	6.7	5.5
Exports of goods and services (real growth)	%	21.6	9.7	9.6	11.6	9.7
Imports of goods and services (real growth)	%	14.2	9.8	10.1	11.6	9.4
Unemployment rate (average, Labour Force Survey)	%	17.3	16.1	15.4	14.5	14.0

Source: Committee on Macroeconomic Forecasts

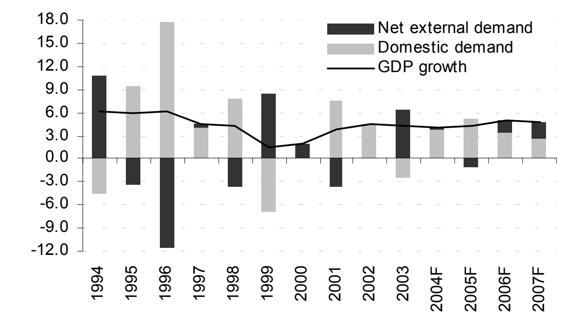
ANNEX No.3 – Graphs

GDP growth (%)



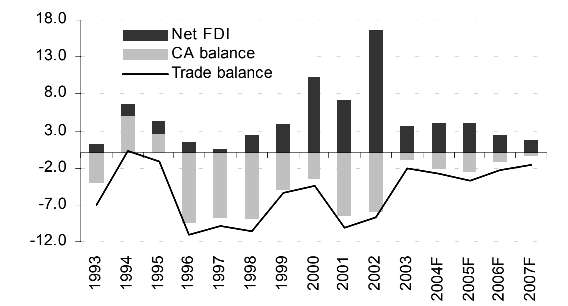
Source: Statistical Office, Ministry of Finance

Contribution to GDP growth (p.p.)



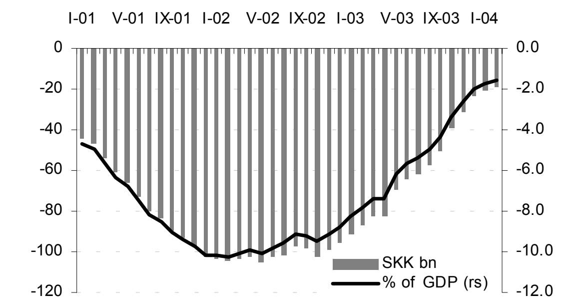
Source: Statistical Office, Ministry of Finance

Trade balance deficit (% of GDP)



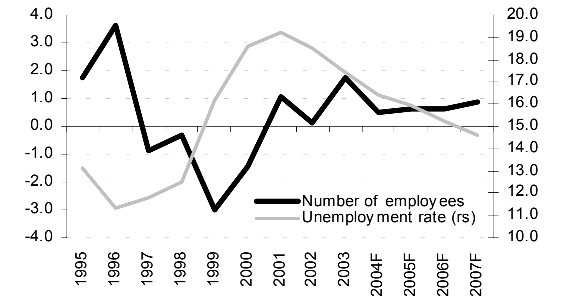
Source: Statistical Office, Ministry of Finance

Trade balance, 12-month cumulative



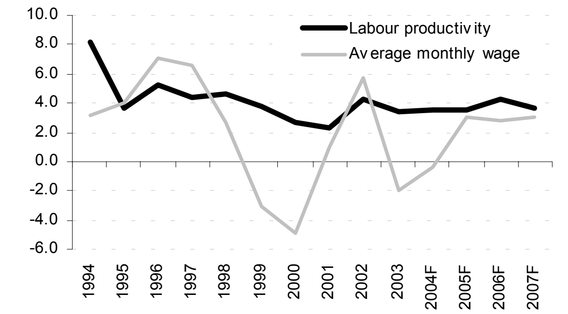
Source: Statistical Office, Ministry of Finance

Econ. activity as per Labour Force Survey (%)



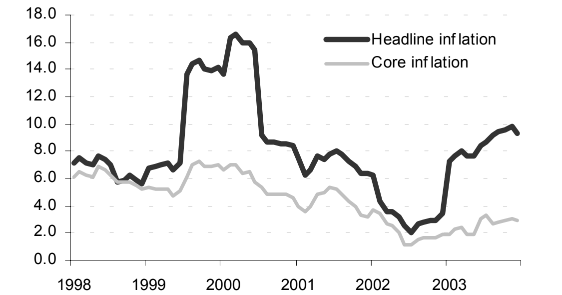
Source: Statistical Office, Ministry of Finance

Real labour productivity growth (%)



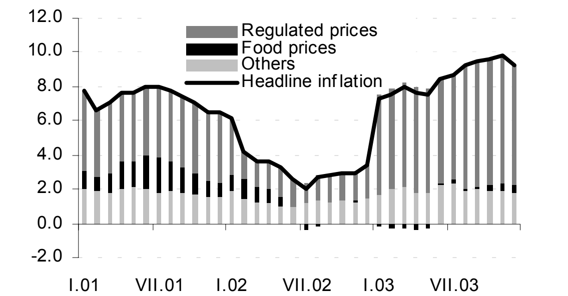
Source: Statistical Office, Ministry of Finance

Inflation development (%)



Source: Statistical Office, Ministry of Finance

Structure of headline inflation (p.p.)



Source: Statistical Office, Ministry of Finance

ANNEX No.4 – Tables Requested

Table 1: Growth and associated factors (%, if not stated otherwise)

	ESA code	2003	2004F	2005F	2006F	2007F
GDP growth at constant market prices (7+8+9)	B1g	4.2	4.1	4.3	5.0	4.7
GDP level at current market prices, SKK bn	B1g	1,195.8	1,291.3	1,383.6	1,495.9	1,602.6
GDP deflator (year-on-year growth)		4.7	3.7	2.7	3.0	2.3
CPI Change (annual average)		8.5	8.1	4.0	2.9	2.5
Employment growth*		1.8	0.5	0.6	0.6	0.9
Labour productivity growth**		3.4	3.5	3.6	4.3	3.7
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	-0.6	1.3	3.8	4.1	3.8
2. Government consumption expenditure	P3	2.9	-0.1	1.0	1.9	1.5
3. Gross fixed capital formation	P51	-1.2	3.8	7.0	7.0	3.3
4. Changes in inventories and net acquisition of valuables as % of GDP***	P52 + P53	-0.7	1.3	2.5	1.6	1.2
5. Exports of goods and services	P6	22.6	9.7	8.7	13.0	8.4
6. Imports of goods and services	P7	13.8	9.5	10.0	11.6	6.8
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		0.1	1.6	3.9	4.2	3.0
8. Change in inventories and net acquisition of valuables (=4) ***	P52 + P53	-2.3	2.0	1.4	-0.9	-0.3
9. External balance of goods and services	B11	6.4	0.4	-1.0	1.6	1.9

** According to the Labour Force Survey*
*** GDP growth at market prices per person employed at constant price*
**** Including statistical discrepancy*
Source: Statistical Office, Ministry of Finance

Table 2: General government budgetary developments (% of GDP)						
	ESA code	2003E	2004F	2005F	2006F	2007F
Net lending (B9) by sub – sectors						
l. General government	S13	-3.6	-4.0	-3.4	-3.0	-2.0
2. Central government	S1311	-4.2	-4.3	-4.1	-3.6	-2.7
3. State government	S1312	-0.2	0.0	0.0	0.0	0.0
4. Local government	S1313	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S1314	0.8	0.3	0.7	0.5	0.7
General government (S13)						
6. Total receipts	ESA	37.4	37.4	38.4	37.8	37.6
7. Total expenditures	ESA	40.9	41.5	41.8	40.9	39.6
8. Budget balance	B9	-3.6	-4.0	-3.4	-3.0	-2.0
9. Net interest payments		2.4	2.6	2.8	2.7	2.6
10. Primary balance		-1.2	-1.5	-0.6	-0.3	0.6
Components of revenues						
11. Taxes	D2+D5	18.2	17.9	17.6	17.3	17.0
12. Social contributions	D61	13.9	13.1	13.7	13.6	13.6
13. Interest income	D41	0.8	0.5	0.6	0.6	0.5
14. Other		4.5	5.9	6.4	6.3	6.5
15. Total receipts	ESA	37.4	37.4	38.4	37.8	37.6
Components of expenditures						
16. Public consumption		15.0	14.7	14.5	14.0	13.5
17. Social transfers other than in kind	D62	18.1	17.1	17.1	17.1	16.8
18. Interest payments	D41	2.4	2.6	2.8	2.7	2.6
19. Subsidies	D3	1.4	1.7	1.8	1.7	1.7
20. Gross fixed capital formation	P51	2.6	3.3	3.6	3.7	3.6
21. Other		1.5	2.1	1.9	1.6	1.5
- other current subsidies and transfers		*0.9*	*0.8*	*0.3*	*0.2*	*0.2*
- capital transfers		*0.6*	*0.6*	*0.6*	*0.5*	*0.4*
- contributions to the EU budget		*0.0*	*0.7*	*1.0*	*0.9*	*0.9*
22. Total expenditures	ESA	40.9	41.5	41.8	40.9	39.6

Source: Ministry of Finance

Table 3: General government – debt developments (% of GDP)						
	ESA code	2003E	2004F	2005F	2006F	2007F
Gross debt level		42.8	45.1	46.4	46.1	45.5
Change in gross debt		-0.6	2.3	1.3	-0.3	-0.5
Contributions to change in gross debt						
Primary balance		1.2	1.5	1.1	1.2	0.4
Interest payments	D41	2.3	2.7	2.9	2.7	2.6
Nominal GDP growth	B1g	-3.6	-3.3	-3.1	-3.5	-3.0
Other factors influencing the debt ratio		-0.6	1.5	0.4	-0.8	-0.5
p.m. implicit interest rate on debt (in %)		6.0	6.4	6.7	6.3	6.0

Source: Ministry of Finance

Table 4: Cyclical developments (% of GDP, ESA 95)						
	ESA code	2003	2004F	2005F	2006F	2007F
1. GDP growth at constant prices	B1g	4.2	4.1	4.3	5.0	4.7
2. Actual balance	B9	-3.6	-4.0	-3.9	-3.9	-3.0
3. Interest payments	D41	2.4	2.6	2.8	2.7	2.6
4. Potential GDP growth		4.6	4.0	3.9	4.8	4.7
5. Output gap		-0.2	-0.1	0.2	0.4	0.4
6. Cyclical budgetary component		0.0	0.0	0.0	0.1	0.1
7. Cyclically – adjusted balance (2 - 6)		-3.5	-4.0	-3.9	-4.1	-3.1
8. Cyclically – adjusted primary balance (7 - 3)		-1.2	-1.5	-1.1	-1.4	-0.5

Source: Ministry of Finance

Table 5: Divergence from previous update (% of GDP)

	ESA code	2003	2004B	2005F	2006F	2007F
GDP growth (%)						
Previous update	B1g	4.0	4.1	4.4	4.8	
Latest update	B1g	4.2	4.1	4.3	5.0	4.7
Difference		0.2	0.0	-0.1	0.2	
Actual budget balance						
Previous update	B9	-5.0	-3.9	-3.4	-2.9	
Latest update	B9	-3.6	-4.0	-3.4	-3.0	-2.0
Difference		1.4	-0.1	0.0	-0.1	
Gross debt levels						
Previous update		43.9	44.8	46.4	47.6	
Latest update		42.8	45.1	46.4	46.1	45.5
Difference		-1.1	0.3	0.0	-1.5	

Source: Ministry of Finance

Table 6: Long – term sustainability of public finances (% of GDP)

	2004F	2005F	2010F	2020F	2030F	2050F
Total expenditures	41.5	41.8	37.0	35.2	35.9	38.0
Old – age pensions	7.2	7.3	6.6	5.8	6.7	7.4
Healthcare (including care for the elderly)	4.7	4.6	4.9	5.3	5.7	6.3
Interest payments	2.6	2.8	2.1	0.8	0.3	1.0
Total revenues	37.4	38.4	37.6	37.6	37.6	37.6
of which: from pensions contributions	13.1	13.7	13.6	13.6	13.6	13.6
Assumptions						
Labour productivity growth	3.5	3.6	3.4	3.4	2.5	2.3
Real GDP growth	4.1	4.3	4.1	3.3	2.0	1.5
Participation rate males (aged 15-64)	76.7	77.2	78.0	79.9	79.4	78.7
Participation rate females (aged 15-64)	62.9	63.4	64.1	67.8	68.2	68.1
Total participation rates (aged 15-64)	69.8	70.3	71.0	73.9	73.8	73.5
Unemployment rate (ILO definition)	16.4	15.9	13.2	10.8	8.8	4.9

Source: Ministry of Finance