COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
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Recommendation for a

COUNCIL OPINION

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

On the convergence programme of Slovenia, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

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

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

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

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

> On 14 May 2004, Slovenia submitted its first convergence programme, covering the period 2004-2007. It aspires to an early ERM II entry, by the end of 2004 at the latest, in order to introduce the euro at the beginning of 2007.
>
> The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[4].
>
> The macro-economic scenario underlying the convergence programme has been revised downwards since the 2003 pre-accession economic programme but remains slightly more optimistic than the Commission Spring 2004 forecasts until 2005. In particular, projected growth in 2004 appears on the high side of the current forecasting range. For the rest of the period covered the evolution of growth – drawing closer to and from 2006 slightly exceeding potential growth, estimated at 3.7% by the national authorities – seems plausible and is broadly in line with the Commission projections. Forecast to reach 3.3% in 2004 and settle below 3.0% at the

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

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.07.2001

3 COM(2002) 668 final, 27.11.2002

4 The delimitation of general government has not been applied completely and accrual accounting needs to be further improved.

end of 2005, the projection for inflation reveals rather favourable expectations of future price developments, while the Commission services take a more cautious view of the disinflation process.

The gradual fall in inflation, which began in 2001, accelerated in the second part of 2003. The annual increase of consumer prices reached 4.6% at year-end, decreasing the annual average to 5.7% from 7.5% a year before. The disinflation continued in 2004; in May, however, the year-on-year consumer price inflation rate was 3.9%, up by 0.3 percentage points compared to a month before. The long-term sustainability of lowering inflation – still relatively high at 4.7% on a 12-month moving average basis – needs to be strengthened. A good coordination of economic policies is regarded as key in bringing down inflation durably. Wage moderation and changes to the wage indexation system, in particular, have been identified as essential in supporting the disinflationary process. The new wage adjustment method for 2004-2005, introducing forward-looking indexation mechanisms – with anticipated rather than actual domestic inflation and also taking into account expectations related to EU inflation and euro/tolar exchange rate – should contain wage increases and ease inflationary pressures thereof. The Bank of Slovenia has price stability as its main objective and conducts monetary policy through a combination of interest rate policy and exchange rate management. Since 2003, the interest rates have been cut by a cumulative 350 basis points – leading to a real short-term interest rate of about 2% at present – while the rate of depreciation of the exchange rate against the euro has now been slowed to some 0.1% per month.

Without explicitly referring to the Stability and Growth Pact, the programme strives at achieving a stable budgetary position of close-to-balance. However, with a projected deficit of 0.9% of GDP in 2007, a close-to-balance position is only approached by the end of the programme period through a gradual reduction of general government deficit. Tracking a slightly slower path as compared to the 2003 pre-accession programme, the convergence programme envisages a back-loaded fiscal consolidation as it postpones the deficit reduction to the far end of the programme horizon, whereby the adjustment is channelled mostly through a cut in the expenditure ratio.

The consolidation path appears credible but is rather unambitious in setting the budgetary targets. The convergence programme fails to provide the details and, especially, the quantitative impact of the planned budgetary measures is missing. However, compared to the 2003 pre-accession programme, the consolidation strategy seems to have remained largely unchanged. It envisages the restructuring of general government expenditure and revenue so as to enhance budgetary flexibility. In particular, reducing mandatory budget spending is deemed necessary in order to cope with financial commitments of EU and NATO membership, which the authorities seem to regard as the sources of additional pressure on the budget while the share of mandatory expenditure accounts for more than 80% of the budget. The government has committed itself to meet the targets by gradually lowering the cyclically-adjusted deficit and will, in adverse circumstances, allow the working of automatic stabilisers only on a limited scale (in the order of 0.2% of GDP, according to the implementation bill to the 2004 budget). Given that the projected budget deficit is just slightly below 2% of GDP in the period 2004-2005, there may not be a sufficient safety margin against breaching the 3% of GDP deficit threshold should the authorities not succeed in limiting the play of fiscal stabilisers. Assuming potential setbacks related to downside economic developments, similar to the ones in the recent past, the budgetary outcome could be worse than expected.

Gross public debt is relatively low and will remain so over the programme period. In 2003, the debt-to-GDP ratio rose to 28.6% of GDP. Running a persistent primary deficit, the government anticipates a further increase in the debt ratio in the first two years, peaking at 29.5% of GDP in 2005. By 2007, the debt is forecast to return to 28.4% of GDP as nominal GDP growth is projected to be higher than the interest rate thereby facilitating the stabilisation of debt. Furthermore, the authorities consider the maturity and currency structure of debt portfolio appropriate since a long-term repayment profile spreads evenly over time with a growing share of tolar-denominated debt and external debt being predominantly euro-denominated.

The programme briefly reviews the government's structural reform agenda which focuses on enhancing the competitiveness of the economy by increasing the share of R&D expenditures in the budget. It also announces further measures to sustain economic growth, e.g. promoting job-creation oriented investment and removing structural rigidities in the labour market. However, the programme does not dwell upon the specifics of the restructuring process; policy goals seem fairly general and are only exceptionally accompanied by well elaborated measures. Budgetary implications cannot be unambiguously discerned since no attempt has been made to quantify the planned structural reforms in the projections of the main fiscal aggregates.

Slovenia faces risks of budgetary imbalances in meeting the costs of an ageing population. Implementing thoroughly the pension reform and putting in place a stable health-care system together with securing an adequate primary surplus are essential for placing public finances on a sustainable footing.

Table: Comparison of key macroeconomic and budgetary projections

		2003	**2004**	**2005**	**2006**	**2007**
Real GDP (% change)	**CP**	**2.3**	**3.6**	**3.7**	**3.8**	**3.9**
	COM	2.3	3.2	3.6	n.a.	n.a.
	PEP	*3.1*	*3.9*	*4.0*	*4.4*	*n.a.*
HICP inflation (%)	**CP**	**5.6**	**3.3**	**3.0**	**2.7**	**2.6**
	COM	5.7	3.6	3.2	n.a.	n.a.
	PEP	*5.5*	*4.3*	*4.2*	*3.7*	*n.a.*
General government balance (% of GDP)	**CP**	**-1.8**	**-1.9**	**-1.8**	**-1.5**	**-0.9**
	COM	-1.8	-1.7	-1.8	n.a.	n.a.
	PEP	*-1.9*	*-1.6*	*-1.6*	*-1.3*	*n.a.*
Primary balance (% of GDP)	**CP**	**-0.3**	**-0.3**	**-0.4**	**-0.2**	**0.4**
	COM	0.1	-0.1	-0.1	n.a.	n.a.
	PEP	*-0.5*	*-0.1*	*-0.1*	*0.0*	*n.a.*
Government gross debt (% of GDP)	**CP**	**28.6**	**29.1**	**29.5**	**29.4**	**28.4**
	COM	27.1	28.3	28.2	n.a.	n.a.
	PEP	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

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

Recommendation for a

COUNCIL OPINION

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

On the convergence programme of Slovenia, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July 2004] the Council examined the convergence programme of Slovenia, which covers the period 2004 to 2007. The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".

The budgetary strategy underlying the programme aims at achieving sound public finances as defined by a budgetary position of close-to-balance. To this end, the programme envisages a gradual reduction of the general government deficit over the period covered, consistent with a cut in both the revenue and the primary expenditure ratio, the latter through restraint on mandatory expenditure. According to the adjustment path, the deficit halves over the next four years, reaching just below 1% in 2007. While gearing the policy towards a gradual decrease of the structural deficit, the authorities will allow automatic fiscal stabilisers to operate – although to a limited extent – under unfavourable economic conditions.

The macro-economic scenario underlying the programme beyond 2005 seems to reflect plausible growth assumptions, forecasting real GDP to grow slightly above potential output. Nevertheless, for 2004 growth is assumed rather favourably. The projection for inflation appears on the low side of the current forecasting range in 2004 but is realistic thereafter provided that economic policies continue to be co-ordinated in the aim to lower inflation durably.

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

Increasing marginally to 1.9% of GDP in 2004 and then declining gradually to 0.9% of GDP by 2007, general government deficits are foreseen to stay below the 3% of GDP reference value in each year. The budgetary targets presented in the programme are not sufficient to ensure the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance; the medium-term objective would only be approached by the end of the programme period. Furthermore, the budgetary outcome could be worse than projected, in particular, given that the downside macroeconomic risks – related to an upbeat growth forecast in 2004 highlighted above – could lead to expenditure overruns experienced in the past. Therefore, the budgetary stance in the programme may not provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations especially in the initial years of the programme period.

Gross public debt is relatively low and will remain so in the future. After increasing to 29.5% of GDP by 2005, the debt ratio is expected to fall back to 28.4% of GDP in 2007. Slovenia faces risks of budgetary imbalances in meeting the costs of an ageing population. Implementing thoroughly the pension reform and putting in place a stable health-care system together with securing an adequate primary surplus are essential for placing public finances on a sustainable footing.

Key projections from the convergence programme of Slovenia

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	2.3	3.6	3.7	3.8	3.9
Employment growth (%)	-0.2	0.4	0.6	0.6	0.7
HICP inflation (%)	5.7	3.3	3.0	2.7	2.6
General government balance (% of GDP)	-1.8	-1.9	-1.8	-1.5	-0.9
Government gross debt (% of GDP)	28.6	29.1	29.5	29.4	28.4