COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.1.2008
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Slovakia, 2007-2010

(presented by the Commission)

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EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of Slovakia was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Slovakia, submitted on 29 November 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme)

(3) the country's commitments undertaken at the time of entry into ERM II, the exchange rate mechanism

(4) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

(5) the Commission's assessment of the October 2007 implementation report of the national reform programme.

2.1. The excessive deficit procedure for Slovakia

On 5 July 2004 the Council adopted a decision stating that Slovakia had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007. In particular, Slovakia was recommended to take effective action by 5 November 2004 to achieve the 2005 deficit target, to implement with vigour the measures envisaged in the May 2004 programme, and to accelerate the fiscal adjustment if the implemented structural reforms resulted in higher growth than expected in the programme, in particular by dedicating any higher-than budgeted revenues primarily to faster deficit reduction.

A Commission communication of 22 December 2004 concluded that, on then available information and on the basis of the measures detailed in the 2005 budget, it appeared that the Slovak government had taken effective action to achieve the 2005 deficit target and to correct the excessive deficit by 2007 at the latest.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006-2009, as follows: "The Council considers that the programme is consistent with a correction of the excessive deficit by 2007 and envisages progress, but limited, towards the MTO thereafter". Also in the light of the recommendation under Article 104(7) of 5 July 2004, the Council invited Slovakia to "exploit the strong growth prospects to strengthen the structural adjustment in order to ensure the correction of the excessive deficit in 2007 with a larger margin and to speed up the progress towards the MTO; to reinforce the binding character of the medium-term expenditure ceilings for central government".

2.3. ERM II commitments of Slovakia

On 28 November 2005, Slovakia joined ERM II[2], thus linking its currency to the euro, and undertook the following commitments to ensure a smooth participation in ERM II[3]. "The agreement on participation of the Slovak koruna in ERM II is based on a firm commitment by the Slovak authorities to promote wage developments that are kept in line with productivity growth, thereby contributing to achieving price stability in a sustainable manner, and to pursue sound fiscal policies which are essential for preserving macroeconomic stability, including low inflation, and for ensuring the sustainability of the convergence process. The Slovak government's medium-term fiscal consolidation strategy requires a high degree of budgetary discipline and needs to be implemented decisively through measures of a permanent nature. Strict monitoring of budget execution will be required, aimed at a timely detection and correction of slippages. The authorities, together with the responsible EU bodies, will closely monitor macroeconomic developments. The authorities commit to strengthen the fiscal stance if warranted. They will remain vigilant concerning risks of strong

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2 ERM II is the exchange rate mechanism established by the Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union of 16 June 1997 (OJ C 236, 2.8.1997, p. 5).

3 Available at: http://ec.europa.eu/economy_finance/publications/eurorelated_en.htm.

domestic credit growth. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms, reduce unemployment and maintain the overall competitiveness of the economy".

The updated convergence programme contains a section with an assessment of the implementation of these commitments.

2.4. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[4]. Slovakia was not recommended to take particular action in the area of budgetary policies.

2.5. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Slovakia's national reform programme[5]. It can be summarised as follows.

Slovakia's national reform programme identifies as key challenges/priorities: developing the information society; increasing R&D and innovation; improving the business environment; improving education and raising employment.

The Commission's assessment was that Slovakia has made some progress in implementing its national reform programme over the period 2005-2007.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Slovakia is recommended to give highest priority to the challenges in the areas of: R&D and innovation; regulatory environment; lifelong learning and education reform, including reallocation of resources.

In addition, Slovakia should also focus on the areas of: ICT policies; one-stop shops for start-up companies, entrepreneurship education, competition in power supply, gender pay and employment gap, active ageing, and youth employment.

4 OJ L 92, 3.4.2007, p. 23.

5 Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)" - COM(2007) 803, 11.12.2007.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[6];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[7], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[6] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[7] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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

On the updated convergence programme of Slovakia, 2007-2010

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[8], 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 [12 February 2008] the Council examined the updated convergence programme of Slovakia, which covers the period 2007 to 2010.

(2) Slovakia is currently experiencing a period of strong growth induced by wide-range structural reforms introduced in previous years combined with substantial inflows of FDI, especially into the manufacturing sector. Although consequential to growth employment picked up as well and the unemployment rate fell substantially, certain segments of the population concentrated in eastern regions do not seem to take part in this economic expansion. Apart from constituting a drag on public finances and a social problem, the low employability of certain segments of the labour force limits the country's potential output growth and thus hampers the catching-up process. This unevenness in the distribution of economic activity across population groups and regions would call for an increase in the quality of public education and some reallocation of government expenditure to education, R&D and innovation and infrastructure development. Following a predominantly restrictive budgetary policy in previous years, the fiscal stance turned expansionary in 2006, while monetary conditions tightened on the back of increased policy rates and continued exchange rate appreciation which however, as testified by the strong growth in exports and falling

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8 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

current account deficit, does not seem to have affected external competitiveness of the Slovak economy. As a Member State with a derogation and an ERMII participant Slovakia should gear its macroeconomic and structural policies towards achieving sustainable convergence. Although inflation has decelerated markedly in 2007, it is expected to pick up again on the back of rising food and energy prices, strong growth, a tightening labour market and a fading effect of the strong exchange rate appreciation in 2006-07. In order to meet the inflation targets set out in the programme – which assumes euro area membership from 2009 – and to contain possible inflationary pressures after the disinflationary effect from past substantial exchange rate appreciation fades out, further structural reforms are necessary and the government should stand ready to adopt a tighter fiscal stance than that envisaged in the programme.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will drop from 8.8% in 2007 to 5.0% in 2010. Assessed against currently available information[9], this scenario appears to be based on plausible growth assumptions until 2009 and cautious ones for 2010, as the exceptional export performance recorded in 2007 induced by the launch of new production capacities in the manufacturing sector is not expected to be repeated in the coming years. The programme's projections for inflation appear to be on the low side as they are based on more favourable external assumptions than the Commission services' autumn 2007 forecast and on a different assumption on the fading out of the effect of past exchange rate appreciation.

(4) For 2007, the general government deficit is estimated at 2.7% of GDP in the Commission services' autumn 2007 forecast, against a target of 2.9% of GDP set in the previous update of the convergence programme and of 2.5% of GDP in the current update. This improvement was enabled by a revenue over-performance outweighing higher-than-budgeted expenditure. Given that the estimated 2007 deficit outturn is lower (by 0.2% of GDP) than previously targeted both in nominal and structural (i.e. cyclically-adjusted net of one-off and other temporary measures) terms, the Slovak authorities have partly responded to the invitation in the Council opinion of 27 February 2007 on the previous update of the convergence programme[10] which called for a strengthening of the structural adjustment in order to ensure the correction of the excessive deficit in 2007 with a larger margin.

(5) The main goal of the budgetary strategy is to reach the medium-term objective (MTO) for the budgetary position of a structural deficit of just below 1% of GDP by 2010. The programme foresees the general government deficit to decrease from 2.5% of GDP in 2007 to 0.8% of GDP in 2010 in nominal terms, with the primary balance improving from a deficit of 1.0% of GDP in 2007 to a surplus of 0.5% of GDP in 2010. The adjustment in both structural and nominal terms is back-loaded towards the end of the programme period. Compared to the previous update, the new update broadly confirms the planned adjustment against a more favourable macroeconomic scenario. Fiscal consolidation is envisaged to be expenditure-based (especially cuts in social payments and compensation of public employees) as the expenditure ratio is

[9] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

[10] OJ C 72, 29.3.2007, p. 1.

planned to be reduced by 3 percentage points of GDP over the programme horizon while the revenue ratio would decline by half this amount.

(6) The budgetary outcomes could be better in 2008 and worse in 2009 and 2010 than projected in the programme. In particular, strong growth prospects, already adopted revenue-increasing measures (broadening of the corporate tax base and increase in the maximum ceiling for social contribution foreseen to generate additional revenue of some 0.3% of GDP) and the likely outflow of participants from the second pension pillar[11] (positive impact estimated at about 0.2% of GDP) should allow for a better-than-foreseen deficit outcome in 2008 if expenditure growth is kept more in check than suggested by the programme as was the case in previous years. However, substantial risks exist for the planned fiscal consolidation back-loaded to 2009 and 2010. In particular, there are no binding expenditure ceilings, there is a lack of information on the measures that underpin the adjustment and there are potentially some risks to expenditure related to planned partnerships with the private sector notably as regards construction of motorways.

(7) In view of this risk assessment, the budgetary stance in the programme seems broadly consistent with a durable correction of the excessive deficit by 2007 as recommended by the Council. A sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations (estimated around a structural deficit of 2% of GDP) would only be provided from 2010 onwards if the envisaged consolidation is strictly implemented. Moreover, the budgetary stance in the programme seems insufficient to ensure that the MTO is achieved by the end of the programme period, as envisaged in the programme. In 2008, only a slight improvement (¼% of GDP) in the structural balance can be expected when good times are foreseen to occur. The pace of adjustment towards the MTO implied by the programme in 2008 should be therefore strengthened to be in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times. Moreover, budgetary room needs to be created for the expected increase in inflows of EU funds in order to maintain the restrictive fiscal stance planned for 2009-10. The planned adjustment in the remaining years of the programme – in line with the Pact – should be strictly implemented and, if necessary, backed up with measures. Finally, should inflationary pressures emerge, a tighter fiscal stance than foreseen in the programme would be required.

(8) Slovakia appears to be at medium risk with regard to the long-term sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, with pension expenditure showing a more limited increase than in many other countries, notably thanks to the 2005 pension reform. However, those projections hinge upon the assumption that a relatively low share of workers will leave the mixed pension system in the first half of 2008, during which they will have the opportunity to do so. The budgetary position in 2007 as estimated in the programme with a structural primary deficit constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Consolidating

[11] In the first half of 2008 the second pension pillar will be temporarily opened, allowing current participants to leave and new participants to join the scheme.

the public finances, as planned in the convergence programme, would therefore contribute to reducing risks to the sustainability of public finances.

(9) The convergence programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. It confirms that the government's expenditure priorities (healthcare, education and agriculture) continue to partly diverge from the key challenges identified in the NRP (information society; R&D and innovation; business environment; and education and employment). Moreover, it does not specify whether the national R&D expenditure target of 0.8% of GDP will be met by 2010 while education spending tends to increasingly rely on EU Structural Funds. The programme does not contain a qualitative assessment of the overall impact of the National Reform Programme within the medium term fiscal strategy but it provides systematic information on the direct budgetary costs associated with the main reforms envisaged in the NRP for 2008.

(10) In terms of progress in implementing its ERM II commitments, the fiscal targets in successive convergence programmes have been consistently overachieved but the targets themselves have turned out not to be particularly ambitious given the better-than-originally-assumed initial fiscal position and stronger-than-expected economic performance. As regards income policies, collective bargaining agreements in the public sector have provided an important signal of wage moderation for the whole economy. With a view to containing credit growth, the National Bank of Slovakia has closely monitored risk management practices of banks and strengthened cooperation with home country supervisors of banks operating in Slovakia.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[12].

The overall conclusion is that the programme is consistent with a correction of the excessive deficit by 2007. Thereafter, it envisages back-loaded progress towards the MTO in a context of strong growth prospects; in 2008, the envisaged structural improvement is not in line with the Pact and should be more ambitious. Given risks to the budgetary targets from 2009 onwards, the MTO may not be achieved by 2010 as planned in the programme and therefore additional efforts might be required. Moreover, should inflationary pressures emerge, a tighter fiscal stance than foreseen in the programme would be required along with further structural reforms to improve the labour market performance. As regards the long-term sustainability of public finances, Slovakia appears to be at medium risk. With respect to medium-term challenges, the programme does not envisage any progress in reallocating expenditure towards R&D and innovation while it states that education spending should increasingly rely on EU funds.

In view of the above assessment and the Recommendation under Article 104(7) of 5 July 2004 and also given the need to ensure sustainable convergence and a smooth participation in ERM II, Slovakia is invited to:

[12] In particular, the data on the functional classification of government expenditure (COFOG) for 2010 are not provided.

(i) exploit the strong growth conditions to strengthen the pace of structural adjustment towards the MTO in 2008 and strictly implement the envisaged structural consolidation thereafter backed up, if necessary, by additional measures as well as more binding medium-term expenditure ceilings and

(ii) introduce further structural reforms to improve the labour market performance and stand ready to adopt a tighter fiscal stance, in particular in order to contain possible inflationary pressures, especially after the disinflationary effect of past substantial exchange rate appreciation fades out.

Comparison of key macro economic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Nov 2007**	**8.3**	**8.8**	**6.8**	**5.8**	**5.0**
	COM Nov 2007	8.3	8.7	7.0	6.2	n.a.
	CP Dec 2006	*6.6*	*7.1*	*5.5*	*5.1*	*5.0*
HICP inflation (%)	**CP Nov 2007**	**4.3**	**1.7**	**2.3**	**2.6**	**2.7**
	COM Nov 2007	4.3	1.7	2.5	3.0	n.a.
	CP Dec 2006	*4.4*	*3.1*	*2.0*	*2.4*	*2.6*
Output gap[1] (% of potential GDP)	**CP Nov 2007**	**-0.5**	**1.8**	**2.3**	**2.1**	**1.4**
	COM Nov 2007[2]	-0.8	1.0	1.3	0.8	n.a.
	CP Dec 2006	*-0.9*	*1.0*	*1.6*	*1.9*	*2.4*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Nov 2007**	**-8.4**	**-3.4**	**-1.9**	**-1.1**	**-0.4**
	COM Nov 2007	-7.8	-4.2	-2.7	-1.6	n.a.
	CP Dec 2006	*-6.4*	*-3.1*	*-2.5*	*-2.0*	*-1.6*
General government balance (% of GDP)	**CP Nov 2007**	**-3.7**	**-2.5**	**-2.3**	**-1.8**	**-0.8**
	COM Nov 2007	-3.7	-2.7	-2.3	-2.4	n.a.
	CP Dec 2006	*-3.7*	*-2.9*	*-2.4*	*-1.9*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2007**	**-2.2**	**-1.0**	**-0.9**	**-0.3**	**0.5**
	COM Nov 2007	-2.2	-1.2	-0.8	-0.9	n.a.
	CP Dec 2006	*-1.9*	*-0.9*	*-0.6*	*-0.2*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Nov 2007**	**-3.5**	**-3.0**	**-3.0**	**-2.4**	**-1.2**
	COM Nov 2007	-3.4	-3.0	-2.7	-2.6	n.a.
	CP Dec 2006	*-3.4*	*-3.2*	*-2.9*	*-2.5*	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2007**	**-3.1**	**-3.0**	**-3.1**	**-2.4**	**-1.2**
	COM Nov 2007	-3.4	-3.0	-2.7	-2.6	n.a.
	CP Dec 2006	*-3.5*	*-3.2*	*-2.9*	*-2.5*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2007**	**30.4**	**30.6**	**30.8**	**30.5**	**29.5**
	COM Nov 2007	30.4	30.8	30.7	30.6	n.a.
	CP Dec 2006	*33.1*	*31.8*	*31.0*	*29.7*	*n.a.*

Notes:

[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 6.4%, 6.7%, 6.7% and 6.7% respectively in the period 2006-2009.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.4% of GDP in 2006 - deficit-increasing and 0.1% of GDP in 2008 - deficit-reducing according to the most recent update of the programme. There are no one-off measures in the Commission services' forecast.

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations