COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2009
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Recommendation for a

COUNCIL OPINION

in accordance with the second paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the stability programme of Slovakia, 2008-2011

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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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to the definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the stability programme of Slovakia, submitted on 30 April 2009, and has adopted a recommendation for a Council opinion on it.

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

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”); and

(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 last update of the convergence programme).

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[2] Communication from the Commission to the European Council - COM(2008) 800, 26.11.2008.

priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. While it is still relatively early to assess the impact of these measures, the opinions of stability and convergence programmes include a preliminary evaluation of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term.

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

In its opinion of 12 February 2008, the Council summarised its assessment of the last update of the convergence programme, covering the period 2007-2010, as follows: "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 this assessment, the Council invited Slovakia to "(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".

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On the stability programme of Slovakia, 2008-2011

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[3], and in particular Article 5(2) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [7 July 2009] the Council examined the stability programme of Slovakia, which covers the period 2008 to 2011.

(2) Following several years of high GDP growth, the Slovak economy started to lose momentum in the fourth quarter of 2008 when GDP growth slowed down to 2.5% year-on-year. As a small, open economy that is relatively specialised in the automobile and electronics sectors, Slovakia is affected by the economic downturn through a significant drop in external demand. Exports have been on a steeply declining path since the fourth quarter of 2008 with negative repercussions on industrial production and business confidence. The manufacturing sector is the most hard-hit by the crisis, while the banking sector has been only marginally affected. After a period of gradual decline, the unemployment rate started to rise in the fourth quarter of 2008, against the backdrop of lay-offs due to the economic downturn. Public finances are projected to worsen considerably in 2009 and 2010. The deterioration of the headline general government balance and the structural balance entails a rapid shrinking of the fiscal room for manoeuvre. The overall volume of the stimulus packages adopted by the Slovak authorities in response to the crisis is estimated at around ½% of GDP in 2009. Moreover, Slovakia's competitive position has been weakened due to the koruna's

[3] OJ L 209, 2.8.1997, 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.

appreciation before the euro adoption and the relatively strong wage growth in 2008, which may present an additional challenge.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will fall from 6.4% in 2008 to 2.4% in 2009 before recovering gradually to a rate of 4.5% by 2011. Assessed against the estimates of GDP for the first quarter of 2009, which reveal a contraction of 5.6% year-on-year, this scenario appears to be based on markedly favourable growth assumptions[4]. The Commission services forecast a contraction of 2.6% in 2009 and a modest recovery of 0.7% in 2010. In view of the rapid deterioration of the economic outlook for the main trading partners of Slovakia in recent months, exports are projected to decline more markedly while their rebound is likely to be more subdued than expected in the programme. Moreover, in the programme, the recovery of the economy in 2010 is based on the assumption that potential growth will not be affected by the current downturn, which appears to be unlikely given the expected decline in fixed investment. The programme projects a slowdown in inflation in 2009 to 2.2% and a subsequent acceleration in 2010 and 2011, to 3.6% and 4.1%, respectively. These estimates appear realistic, but are not fully consistent with the programme higher growth assumptions for 2009.

(4) In 2008, the general government deficit amounted to 2.2% of GDP, against a target of 2.3% of GDP set in the previous update of the convergence programme. The slightly lower-than-expected general government deficit is the result of a better starting position from 2007 (by 0.6% of GDP) and higher-than-expected revenue growth, but also higher-than-expected expenditure growth. Revenues were in particular supported by transfers of pension contributions from the fully-funded pension pillar to the PAYG pension pillar, the sale of extra emission quotas and somewhat higher-than-expected revenue from non-tax items. Unexpected expenditure increases were mainly due to liabilities from past privatisations and debt forgiveness vis-à-vis non-financial corporations. Favourable labour market developments and lower-than-planned spending of local governments however helped to limit expenditure growth.

(5) The programme foresees a widening of the general government deficit for 2009 to 3% of GDP. The bulk of the increase is due to the current slowdown and the operation of automatic stabilisers. The Commission services forecast a more marked increase in the government deficit to 4.7% of GDP, due to a considerably less favourable macroeconomic scenario. The implied fiscal stance measured as the change in the structural balance, as recalculated by the Commission services on the basis of the information provided in the programme, is around ½% and hence mildly expansionary.

(6) There is no Medium Term Objective (MTO) specified in the stability programme[5], which focuses on maintaining the headline deficit below 3% of GDP thereby avoiding an excessive deficit procedure. The consolidation efforts are expected to resume in 2010, when the majority of the stimulus measures are to be terminated as the economy recovers, and particularly in 2011. The headline deficit for these two years is planned

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4 The programme presents an alternative, not fully fledged scenario, which is based on favourable growth assumptions for 2009 and more plausible assumptions for 2010, as it expects GDP growth to fall from 6.4% in 2008 to -1% in 2009 before recovering to 1% in 2010.

5 In the November 2007 update of the convergence programme, it was specified as a structural deficit (i.e. cyclically adjusted and net of one-off measures) of 1% of GDP to be achieved by 2010.

at 2.9% and 2.2% of GDP, respectively. The adjustment is concentrated on the expenditure side where the ratio is projected to fall by 1 percentage point of GDP between 2009 and 2011, mainly due to a reduction of expenses on employees' compensations and intermediate consumption, social payments and subsidies. The underlying measures are, however, not specified. The revenue fall is projected at 0.3 percentage points of GDP driven by a decrease in social contributions.

(7) The budgetary targets are subject to significant downside risks. The macroeconomic scenario appears to be overly optimistic. Assumed low levels of unemployment are likely to lead to an underestimation of the social benefits payments. The current version of the government budget does not guarantee sufficient resources for both active and passive labour market measures, considering the increasing number of unemployed. A planned significant reduction of employees' compensations and intermediate consumption amounting to 0.6 percentage points of GDP in 2009-2011 is not supported by further details about the measures required to achieve this result. The planned reduction in subsidies seems difficult to be achieved against the deteriorating macroeconomic environment. The revenue estimates need to be treated with caution based on two counts. First, given the recent economic developments, tax collection may be considerably worse than expected, especially in 2009. Second, the 2009 budget relies on a significant transfer of funds from the fully-funded to the PAYG pension pillar which is not likely to materialize given the low observed take-up by contributors of the option to switch back to the PAYG pillar.

(8) The long-term budgetary impact of ageing is slightly higher than the EU average, mainly due to a relatively high increase in pension expenditure during the coming decades. It is therefore important not to backtrack on the pension reform already enacted. Ensuring stable rules for the fully-funded pension pillar is necessary to preserve long-term sustainability of public finance in view of an ageing population. The budgetary position in 2008, as estimated in the programme, though improved from the estimated starting position of the previous programme, compounds the budgetary impact of population ageing on the sustainability gap. If the 2009 budgetary position as projected by the Commission services' spring 2009 forecast was taken as the starting point, the sustainability gap would worsen substantially. Achieving higher primary surpluses over the medium term, as foreseen in the programme, would contribute to reducing risks to the sustainability of public finances, which are currently at a medium level.

(9) Slovakia has a non-binding multi-annual budgetary framework with three-year budgetary planning. Despite the recommendation in the 2007 Council Opinion, binding rules such as expenditure ceilings have not been introduced. Deficit targets set out in the past convergence programmes have been achieved mainly due to stronger-than-expected economic performance. However, expenditure plans outlined in the medium-term budgetary frameworks have always been exceeded in the past and subsequently revised upwards. This makes advisable the introduction of a legally binding expenditure rule to ensure fiscal discipline in a context of less buoyant revenues. With respect to implementation of institutional reforms, the stability programme notes that no significant changes have occurred since the last update of the convergence programme. In June 2008, Slovak authorities adopted the Modernisation Programme ‘Slovakia 21’ which includes several measures aimed at simplification of tax and social contribution systems and creation of an integrated system of collection of taxes, customs duties, health and social contributions. To this end, a single agency

for tax collection is expected to be established by 2013. The implementation of IT systems enabling real-time electronic data exchange among public and private sector is also envisaged. These measures would improve the efficiency of public administration.

(10) In response to the financial crisis, the Slovak authorities introduced a full guarantee for deposits. More stringent liquidity requirements for banks were introduced by the National Bank of Slovakia. In order to alleviate the impact of potential credit tightening measures for the corporate sector, especially for SMEs, the Slovak authorities recapitalised two state-owned banks (the Slovak Guarantee and Development Bank and Eximbanka) and opened a credit line with the European Investment Bank. A memorandum on cooperation and exchange of information for co-financing of SMEs was signed between the Ministry of Finance, the Slovak Bank Association, Eximbanka and the Slovak Guarantee and Development Bank with the aim of providing bank guarantees for loans issued by commercial banks to SMEs.

(11) In view of the limited fiscal room for manoeuvre due to the external imbalances, the limited fiscal stimulus package for 2009 and 2010 adopted by Slovakia appears to be an adequate response to the economic downturn. On the revenue side, the main measures include a temporary increase in tax-free income, higher in-work benefits for low-income employees, a decrease in social contributions for self-employed and tax reliefs for business R&D activities. The main expenditure measures include subsidies for R&D projects carried out by businesses, additional funding of SMEs and social enterprises, a car scrapping scheme and subsidies to create and sustain employment. The total volume of the measures is estimated by the Slovak authorities at around ½% of GDP in each year (2009 and 2010). In addition, the Slovak authorities plan to improve absorption of EU funds and accelerate the implementation of public private partnerships (PPP) for motorway construction. The adopted measures are in line with the European Economic Recovery Plan in that they are targeted on disadvantaged groups and in most cases temporary. With respect to the timeliness, the implementation of the stimulus packages is somewhat back-loaded in the sense that only half of the total fiscal impact will occur in 2009. While the PPP projects for transport infrastructure show the potential of a significant boost to the economy, their implementation may be postponed due to administrative and credit constraints. Overall, the stimulus measures are likely to help mitigate the adverse impact of the crisis on domestic demand and labour market. They are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs and endorsed by the Spring European Council on 19 March.

(12) The projected fiscal stance is mildly expansionary in 2009 according to the Commission services' spring 2009 forecast due to the implementation of the fiscal stimulus package. The structural balance is set to improve marginally after 2009 as a result of the planned budgetary consolidation, in particular cuts on the expenditure side. However, the safety margin against breaching the 3% of GDP reference value is not respected over the whole programme period. The achievement of fiscal targets is likely to be difficult given the programme's markedly favourable macroeconomic scenario and a lack of concrete measures to back up the planned expenditure cuts.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides nearly all the required and optional data[6].

The overall conclusion is that fiscal policy in Slovakia will be mildly expansionary in 2009 and turn restrictive from 2010 on. The budgetary projections presented in the stability programme are based on markedly favourable macroeconomic assumptions. The risks to the budgetary targets are clearly negative. The expansionary fiscal stance in 2009, including the limited stimulus measures, appears appropriate given the competitiveness challenge and is therefore in line with the EERP. However, achieving medium-term budgetary targets will require more significant structural consolidation after 2009 than envisaged in the programme. The consolidation effort needs to be backed up by concrete expenditure measures. In addition, the deterioration of public finances presents a risk also for long-term sustainability. In this context, it is crucial to keep stable rules for the fully-funded pension pillar and therefore to avoid measures that create uncertainty for the business strategy of pension funds.

In view of the above assessment, Slovakia is invited to:

(i) implement the anti-crisis measures in line with the EERP as planned;

(ii) ensure consolidation from 2010 onwards as the economy recovers and back up the budgetary strategy with specific measures for reducing expenditure from 2010 onwards. This should be supported by the introduction of legally binding expenditure ceilings for the general government to ensure fiscal discipline in a less buoyant revenue scenario;

(iii) ensure stable rules for the fully-funded pension pillar, given the upcoming challenges of an ageing population, in order to improve the long-term sustainability of public finance.

[6] In particular, changes in inventories and net acquisition of valuables in section on macroeconomic prospects are missing. Some sections lack 2007 data (which were, however, additionally provided upon request).

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	**SP Apr 2009**	**10.4**	**6.4**	**2.4**	**3.6**	**4.5**
	COM Spring 2009	10.4	6.4	-2.6	0.7	n.a.
	CP Nov 2007	*8.8*	*6.8*	*5.8*	*5.0*	*n.a.*
HICP inflation (%)	**SP Apr 2009**	**1.9**	**3.9**	**2.2**	**3.6**	**4.1**
	COM Spring 2009	1.9	3.9	2.0	2.4	n.a.
	CP Nov 2007	*1.7*	*2.3*	*2.6*	*2.7*	*n.a.*
Output gap[2] (% of potential GDP)	**SP Apr 2009**	**5.1**	**6.5**	**3.5**	**1.7**	**1.0**
	COM Spring 2009[2]	6.5	8.0	0.9	-2.2	n.a.
	CP Nov 2007	*1.8*	*2.3*	*2.1*	*1.4*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Apr 2009**	**-4.6**	**-5.8**	**-4.2**	**-2.9**	**-2.6**
	COM Spring 2009	-4.7	-5.6	-7.6	-6.2	n.a.
	CP Nov 2007	*-3.4*	*-1.9*	*-1.1*	*-0.4*	*n.a.*
General government revenue (% of GDP)	**SP Apr 2009**	**32.7**	**33.4**	**32.1**	**31.6**	**31.8**
	COM Spring 2009	32.5	32.7	33.6	34.1	n.a.
	CP Nov 2007	*33.2*	*33.0*	*31.8*	*31.8*	*n.a.*
General government expenditure (% of GDP)	**SP Apr 2009**	**34.6**	**35.6**	**35.1**	**34.5**	**34.1**
	COM Spring 2009	34.4	34.9	38.3	39.4	n.a.
	CP Nov 2007	*35.7*	*35.3*	*33.7*	*32.6*	*n.a.*
General government balance (% of GDP)	**SP Apr 2009**	**-1.9**	**-2.2**	**-3.0**	**-2.9**	**-2.2**
	COM Spring 2009	-1.9	-2.2	-4.7	-5.4	n.a.
	CP Nov 2007	*-2.5*	*-2.3*	*-1.8*	*-0.8*	*n.a.*
Primary balance (% of GDP)	**SP Apr 2009**	**-0.6**	**-0.9**	**-1.7**	**-1.7**	**-1.0**
	COM Spring 2009	-0.5	-0.9	-3.3	-4.0	n.a.
	CP Nov 2007	*-1.0*	*-0.9*	*-0.3*	*0.5*	*n.a.*
Cyclically-adjusted balance[3] (% of GDP)	**SP Apr 2009**	**-3.4**	**-4.1**	**-4.0**	**-3.4**	**-2.5**
	COM Spring 2009	-3.8	-4.5	-4.9	-4.7	n.a.
	CP Nov 2007	*-3.0*	*-3.0*	*-2.4*	*-1.2*	*n.a.*
Structural balance[4] (% of GDP)	**SP Apr 2009**	**-4.2**	**-3.8**	**-4.4**	**-3.5**	**-2.6**
	COM Spring 2009	-3.8	-4.7	-5.0	-4.7	n.a.
	CP Nov 2007	*-3.0*	*-3.1*	*-2.4*	*-1.2*	*n.a.*
Government gross debt (% of GDP)	**SP Apr 2009**	**29.4**	**27.6**	**31.4**	**32.7**	**32.7**
	COM Spring 2009	29.4	27.6	32.2	36.3	n.a.
	CP Nov 2007	*30.6*	*30.8*	*30.5*	*29.5*	*n.a.*

Notes:

[1] The 2007 data on real GDP, HICP inflation were provided on a bilateral basis.

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

[3] Based on estimated potential growth of 5.6%, 4.9%, 4.4% and 3.9% respectively in the period 2007-2010.

[4] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.8% of GDP in 2007, 0.4% of GDP in 2009, 0.1 of GDP in 2009 and 2010 - deficit-increasing and 0.3% of GDP in 2008 deficit-reducing according to the most recent programme and 0.2% of GDP in 2008 and 0.1% of GDP in 2009 and 2011 deficit-increasing in the Commission services' forecast.

Source:

Stability programme (SP); Commission services' April 2009 spring forecasts (COM); Commission services' calculations.