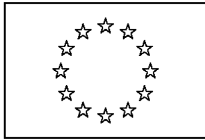

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.2.2005
SEC(2005) 146 final

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Slovakia, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission. 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 Member States that joined the EU on 1 May 2004 do not participate in the single currency, but are required to fulfil in due time the convergence criteria, including the one on the sustainability of the government financial position, in order to qualify for the adoption of the euro. In view of a general government deficit of 3.6% of GDP recorded in 2003, the Council decided that Slovakia was in excessive deficit on 5 July 2004 and recommended that the excessive deficit be corrected by 2007 at the latest, in line with the May 2004 convergence programme. In particular, Slovakia was recommended to implement with vigour the measures envisaged in that programme and to accelerate the fiscal adjustment if the implemented structural reforms result in higher growth than expected. In its Communication of 22 December 2004, the Commission concluded that the Slovak government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target.

The Member States which joined the EU on 1 May 2004 committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004. The first convergence programme of Slovakia, covering the period 2004-2007, was submitted on 14 May 2004 and assessed by the Council on 5 July 2004. Slovakia submitted an update of its convergence programme on 30 November 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[2], the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 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 coordination of budgetary policies[3]. This evaluation warrants the following assessment:

– Slovakia submitted its update of the convergence programme on 30 November 2004. The update covers the period 2004 to 2007 and, in addition, provides indicative projections until 2010. The document was adopted by the government. It is in line with the budget 2005, which the parliament passed on 9 December 2004, and the government's multi-annual budgetary framework 2005-2007, which the parliament took into account. The

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1 OJ L209, 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 10.7.2001.

3 COM(2002) 668 final, 27.11.2002.

programme is very well presented and complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[4].

– The update projects real GDP expansion at an average rate of 5% over the period 2004 to 2007 – with an expected slowdown to 4½% in 2005 (due to a falling external contribution) and an acceleration to almost 5½% in 2007 (when the external contribution is expected to rebound). Unemployment is predicted to fall only gradually from around 18½% in 2004 (in labour force survey terms) to 16½% in 2007. These developments are plausible and broadly confirmed by the Commission Autumn 2004 forecasts covering the period until 2006. A rapid fall of inflation to some 2½% in 2007 is only plausible if second-round effects from the high headline inflation in 2004 are strictly contained. The update anticipates the current account balance to become positive in 2007 (after a temporary deterioration to a deficit of almost 3% of GDP in 2005). Projected current account balances and planned fiscal deficits imply positive private net savings throughout the update horizon.

– Slovakia recently switched from implicit to explicit inflation targets but continues with a managed float of the exchange rate. The update confirms the authorities' intention to join the euro area in 2009 and states that Slovakia is likely to enter ERM2 no later than in the first half of 2006. In 2004, the headline inflation of 7.5% reflected again mostly the impact of adjustments in regulated prices and indirect taxes. The spread towards the euro area of long-term interest rates has been hovering at or below 100 basis points. After some months of stabilisation in the wake of cuts in the policy interest rate, the exchange rate has recently started to appreciate again. Altogether, the koruna has gained almost 6% in 2004.

– The update aims at reducing the deficit to the 3% of GDP reference value in 2007, in line with the Council recommendation under Article 104 (7). The reduction of the headline and primary general government deficits is back-loaded: both are envisaged to stay basically constant at, respectively, around 3.8% and 1.5% of GDP until 2006 and their planned overall adjustment by 0.8 percentage points is postponed to 2007. Even net of the impact resulting from the introduction of a funded pension pillar at the beginning of 2005 (estimated at 0.4% of GDP in 2005 and some 1% of GDP in 2006 and 2007), most of the deficit reduction takes place in the last two years. Compared to the May 2004 programme, in which the adjustment was expenditure-based, the update plans a correction of the deficit through expenditure retrenchment and revenue increases. In spite of a more favourable macroeconomic scenario, the update broadly confirms the planned adjustment path of the previous programme and looks therefore less ambitious. Notwithstanding the considerable past consolidation achievements and the pension reform impact, accelerating the deficit reduction (in particular in 2005) becomes thus an even more important consideration. It would help the implementation of Slovakia's euro adoption strategy, enhance fiscal credibility in an ERM2 context, foster counter-cyclicality, and could assist in stemming appreciation pressures. It would also pave the way to a structural budgetary position of

[4] The programme provides not only the required but, with a few exceptions, also the optional information indicated in the code. It furnishes a broad array of supplementary data, thus facilitating the analysis. While not hampering the assessment, there remain (relatively small) differences with the Statistical Office as regards the consolidated expenditure- and revenue-to-GDP ratios for 2003 and, furthermore, concerning the classification of components of general government consumption; notably social transfers in kind are not provided as separate category. The other optional data missing are the nominal effective exchange rates for the years 2006 and 2007. Furthermore, in part of the programme update, the general government primary balance is calculated on the basis of net interest payments.

close to balance or in surplus and to attain a sufficient safety margin against breaching the 3% of GDP Treaty reference value for the deficit criterion with normal macroeconomic fluctuations.

– The risks to the budgetary projections in the programme appear broadly balanced for the programme horizon as a whole. On the basis of the given macroeconomic assumptions, there seems to be an upside risk on the revenue side throughout the considered period. Balanced uncertainties exist with respect to the impact of the pension reform. The use of EU-funds (and of co-payments) is likely to be lower than budgeted in 2004 to 2006 as the absorption capacity still develops. However, it could exceed the budgeted amount in 2007 if sufficient catch-up in the implementation of postponed spending takes place. And finally, the parliamentary elections scheduled in 2006 lead to uncertainties, in particular on the extent to which further expenditure retrenchments will be implemented in 2007. The latter could fall short of or exceed the current plans. In view of this risk assessment, the budgetary stance in the programme seems sufficient to reduce the deficit to 3% of GDP by 2007, which is the end-year of the programme, but does not provide for any safety margin.

– The programme projects an increase of the debt-to-GDP ratio between 2004 and 2007 by 2½ percentage points to 45½%. The dynamics of the debt-to-GDP ratio reflect the back-loaded deficit reduction and are much less influenced by stock-flow adjustments and exceptional factors than in the past, although projected cash/accrual deviations and privatisation proceeds remain significant until 2006.

– The update focuses on recent structural reforms that improve the quality of public finances and are likely to enhance growth – similar to earlier far-reaching reforms (including major tax reforms), which already took effect in 2004. The recent reforms are basically a second tranche of healthcare reforms and the introduction of a funded pension pillar, both effective from the beginning of 2005.

– Slovakia presents some risks with regard to long-term sustainability of the public finances. These risks are importantly driven by the projected budgetary cost of an ageing population. Even assuming the achievement of the planned deficit reduction over the medium-term, long-term sustainability is not fully ensured, although the structural reform measures enacted and planned, in particular the pension and health reforms, contribute to the achievement of a sustainable position over the long term. Their full implementation is a key condition, in addition to the achievement of the planned budgetary consolidation path over the programme period.

– Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, Slovakia is on track to correct its excessive deficit by the deadline set by the Council.

– In view of the above assessment and in light of the recommendations made by the Council under Article 104(7), it would be appropriate for Slovakia to (i) seize every opportunity for an accelerated deficit reduction, including through the use of better-than-expected revenues and of savings on the expenditure side, in particular in 2005; (ii) make the medium-term expenditure ceilings more binding; (iii) be vigilant that second-round effects from the high inflation in 2004 do not affect the inflation convergence path envisaged in the programme.

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

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Slovakia, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [17 February 2005], the Council examined the updated convergence programme of Slovakia, which covers the period 2004 to 2007. The programme complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes".

(2) The macro-economic scenario underlying the programme envisages an average real GDP growth rate of 5% – with an expected slowdown to 4½% in 2005 (due to a falling external contribution) and an acceleration to almost 5½% in 2007 (when the external contribution is expected to rebound). On the basis of currently available information, this scenario seems to reflect plausible growth assumptions. The programme's projections for inflation appear on the low side and are only plausible if second-round effects from the high headline inflation in 2004 are strictly contained.

(3) On 5 July 2004, the Council decided that an excessive deficit existed in Slovakia and recommended that this be corrected by 2007. The programme update aims at reducing the deficit to the 3% of GDP reference value in 2007, in line with the Council recommendation under Article 104 (7). The reduction of the headline and primary general government deficits is back-loaded: both are envisaged to stay basically constant at, respectively, around 3.8% and 1.5% of GDP until 2006 and their planned

5 OJ L209, 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.

overall adjustment by 0.8 percentage points is postponed to 2007. Even net of the impact resulting from the introduction of a funded pension pillar in 2005, most of the deficit reduction takes place in the last two years. Compared to the May 2004 programme, when the adjustment was expenditure-based, the update plans a correction of the deficit through expenditure retrenchment and revenue increases. In spite of a more favourable macroeconomic scenario, the update broadly confirms the planned adjustment path of the previous programme and looks therefore less ambitious. Notwithstanding the considerable past consolidation achievements and the pension reform impact, accelerating the deficit reduction, in particular in 2005, would help the implementation of Slovakia's euro adoption strategy, enhance fiscal credibility in an ERM2 context, foster counter-cyclicality, and could assist in stemming appreciation pressures. It would also pave the way to a structural budgetary position of close to balance or in surplus and to attain a sufficient safety margin against breaching the 3% of GDP Treaty reference value for the deficit criterion with normal macroeconomic fluctuations.

(4) The risks to the budgetary projections in the programme appear broadly balanced for the programme horizon as a whole. On the basis of the given macroeconomic assumptions, there seems to be an upside risk on the revenue side throughout the considered period. Balanced uncertainties exist with respect to the impact of the pension reform. The use of EU-funds (and of co-payments) is likely to be lower than budgeted in 2004 to 2006 as the absorption capacity still develops. However, it could exceed the budgeted amount in 2007, if sufficient catch-up in the implementation of postponed spending takes place. And finally, the parliamentary elections scheduled in 2006 lead to uncertainties, in particular on the extent to which further expenditure retrenchments will be implemented in 2007. The latter could fall short or exceed the current target. In view of this risk assessment, the budgetary stance in the programme seems sufficient to reduce the deficit to 3% of GDP by 2007, which is the end-year of the programme, but does not provide for any safety margin.

(5) The debt ratio is estimated to have reached 43.0% of GDP in 2004, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase by 2½ percentage points over the programme period.

(6) Slovakia presents some risks with regard to long-term sustainability of the public finances. These risks are importantly driven by the projected budgetary costs of an ageing population. The structural reform measures enacted and planned, in particular the pension and health reforms, contribute to long-term sustainability. However, a full implementation of these measures is a key condition, in addition to the achievement of the planned budgetary consolidation path over the programme period.

(7) The economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, Slovakia is on track to correct its excessive deficit by the deadline set by the Council.

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In view of the above assessment and in light of the recommendations made by the Council under Article 104(7), the Council is of the opinion that Slovakia should:

(i) seize every opportunity for an accelerated deficit reduction, including through the use of better-than-expected revenues and of savings on the expenditure side, in particular in 2005.

(ii) make the medium-term expenditure ceilings more binding.

(iii) be vigilant that second-round effects from the high inflation in 2004 do not affect the inflation convergence path envisaged in the programme.

Comparison of key macroeconomic and budgetary projections

		2004	**2005**	**2006**	**2007**
Real GDP (% change)	**CP Nov. 2004**	**5.0**	**4.5**	**5.1**	**5.4**
	COM Oct.2004	4.9	4.5	5.2	n.a.
	CP May 2004	4.1	4.3	5.0	4.7
HICP inflation (%)	**CP Nov. 2004**	**7.8**	**3.3**	**2.8**	**2.5**
	COM Oct.2004	7.7	3.9	3.0	n.a.
	CP May 2004	8.1	4.0	2.9	2.5
General government balance (% of GDP) [1]	**CP Nov. 2004**	**-3.8**	**-3.8**	**-3.9**	**-3.0**
	COM Oct.2004	-3.9	-4.0	-4.1	n.a.
	CP May 2004	-4.0	-3.9	-3.9	-3.0
Primary balance (% of GDP) [1]	**CP Nov. 2004**	**-1.5**	**-1.4**	**-1.6**	**-0.7**
	COM Oct.2004	-1.6	-1.6	-1.8	n.a.
	CP May 2004	-1.4	-1.1	-1.2	-0.4
Government gross debt (% of GDP)	**CP Nov. 2004**	**43.0**	**44.2**	**45.3**	**45.5**
	COM Oct.2004	44.2	45.2	45.9	n.a.
	CP May 2004	45.1	46.4	46.1	45.5

[1] General government balance and primary balance include the revenue-decreasing and hence, *ceteris paribus,* deficit-increasing effect of the introduction of a funded pension pillar in 2005 (estimated at 0.4% of GDP in 2005; 1.0% of GDP in 2006; and 1.1% of GDP in 2007).

Sources:

Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM).