COUNCIL OPINION

of 24 January 2006

on the updated convergence programme of Slovakia, 2005-2008

(2006/C 55/05)

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 [1], 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 24 January 2006 the Council examined the updated convergence programme of Slovakia, which covers the period 2005 to 2008.

(2) Slovak real GDP growth averaged 4,3 % between 1994 and 2004 almost two percentage points above the EU25 average of 2,4 %. Despite improvement in 2005, the labour market situation remains the country's major problem. As a consequence of accelerated enterprise restructuring in the late 1990s, the unemployment rate increased from 13,7 % in 1994 to 18,2 % in 2004 while total employment decreased by two percentage points over the same period. The macroeconomic scenario assumes that real GDP growth will average 5,6 % per year over the programme period and, starting with a negative output gap in 2005, implies a marked swing in cyclical conditions. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation also appear realistic.

(3) On 5 July 2004, the Council decided that Slovakia was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit has to be corrected by 2007. In its opinion of 17 February 2005 on the previous update of Slovakia's convergence programme covering the period 2004-2007, the Council invited 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'.

(4) The updated programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct [2].

[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 can be found at the following website:
http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

[2] The programme update has gaps in the 'compulsory' and does not provide all optional data prescribed by the new code of conduct. Compulsory data on nominal effective exchange rate and on FISIM are missing, as well as optional data on general government expenditure by function for 2008.

(5) The programme aims at reducing the deficit to below the 3 % of GDP reference value in 2007, in line with the Council recommendation under Article 104(7) from 5 July 2004. The general government deficit (net of the pension reform costs) is projected to decrease from 4,1 % of GDP (including 0,8 % of GDP debt cancellations) in 2005 to 2,9 % in 2006, then decline sharply to 1,6 % of GDP in 2007 and reach 1,3 % of GDP in 2008. The profile of the primary balance is similar, which is expected to improve from -2,3 % of GDP (-1,5 % of GDP excluding debt cancellations amounting to 0,8 % of GDP) in 2005 to 0,7 % in 2008. The budgetary adjustment is mainly expenditure based. The government expenditure-to-GDP ratio is expected to fall by 3,4 percentage points between 2005 and 2008 (by 2,6 percentage points excluding 0,8 % of GDP of debt cancellations in 2005). General government revenues are estimated to remain broadly stable until 2007 and then decrease by 0,7 % of GDP in 2008. The budgetary impact of the classification of the second-pillar funded pension scheme outside the general government sector (which has to be implemented by the time of the spring 2007 notification) is estimated at 0,8 %, 1,3 %, 1,4 % and 1,4 % of GDP in 2005, 2006, 2007 and 2008 respectively. The planned fiscal consolidation is back-loaded, mainly concentrated in 2007.

(6) Over the programme period, the structural balance (i.e. the cyclically-adjusted budget balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve on average by 0,4 % of GDP per year, from -2,8 % of GDP to -1,5 % of GDP. The programme sets the medium-term objective (MTO) for the budgetary position in structural terms at a deficit of 0,9 % of GDP and aims at achieving this position by 2010 (beyond the programme period). As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2¼ % of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct, and adequately reflects the debt ratio and average potential output growth in the long term.

(7) The risks to the budgetary projections in the programme appear broadly balanced. Although the programme is not very explicit about the specific measures planned to be adopted in order to reach the 2007 deficit target, the update emphasizes that the medium-term budgetary framework approved by the government is based exclusively on currently valid legislation and on government approved legislative changes. The current government has so far more-than-respected the budgetary targets set in the previous programmes: after a lower-than-expected 2004 deficit, a better-than-planned result is also anticipated for 2005 (if debt cancellations of 0,8 % of GDP are excluded). Nevertheless, some of the financial resources that were freed by lower-than-expected interest expenditure in 2005 were used to cover other unbudgeted public expenditures highlighting the need for more binding ceilings for expenditure items.

(8) In view of this risk assessment, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2007 as recommended by the Council. However, the budgetary stance in the programme may not be sufficient to ensure that the programme's MTO is achieved in 2010, as envisaged in the programme. In 2008 (the year following the correction of the excessive deficit), the pace of the adjustment towards the programme's MTO implied by the programme is not 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 and could be lower in bad economic times. In particular, in 2008 the improvement in the structural balance is only around ¼ % of GDP, when cyclical conditions signal 'good times' ([1]).

(9) The debt ratio is estimated to have reached 33,7 % of GDP in 2005, which is well below the 60 % of GDP Treaty reference value and 10,5 % points lower than envisaged in the previous update of the programme. This downward revision is mostly due to a stock-flow adjustment. The programme projects the debt ratio to increase by 2,5 percentage points over the programme period.

([1]) Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services, to be published at the website:
http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

(10) With regard to the sustainability of public finances, Slovakia appears to be at low risk on grounds of the projected budgetary costs of ageing populations, subject to the sustained fiscal consolidation also beyond the programme period and the full implementation of enacted reforms, as well as other reforms of a structural nature (including a reduction of unemployment). The level of debt is significantly under the 60 % reference value and should remain so under the assumption of unchanged policies for the coming two decades. However, the continuation of the currently high structural deficit will prevent the reduction of the debt/GDP ratio, which increases the risk to long-term sustainability. Implementing rigorously the planned consolidation of public finances over the medium-term is necessary in order to reduce risks to long-term sustainability.

(11) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. Slovakia is on track to correct its excessive deficit by the deadline set by the Council.

(12) The National Reform Programme of Slovakia, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) information society; (ii) R&D and innovations; and (iii) education and employment. The budgetary implications of the actions outlined in the National Reform Programme are fully reflected in the budgetary projections of the convergence programme. The convergence programme describes already adopted reforms of tax and pension systems. The 2006 budget as well as the 2006-2008 budgetary framework foresee significant increases in the expenditure on education and research and development and thus reflect priorities set in the National Reform Programme.

In view of the above assessment, the Council notes that the programme follows the deficit adjustment path set by the Council recommendations under Article 104(7). In the light of these recommendations, the Council is of the opinion that Slovakia should:

(i) strengthen, in the context of strong growth outcome and prospects, the effort in the structural budgetary adjustment, in order to speed up the attainment of the MTO; and

(ii) reinforce the binding character of the medium-term expenditure ceilings for central government.

Comparison of key macroeconomic and budgetary projections (1)

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Dec 2005**	**5,5**	**5,1**	**5,4**	**6,1**	**5,6**
	COM Nov 2005	5,5	5,1	5,5	6,3	n.a.
	CP Nov 2004	*5,0*	*4,5*	*5,1*	*5,4*	*n.a.*
HICP inflation (%)	**CP Dec 2005**	**7,5**	**2,9**	**3,6**	**2,0**	**2,0**
	COM Nov 2005	7,5	2,9	3,6	2,1	n.a.
	CP Nov 2004	*7,8*	*3,3*	*2,8*	*2,5*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2005** (2)	**– 1,9**	**– 1,6**	**– 1,1**	**0,1**	**0,8**
	COM Nov 2005 (6)	– 1,5	– 1,3	– 0,9	0,2	n.a.
	CP Nov 2004 (2)	*0,4*	*0,2*	*0,4*	*0,9*	*n.a.*

		2004	2005	2006	2007	2008
General government balance (% of GDP)	**CP Dec 2005** (2)	**– 3,2**	**– 4,1**	**– 2,9**	**– 1,6**	**– 1,3**
	COM Nov 2005	– 3,1	– 4,1	– 3,0	– 2,5	n.a.
	CP Nov 2004	*– 3,8*	*– 3,4*	*– 2,9*	*– 1,9*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2005**	**– 1,0**	**– 2,3**	**– 1,0**	**0,4**	**0,7**
	COM Nov 2005	– 0,9	– 1,9	– 0,8	– 0,2	n.a.
	CP Nov 2004	*– 1,5*	*– 1,0*	*– 0,6*	*0,4*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2005** (2)	**– 2,6**	**– 3,6**	**– 2,6**	**– 1,6**	**– 1,5**
	COM Nov 2005	– 2,7	– 3,8	– 2,7	– 2,5	n.a.
	CP Nov 2004 (2)	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance (3) (% of GDP)	**CP Dec 2005** (4)	**– 2,6**	**– 2,8**	**– 2,6**	**– 1,7**	**– 1,5**
	COM Nov 2005 (5)	– 2,7	– 3,0	– 2,7	– 2,5	n.a.
	CP Nov 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (7) (% of GDP)	**CP Dec 2005**	**42,6**	**33,7**	**35,5**	**35,2**	**36,2**
	COM Nov 2005	42,6	36,7	38,2	38,5	n.a.
	CP Nov 2004	*43,0*	*44,2*	*45,3*	*45,5*	*n.a.*

Notes:

(1) The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated programme would be -3,2 % of GDP in 2004, -4,9 % in 2005, -4,2 % in 2006, -3,0 % in 2007 and -2,7 % in 2008.

(2) Commission services calculations on the basis of the information in the programme.

(3) Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

(4) One-off and other temporary measures taken from the programme (0,8 % of GDP in 2005, deficit-increasing and 0,1 % in 2007, deficit-reducing).

(5) One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (0,8 % of GDP in 2005, deficit-increasing).

(6) Based on estimated potential growth of 4,9 %, 4,8 %, 5,1 % and 5,1 % respectively in the period 2004-2007.

(7) The debt projections (in contrast with deficit projections) in the programme have been prepared taking into account the Eurostat decision of 2 March 2004 on the classification of funded pension schemes.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations