Ministry of Finance of the SR

CONVERGENCE PROGRAMME FOR THE SLOVAK REPUBLIC

covering the period 2005 – 2010

November 2005

CONTENTS

INTRODUCTION

The presented Convergence Programme of Slovakia by 2010 builds on objectives and measures specified in the first Convergence Programme prepared in May 2004 and its updated version from November 2004. The content and formal aspects of the document fully comply with the most recent guidelines of the European Commission adopted in 2005 for the preparation of stability and convergence programmes. The adjustment of the guidelines is intended to improve the implementation of the Stability and Growth Pact, constituting a basis for the macroeconomic framework of the Economic and Monetary Union (EMU).

It is important to state at the very beginning that the **main fiscal targets presented in the historically first Convergence Programme remain unchanged and the Government further deems the reduction of the fiscal deficit to be important from the convergence criteria perspective as well as for attaining long-term sustainability of public finance and macroeconomic stability assurance.** The general government budget for years 2006 to 2008, approved by the Government and representing the core of this programme, fully reflects these intentions.

The current Convergence Programme presents **three main targets** in the fiscal, monetary and labour market areas:

1. The medium-term fiscal target is to reduce general government deficit together with the impact of the pension reform, to 3% of GDP in 2007, and to 0.9% by 2010, which is in line with the range recommended for the SR by the EC under the Stability and Growth Pact reform. Furthermore, **long-term sustainability of public finance at the end of the decade is to be ensured**.
2. As regards the monetary area, the key intention is **integration into the Eurozone**. Presently, Slovakia belongs to the EMU member countries, with a temporary exception granted for the use of the uniform euro currency, and full membership of the SR in EMU is still expected to begin **in 2009**.
3. The main medium-term target of the labour market is **to increase the employment rate by 1 to 2% per annum.**

These three targets have been unanimously formulated in the following Government-approved documents:

- the Convergence Programme of Slovakia for years 2004 to 2010,
- the Euro Adoption Strategy of Slovakia, and its particularisation,
- the National Reform Programme of Slovakia for Years 2006-2008, fully building on the SR Competitiveness Strategy by 2010.

The Convergence Programme of the SR reflects the Government's economic policy applied in practice. The importance of the Convergence Programme's position is also documented by the fact that the EC's statement and recommendations concerning the Convergence Programme of the SR, prepared in November 2004, were discussed with members of the Parliament in the Finance, Budget and Currency Committee of the Slovak Republic National Council. This Committee has also been informed of the Stability and Growth Pact reform process. The Convergence Programme has been discussed within this SR NC Committee as well as in the SR NC Committee for European Affairs. Over the forthcoming weeks, the Programme will be also submitted for discussion to the Slovak Republic National Council.

I. FRAMEWORKS AND OBJECTIVES OF ECONOMIC POLICY

I.1. Main Objectives of Economic Policy

Objectives of the economic policy of the SR Government remain unchanged. The achievement of **a high and sustainable growth in the economy** remains the top priority, as it is a necessary prerequisite for acceleration in the growth of living standards, and convergence with those of developed EU member States.
The aim includes the promotion of a fast, and yet irreversible process of general convergence on a qualitative basis with a view to acquiring full membership in the Eurozone as of 1 January 2009; the SR joined the ERMII exchange regime as of 28 November 2005, and the readiness review of the SR should be successfully undertaken in the first half on 2008. Economic objectives are being achieved through a suitable selection and thorough coordination of partial policies - both macroeconomic and sector-specific, supported by an effective implementation of structural reforms.
Since upon integration into the Eurozone, the SR will lose its national monetary policy instruments for shock elimination, a major emphasis is placed on the readiness and mutual harmonisation of remaining partial policies. The main objectives and principles of economic and social policy of the Slovak Republic are as follows:

- ***fiscal policy*** – it is based on the three principles that have already been pronounced in the first Convergence Programme of Slovakia. These include transparency, responsibility, and effectiveness. The main medium-term target of fiscal policy is a reduction in the general government deficit, inclusive of costs from the launching of the second pension scheme pillar, to below 3% of GDP by 2007. This target has been defined in the three-year General government Budget for years 2006-2008, compiled on the basis of the effective legislative framework. Another medium-term target is the reduction of the cyclically adjusted general government deficit to 0.9% of GDP in 2010. This target is in line with the Slovakia's medium-objective set out under the Stability and Growth Pact and, according to the opinion of the SR Ministry of Finance, the objective to create conditions for long-term sustainability of public finance by 2010. The 2010 objective extends beyond the incumbency of the current Government, and requires the adoption of certain measures exceeding the current legislative framework. These involve in particular policy set-ups able to assure lower increases in public expenditure in comparison with the economic growth for the future.

- ***monetary and exchange policy*** – starting from 2005, this has shifted to the definition of the medium-term framework in the form of a binding objective, and the definition of the monetary policy performance as inflation targeting under ERM II conditions. Thus, the central bank provides the various economic subjects with a more transparent and unambiguous framework for the formulation of their expectations and intentions over longer terms. Medium-term objectives are specified consistently with 1) obligations arising from EU membership; 2) the intention to create conditions for euro adoption; and 3) the Government's obligations in respect of the fiscal deficit reduction. The inflation target is set out as a year-to-year inflation rate[1] below 2.5% at December 2006, and below 2% at December 2007 and 2008. This inflation target is consistent with the Maastricht monetary and exchange criteria. Since Slovakia is a small and open economy, the exchange rate represents an important channel of the monetary policy's transmission mechanism. The

[1] measured by the harmonised consumer price index

development of the exchange rate and its deviations from a balanced path will be assessed by the NBS in relation to the defined inflation target during the entire period up to the adoption of the euro. The ERMII exchange regime should provide a suitable framework for nominal convergence and real convergence: 1)a certain degree of exchange rate stability; 2) pressure on macroeconomic discipline; and, at the same time, 3) sufficient room for adaptation to shocks and economic development.

- ***labour market, product and service, and financial market policies*** – the main target in the area of *employment* is 1% to 2%[2] average annual employment growth. In addition, the reduction in the structural rate of registered unemployment below 10% by 2010 still remains an important target. Balanced employment growth should be a reflection of multiple factors, namely: 1) the growth of the production side of the economy linked to an improved business environment; 2) the improvement of labour market flexibility; and 3) a rising interest in work. In the *product and service market*, the key intention is to increase productivity with the help of a suitable investment climate, more intense competition, liberalisation, support for businesses, and effective regulation. In *financial markets*, the primary intention is to maintain sound competition and strengthen an efficient regulation framework. The achievement of these targets is to a large extent facilitated by the *Competitiveness Strategy of Slovakia by 2010*, adopted by the SR Government in February 2005 and considered to be the National Lisbon Strategy for the SR. The strategy is aligned with the main priorities and objectives of the renewed Lisbon Strategy and new integrated principles, and has become a basis for the *National Reform Programme* for Slovakia. Both the strategy and the reform programmes rely on two pillars: 1) the completion of structural reforms and the maintenance of their results; 2) the development of a knowledge economy through the promotion of education, employment, an information society, science, research and innovation, and a business environment. The programme funding will not put the stability of public finance and fiscal targets at risk; it is addressed through a review of general government expenditure, a higher degree of utilisation of private resources and EU schemes.

I.2. Fiscal Policy

From the macroeconomic stability point of view, the main medium-term objective of fiscal policy is the reduction of the general government deficit, inclusive of the costs of launching of the second pension scheme pillar, to below 3% of GDP by 2007. The government's consolidation efforts over a longer medium-term period are directed towards the creation of conditions for a long-term sustainability of public finance, which primarily means adjusting public budgets to the consequences of ageing of the population. **Reflected in a specific medium-term interim objective, this long-term objective means the reduction of the cyclically adjusted general government deficit to 1% of GDP by 2010**. The updated estimate of the Ministry of Finance of the Slovak Republic (MoF) contemplates a cyclically adjusted deficit of 0.9% of GDP in 2010. This target falls within the deficit range of 0.5 – 1.0% of GDP, set out as the medium-term target for Slovakia within the framework of the revised Growth and Stability Pact[3].

[2] The medium-term scenario of SR MF contemplates an average annual growth around 1% primarily with a view to assuring that fiscal parameters will continue to be set up less conservatively.
[3] "The definition of country-specific medium-term objectives in the revised Stability and Growth Pact", EFC, 14 September 2005

Although the medium-term objective set out in the Pact for Slovakia results from a transitive methodology which only takes into consideration the expected potential product growth and the initial public debt level[4], pursuant to analyses by MoF, the cyclically adjusted deficit of 0.9% in 2010 is also sufficient in terms of the long-term sustainability of public finance (if accompanied by certain further specified changes in the pension scheme at a later stage).

The consolidation of public finance is the Government's focal medium-term objective. Its success is the main prerequisite for the efficient functioning of automatic stabilisers in the future. The Government's current priority in the stabilisation policy area is to assure that consolidation objectives will not threaten sound economic growth, and will support the effective performance of monetary policy. An increased efficiency of the stabilisation policy will be also contributed to by structural reforms, and in the case of Slovakia, primarily the recent labour market reforms.

Consolidation objectives are important from the perspective of financial stability, although the Government is also well aware of the key importance of the qualitative aspect of public finance. A successful continuation of the fulfilment of medium-term objectives enables focus on this issue in particular. Therefore, a political priority for the next periods is an improvement in the efficiency and effectiveness of the use of public resources, and their orientation towards the promotion of the economy's potential growth. This is the key purpose of the continuing improvement of the programmed budgeting as one of main priorities for the upcoming period. However, the Government also recognises that a greater focus on the qualitative aspects of public finance must not compromise fiscal consolidation.

Therefore, fiscal policy will continue to promote: long-term sustainability, macroeconomic stability, economic growth support, as well as efficiency in the use of public resources.

I.3. Monetary and Exchange-rate Policy

In connection with the process of integration of the Slovak Republic into the Eurozone, the National Bank of Slovakia (hereinafter "NBS") took a decision at the end of 2004 to change the principal monetary policy framework. With a view to meeting the Maastricht criteria in between 2007 and 2008, starting from 2005 the NBS began to apply a policy whose performance was defined in its Monetary Programme by 2008 [5] as **inflation targeting under ERM II conditions**. A nominal anchor of the current monetary policy is represented by the binding targets for a annual change in the end-of-year inflation, measured by the harmonised consumer price index, set by the NBS at 3.5% +/- 0.5% for 2005, below 2.5% for 2006 and below 2.0% in the subsequent two years. The NBS, in parallel with a shift to explicit inflation targeting, ceased the publication of its annual monetary programmes and began the quarterly publication of Medium-term Predictions in the form of unconditional economic development forecasts taking account of meeting the inflation targets. It is expected that such clear and binding defined targets and their evaluation will result in a higher degree of transparency of the monetary policy performance, with a positive impact on the formation of inflation expectations.

[4] In 2006, the discussion on a suitable methodology for the definition of medium-term fiscal objectives for each EU country, taking in account aspects of long-term sustainability of public finance, will continue.

[5] Published in December 2004

Given the high level of openness of the Slovak economy and the importance of the exchange-rate channel of the transmission mechanism, in exercising its policy the NBS also takes into account the nominal exchange rate development, evaluated in relation to the development of macroeconomic fundaments and in consistency with the inflation target.

At present, exchange-rate policy is exercised in the ERM II regime **in line with the supposed timing of the adoption of the common European currency as of 1 January 2009**, as declared by the NBS and the SR Government in the "Specification of the Euro Adoption Strategy" document in September 2004. The organisation of the euro adoption preparation process itself is detailed in the National Euro Adoption Plan of the SR, a joint strategic document of the NBS and the SR Ministry of Finance approved by the SR Government in July 2005.

I.4. Structural Policies

Thanks to the speed and force of the reforms implemented so far, Slovakia has almost completed the most demanding part of the planned structural reforms. By enforcing unpopular, so called "deep" reforms, the country has established a good position for the achievement of fast and sustainable economic growth, and has thereby taken a significant step within the process of convergence of the SR's standards of living to those of the most developed countries of the EU. Therefore, the Government priorities for the upcoming period concentrate on fine-tuning the started reforms and the implementation of accepted measures in a manner leading to positive results for the development of the economic potential of the country.

The fine-tuning, and maintenance of results, of structural reforms represents the first one of the two pillars of *the National Lisbon Strategy of the SR* as well as the *National Reform Programme.* The second main pillar of the Slovakia's strategy is *the development of a knowledge economy*, intended to contribute to ensuring the long-term competitiveness of the Slovak economy. The growth in the innovative potential of the Slovak economy within the second pillar will be enforced by the acceleration of the development in five priority areas, perceived as a uniform whole in terms of countries' needs – *science, research and innovation, employment, an information society and business environment.* The government's efforts seek a proper setting for these structural policies with a view to making them lead to ecologically suitable innovations, the introduction of environmental technology and a reduction in energy costs.

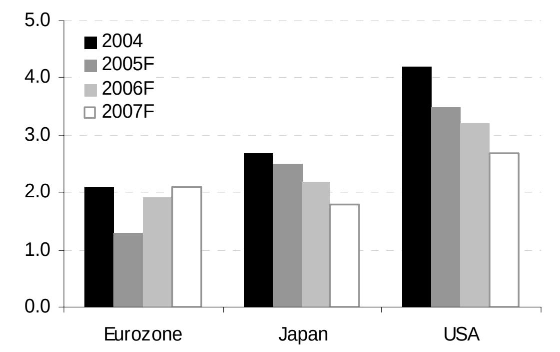
II. ECONOMIC PERSPECTIVES AND ASSUMPTIONS

The updated Convergence Programme further confirms that the Slovak economy is in a sound condition, with economic growth reaching the highest rates across the Central European region. Employment is growing at a fast rate, particularly in the private sector, and the unemployment rate is significantly falling in terms of all available indicators. The current account deficit, as well as the public finance deficit, is heading towards sustainable levels, and the inflation rate is, despite high oil prices, low.

II.1. Development of the Global Economy

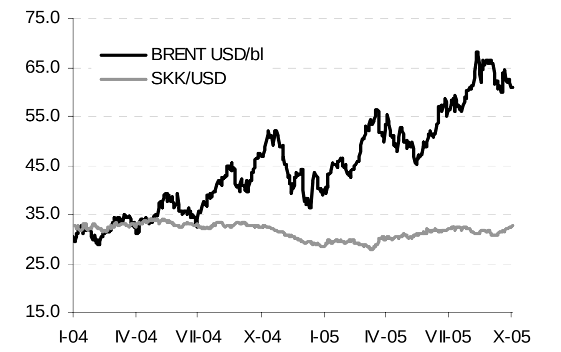
The development of the global economy in 2005 was accompanied by uncertainty and concerns arising mainly from oil price trends and their potential impact on individual economies. Natural elements in the Gulf of Mexico, outages in oil extraction, its unbalanced distribution and the high prices, together with political events in Europe undermined the confidence of both investors and consumers, and therefore disappointed expectations for a more energetic recovery of economy in the Eurozone. On the contrary, dynamic rates of growth were retained by the developing economies of China and India, supported by both a continued growth in exports and a strengthened domestic demand. Although it might appear that main economies have absorbed the high prices of oil without any remarkable losses and inflation pressure, despite the decline in September, their uncertain development, insufficient processing capacities and the approaching heating season continue to pose a risk for the further development of the global economy.

Expected growth of selected countries (%)



Source: EC Economic Forecasts Autumn 2005

BRENT Oil (USD/barrel) and trends of the crown exchange rate

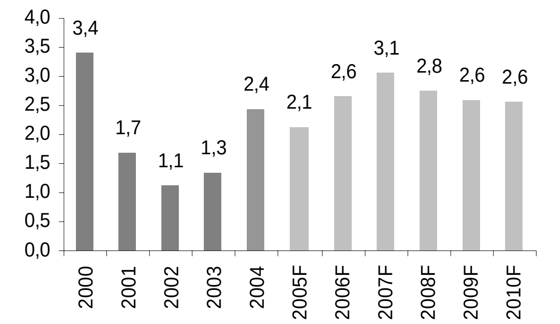


Source: REUTERS

The US economy, affected by hurricanes, should continue to play the prime role in the upcoming years, although it will also face a decline in growth dynamics. Pursuant to the most recent estimates, the adverse impacts of hurricanes and the resulting losses should not have any long-term effect, and this should be also helped by the subsequent reconstruction of destroyed territories and related government expenditure. The high prices of oil could, however, adversely affect the purchasing power of consumers and decelerate further economic growth. Another risk for the US economy is further posed by the excessive twin-deficit, concerns over the non-sustainability of the deepening current account deficit and, recently, also rising prices in the real estate market.

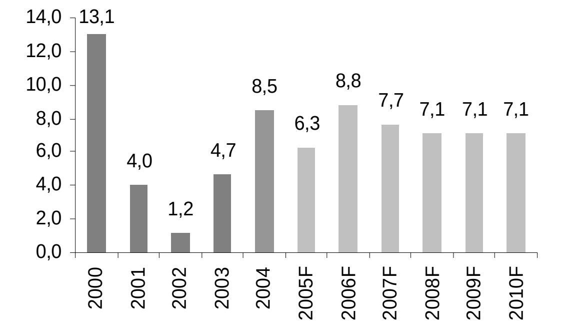
In addition to high oil prices, Europe also experienced political uncertainty further disturbing business and consumer feeling. Unclear macroeconomic results, mixed indicators of conjuncture surveys in recent months, and the expected low demand on the part of US consumers indicate that the Eurozone will still have to wait for its boom. With an effort to support economic growth, ECB has been maintaining the prime interest rate at a level of 2.0% for over two years, but the relatively low performance of the Eurozone's economy is caused by structural reasons; pursuant to recommendations by the European Commission, a number of countries will have to implement inevitable structural reforms. This has been also emphasised in the "half-time" review of the Lisbon process.

Weighted GDP growth of Slovakia's trade partners (%)



Source: OECD (May 2005), Ministry of Finance of the Slovak Republic

Weighted import growth of Slovakia's trade partners (%)



Source: OECD (May 2005), Ministry of Finance of the Slovak Republic

The openness of the Slovak economy predetermines its dependency on the development of the global economy. According to OECD forecasts, after the 2005 stagnation, Slovakia's most important partners should experience the revival. The export-weighted real GDP growth [6] should accelerate from 2.1% in 2005 to 3.1% in 2007. The acceleration in the economic growth of these countries should generate a wider space on the demand side, and a growth in their imports, i.e. Slovakia's exports, in the next years. Major risks in the development of the external environment should be seen primarily in the growing prices of oil, as well as the non-persuasive dynamics of the German economy.

The assumed development of external environment underlying the Convergence Programme and the budget (Annex 4) are very close to the common baselines proposed by the European Commission. This is why it is not necessary to analyse potential risks arising from differences between estimates.

Selected common external assumptions according to the EC

	2005	2006	2007
GDP, world without EU, real growth (%)	5.2	5.0	4.7
GDP, USA, real growth (%)	3.5	3.2	2.7
GDP, Japan, real growth (%)	2.5	2.2	1.8
EU export markets, ex EU (goods, %)	9.1	9.1	8.3
Global exports, without EU (goods, %)	8.8	8.8	8.4
World import prices (goods, USD)	6.3	1.8	1.8
Price of oil (Brent, USD/bl)	55.0	61.4	60.5
Prices of non-oil commodities (USD, %)	7.4	1.7	-0.9

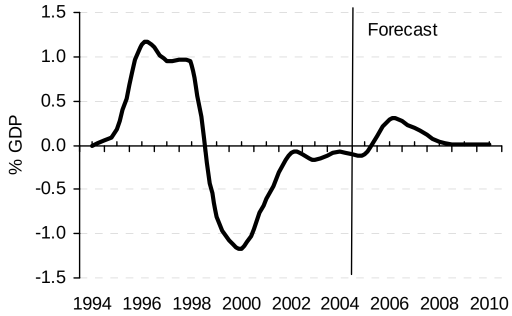
Source: European Commission Common External Assumption, October 2005

II.2. Cyclical Development and Current Perspectives

The analyses of the previous development of the Slovak economy and the current predictions of a number of institutions (SR MF, EC, MMF and NBS) indicated that the Slovak economy is closely below its potential product in 2005. According to the SR MF, the economy will generate a product 0.1% lower than its potential product at a relatively strong growth in the economy's potential (5.1%). This growth will be primarily driven by the increasing capital stock and productivity in the export sector.

[6] Weights used include shares of the particular countries in Slovakia's export. 2004 weights were used for years 2005-2010.

Output gap development (GDP %)



	GDP growth (%)	Potential product (%)	Output gap (% GDP)
2001	3.8	3.2	**-0.6**
2002	4.6	4.1	**-0.1**
2003	4.5	4.6	**-0.2**
2004	5.5	5.4	**-0.1**
2005F	5.1	5.1	**-0.1**
2006F	5.4	5.0	**0.3**
2007F	6.1	6.2	**0.2**
2008F	5.6	5.8	**0.0**

Source: Ministry of Finance of the SR

In 2005, the capital stock increased significantly and partially offset the decline in the contribution of the total factor productivity (TFP) to the potential growth. TFP in 2004 drew a short-term benefit from the integration of the SR into the EU[7], but in 2005 a certain deceleration was experienced, in the form of a reversal of the growth to its trend levels (4.0% growth in 2004 vs. 3.5% in 2005). It is assumed for the years 2006-2008 that the growth in total productivity and potential employment will be positively influenced by direct foreign investment inflows from the structural funds (SF) of the EU and, from the medium-term perspective, primarily by implemented reforms. In the second half of 2005, and in early 2006, the gap will be gradually closed, and in 2006-2007 the economy should achieve a production level slightly above its potential product level.

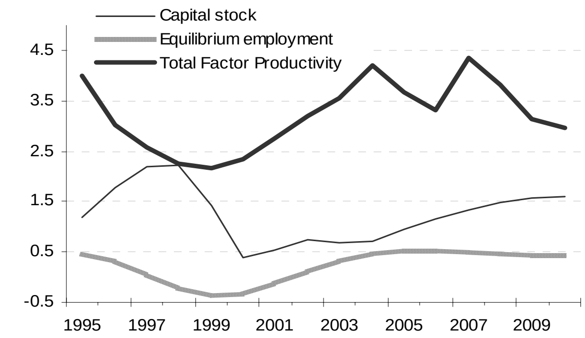
The output gap estimation again employed the production function method, as recommended by the European Commission. However, problems common mainly in new Member States – such as the appropriate incorporation of impacts of direct foreign investment inflows into the labour productivity growth, persist. The estimated effect of the launch of production at the PSA Peugeot Citroën and KIA Slovakia facilities at the turn of 2006 and 2007 is based on the experience with the launch of a new production line of another big automotive manufacturer, VW. Its is assumed that the growth of the total productivity of production factors (TFP) should oscillate around 3.0% p.a. in the next period, and due to the aforesaid launches of production it should temporarily grow to an annual average of approx. 4.0% in 2006-2007.

Another impulse for the potential product should result from the structural fund (SF) inflow from the EU budget. It is expected that these funds should increase investments and, as a result, the capital stock, and particularly the economy's TFP. A major part of SF will flow into the development of infrastructure, significant modernisation of technology in businesses or the development of services. All these changes *per se* mean primarily an increase in the productivity of labour and the existing capital. The aggregate impact of the potential product is estimated to account for 0.5% of GDP, and it has been included in the medium-term TPF growth. The SF inflow and impact on TPF improvement will open opportunities for a faster rate of growth in real wages and the general standard of living.

[7] The potential product estimate partially took account of the effect associated with the EU integration in 2004. This effect, together with the possible impact of structural reforms, was incorporated into the potential product calculation through a TFP growth of 0.4 pp.

According to the technical method of estimating balanced employment based on the HP filter, employment in 2005 was slightly above its balanced level (this may be caused, to some extent, by the well-known end-point problem of this filter). The structural employment growth for 2005-2008 is projected to be around 0.9% to 1.0% per annum. Due to permanent supply shocks the tendency to work with conservative assumptions and projections will be maintained. This also applies to the expected employment growth as well as TFP in year 2006 through 2008.

Contributions of main factors to the potential GDP growth (percentage points)

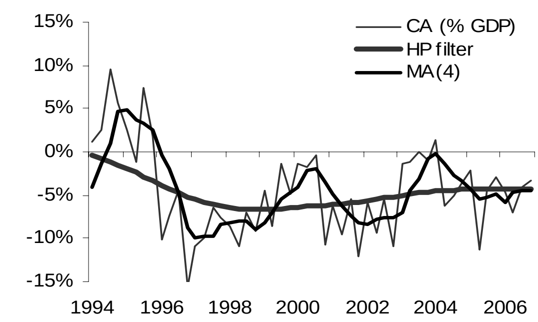


	Output gap	Capital stock	Equilibrium employment	TFP*
2001	**-0.6**	0.5	-0.1	2.8
2002	**-0.1**	0.8	0.1	3.2
2003	**-0.2**	0.7	0.3	3.5
2004	**-0.1**	0.7	0.5	4.2
2005F	**-0.1**	0.9	0.5	3.7
2006F	**0.3**	1.2	0.5	3.3
2007F	**0.2**	1.3	0.5	4.4
2008F	**0.0**	1.5	0.5	3.8

Source: Ministry of Finance of the SR

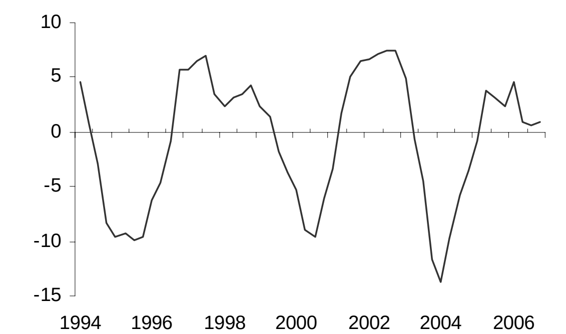
Given the uncertainty involved in the quantification of the output gap, in the case of small and open economies it is useful to keep track of a series of important indicators that may indicate whether or not an economy is at a level above its potential. These include *inter alia* net inflation without fuel, the current account deficit, the number of vacancies per unemployed, or the capacity utilisation from business surveys. These indicators are sensitive to unbalances in economy on both the external and internal side. The following two graphs show their development trend and a balance indicator derived from them. These indicators indicate that the economy is at a level close to its potential at present, and in the upcoming period the output gap can be positive. Such an approach entails many shortcomings and the calculation was made only for illustrative purposes. Its use can be seen as supporting the assessment of the output gap development trend, rather than a discussion on its exact value.

Current account deficit (% of GDP)



Source: Ministry of Finance of the Slovak Republic

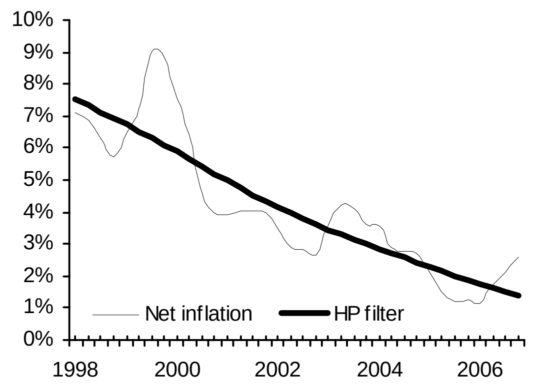
Deviation of current account deficit from the trend section.



Note: The deviation has been calculated as the differential between the trend section ((HP filter approx.) and the four-period sliding average.

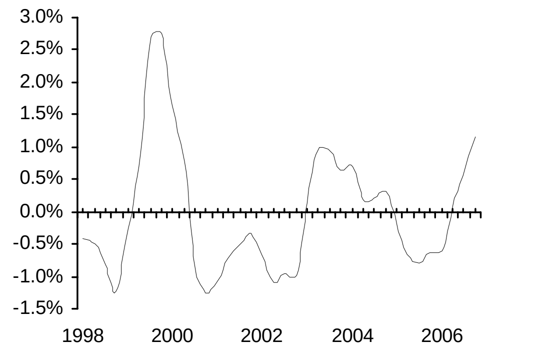
Source: Ministry of Finance of the SR

Net inflation without fuels (%)



Source: Ministry of Finance of the SR

Deviation of net inflation from trend section (percentage points)



Source: Ministry of Finance of the SR

II.3. Medium-term Scenario

With a view to permanently increasing objectiveness, transparency and, in particular, the likelihood of meeting medium-term macroeconomic projections and, as a result, public finance projections, again the proven form of assessing medium-term forecasts in the Macroeconomic Forecasts Committee was applied[8]. In 2005 the assumed scenario was discussed and confronted with the opinions of seven representatives of independent institutions that regularly compile their own forecasts for the Slovak economy. The presented final Government's forecast was judged by a majority of them as realistic, which provides a sound basis for the correct set up of medium-term fiscal targets.

Brief characteristics of the current development of the economy

Interim data of quarterly national accounts, as well as economic and financial indicators known on a monthly basis until October 2005, confirm the main development trends and expectations towards a **positive direction of the Slovak economy** as presented in the Updated Convergence Programme of Slovakia for the Years 2004 – 2010. They also confirm the assumed factors influencing the development of the various areas of the economy. For the above reasons, the further sections of this document place a greater emphasis on those aspects of the current development of economy that may more significantly influence numerical estimates for 2005, or are essential for the monitoring of sustainable economic growth.

The growth of the Slovak economy during the first half of 2005 at a level of 5.1% slightly exceeded the initial expectations. So far, the high economic growth has not brought any hazards for its further stable development. The inflation rate is relatively low and it further reflects primarily adjustments of regulated prices implemented at the beginning of the year, and the oil price trends on world markets. The current account deficit accounts for 5% of GDP, and is safely set off by the financial and capital account surplus. The public finance deficit also develops in accordance with fiscal objectives and, as a result, good conditions for the implementation of monetary policy consistent with the monetary policy of NBS have been established.

[8] The Committee was established by the SR MF, and has been in the second year of its successful existence.

The increasing performance of the economy has been supported by a combination of **labour productivity growth** and **employment growth.** Since productivity [9] in 2004 grew at the maximum rate observed during the last decade (5.2%), and the employment rate, particularly in 2005, has been steeply accelerating (a 2.2% growth rate in the first half of 2005), the productivity growth has slowed down in 2005.

In terms of the demand side of economy, since mid 2004 GDP has been stimulated by **accelerated domestic consumption and investments,** accompanied by rising inventories.

The improved development in **private consumption**, gradually increasing its dynamics since the end of 2003, is primarily driven by the growth of disposable income of households. The trend in the savings rate, previously declining, seems to have changed and shows a year-to-year increase. It is a good signal indicating that the increase in consumption is not accompanied by a decline in the savings rate, as it was in 2004. Household income grew due to higher average wages, rising by 9.1% in the first half of 2005. One important factor stimulating the income growth was employment growth. The relatively steep decline in the inflation rate compared to 2004 to a large extent contributed to the significant rise of average real wages by 6.2%. The nominal **consumption of general government** during the year corresponds to the approved budget and scheduled timing of expenditures. The minor revision of the real growth estimate primarily reflects the development of the appropriate price deflator. Due to low interest rates, a reduced tax burden, growing profits of businesses and, in particular, the interest of foreign investors, the **investment growth,** which resumed in 2004 after a two-year depression, has been accelerating. The increasing dynamics of the investment process, accompanied by the growth of inventories, promises a further growth of GDP in the future. On the other hand, as of July 2004, the **export** of goods has substantially changed. This is primarily caused by the (assumed) temporary suspension of car exports and their parts and accessories resulting from an innovation in the production line. Nevertheless, export growth will continue, though at a relatively lower rate, as a result of the increasingly larger contribution of other sectors (mainly the production of electrical and optical equipment). **The import of goods** in the SR is strongly linked to the export of goods, but imports in 2005 have been to a large extent driven by domestic demand, primarily that related to the accelerating investment process. Following expectations, for the above reasons the **foreign trade deficit** will significantly worsen against 2004, but only temporarily.

Prediction of the development of real economy

The forecast revision involves consideration of the latest development of the Slovak economy and updated forecast of the further development of the international economy released by the EC and OECD. Due to the current development and expectations, we shifted the oil price estimation for 2006 to USD 65 per barrel. In the next period (up to the end of 2007) we expect a gradual drop in the price to USD 60 per barrel. We applied the same approach in the revision of the assumed trend of the SKK/EUR exchange rate. In last-year's Convergence Programme we applied a technical assumption of a constant nominal exchange rate level, however now we expect a gradual appreciation to 36 SKK/EUR in 2009. The SKK/USD exchange rate trend reflects the cross EUR/USD exchange rate assumed by the EC. Technical methods and general principles adopted in the preparation of projections for the Convergence Programme were retained.

[9] Measured as GDP in constant prices per employee in total economy

According to the forecast update it is expected that throughout the forecasting horizon of 2008 the potential growth of the Slovak economy will shift upwards to a level of around 6.0%. The sources of growth should lie primarily in capital productivity and stock, as well as structural employment growth. These factors should support the required process of real convergence.

It becomes increasingly certain that after 2005, economic growth should be driven by a combination of domestic and foreign demand. While it is still more realistic to expect a negative contribution of foreign trade in goods and services to the growth of GDP in 2005, in upcoming years, 2007 in particular, the contribution of the net export will be positive. The positive contribution of domestic demand to the economic growth should be supported by the stabilisation of the growth of real wages and, as a result, household consumption.

Given the fact that gross nominal wages are growing at a faster rate this year and consumer prices are growing more slowly than expectations[10], the real wage growth estimate was increased to 5%. This will lead to a higher, 5.2% real growth rate of **private consumption** [11] In the next years, real wages could grow at a rate of 3.5% to 3.7% per annum, however this rate will not exceed that of the labour productivity growth as will probably be the case of 2005 [12]. It is assumed that during the forecasting period, the average wage growth will reflect the development of labour productivity, and will not generate a risk of demand-pulled inflation. The wage growth, together with the positive employment trend, will drive an increase in private consumption of 3.7% to 4.7%, and the latter will achieve an average level of around 55% of GDP.

The government consumption [13] will further develop in line with the government's main objectives and measures of its fiscal policy. Therefore, the government consumption continues to be the GDP component with the lowest rate of growth. In view of the update of the public finance expenditure forecast (refer to Chapter III.3) it is expected to grow by 1.8% in 2005, and in 2006, with regard to the price deflator estimate, by 4.2%. In other years it should equal to, or be closely below 3%.

Based on the development observed in the second quarter of 2005 and the launched **investment activities**, a further revival of fixed capital formation can be expected, and will be most noticeable during this year (a real increase of 8.5%). The further progress of the investment process will depend on the timing of investments and the launch of new productions. We assume that the strong growth in investments, at a rate above 7%, will be preserved up to 2007.

Foreign demand for goods and services will be to a large extent influenced by investment inflows into Slovakia, an improvement in the existing export capacities and in competitiveness of the SR, as well as economic growth strength within the EU. Current estimates of the export and import growth for 2005-2006 are below the levels of the previous forecasts; higher growth levels are expected only in 2007. The contribution of net foreign demand to the real growth of GDP should be negative in 2005, and positive starting from 2006; however, it will only be comparable with the contribution of domestic demand in 2007.

[10] compared to the Updated Convergence Programme for the years 2004 to 2010
[11] final consumption of households – a component of GDP
[12] This is a temporary excess, and it is not likely to threaten the sound development of the economy.
[13] final consumption of general government

Growth and related factors (%, unless otherwise indicated)							
	2004	**2005F**	**2006F**	**2007F**	**2008F**	**2009F**	**2006F**
Growth of GDP in fixed market prices	5.5	5.1	5.4	6.1	5.6	5.1	5.0
GDP level in current market prices, bn SKK	1325.5	1432.4	1552.9	1674.4	1788.5	1917.5	2058.1
GDP deflator (year-to-year growth)	4.6	2.8	2.8	1.6	1.2	2.0	2.2
CPI change (annual average)	7.5	2.8	3.3	2.0	2.0	2.4	2.6
Growth of employment*	0.3	1.8	0.9	0.8	0.8	0.8	0.8
Growth of labour productivity**	5.2	3.1	4.4	5.2	4.7	4.2	4.2
Demand impulses of growth Percentages of changes in current prices							
1. Private consumption expenditure	3.5	5.2	4.5	4.8	4.4	4.2	4.1
2. General government consumption expenditure	1.1	1.8	4.2	2.9	3.0	2.9	2.8
3. Gross fixed capital formation	2.5	8.5	7.6	7.4	4.0	4.0	5.5
4. Change in inventories and net acquisition of valuables expressed in % of GDP***	2.2	3.5	3.0	0.8	1.1	1.3	1.5
5. Export of goods and services	11.4	7.5	9.6	16.0	10.5	7.6	7.4
6. Import of goods and services	12.7	7.9	9.2	13.1	9.7	6.9	7.1
Contributions to growth of GDP							
7. Final domestic demand	2.7	5.1	5.0	4.9	3.8	3.7	3.9
8. Change in inventories and net acquisition of valuables (= 4)***	3.6	0.3	-0.2	-2.2	0.4	0.2	0.3
9. Balance of foreign trade in goods and services	-0.8	-0.2	0.6	3.3	1.4	1.2	0.8

* According to the selective labour force survey

Source:: Statistical Office of the SR, Ministry of Finance of the SR

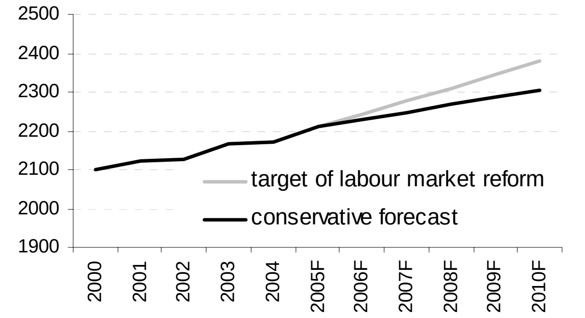
** Growth of GDP in market prices per employed person in fixed prices

*** Inclusive of statistical discrepancy

Development on the labour market

The high growth of the economy in 2005 will bring a growth in **employment**, with an annual increase of 1.8% in the number of employees. The data published for the first half of 2005 were very favourable (2.2%), and therefore we increased the forecast for the entire year 2005. The good employment results were primarily driven by an increase in the number of businesses without employees (1.5 percentage point), as well as by an increase in the number of employees (0.4 percentage point). In the following years 2006-2008 in the baseline scenario we expect 0.8% growth in employment. This is a conservative estimate that tries to avoid risks for the fulfilment of fiscal objectives. In case of the successful implementation of reforms in the labour market (refer to the National Reform Programme of the SR) the annual employment growth rate could reach 1% to 2%.

Workers in the national economy (in thousands of people)



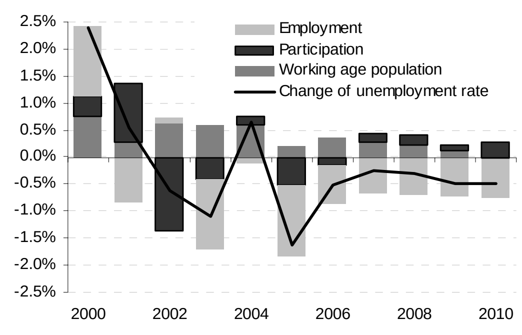
Source: Statistical Office of the SR, SR MF

Deviations from these figures may be experienced in certain years, mainly due to the exceptional recruitment of workers in large production plants and the drawing of EU funds. The amount of dismissals in the public sector in 2006-2008 is not expected to achieve the level of 2002-2004 since the majority of this sector has already undergone rationalisation, and therefore headcounts should be stabilised.

In 2005, positive trends in **unemployment rate** development were observed. In the first half of 2005, the number of unemployed dropped (according to LFS methodology) on a year-to-year basis by a strong 11.4%, and therefore the unemployment rate decreased to 16.9%. This is an unprecedented decrease of 2 percentage points, and therefore the aggregate annual unemployment rate estimate for 2005 was adjusted to 16.4%. This favourable estimate is mainly caused by two factors. The first is the growth of employment *per se* that contributed to the decrease in the unemployment rate by 1.4 pp. The second factor is the declining rate of participation that should drop on a year-to-year basis by 1 pp (primarily due to the impact of early retirements and stricter conditions for registration of the unemployed). This reduction contributed to the unemployment rate decrease of 0.6 pp. The contribution of the growth of the population of productive age was slightly positive (+0.3 pp).

It is expected that in the next period the slight decline in the unemployment rate will continue. We anticipate the participation rate as well as the working age population not to further decline. Since these two factors will have moderate adverse effects on unemployment, the pace of reduction in the unemployment rate will primarily depend on the capability of the economy to generate new jobs. Therefore, it is assumed that unemployment, measured by the LFS, will drop to 15.4% in 2008, and will be below 14.5% by 2010. According to the national methodology that concerns the available number of unemployed, unemployment should drop to approx. 10% by 2010.

Contributions of the factors to the unemployment rate change (in percentage points)



	Employment	Participation rate	Working age population	Unemployment rate change
2003	-1.29	-0.42	0.61	-1.09
2004	-0.11	0.16	0.59	0.65
2005 F	-1.31	-0.52	0.21	-1.63
2006 F	-0.71	-0.16	0.35	-0.52
2007 F	-0.67	0.14	0.29	-0.24
2008 F	-0.71	0.18	0.23	-0.30
2009 F	-0.71	0.12	0.11	-0.48
2010 F	-0.72	0.27	-0.03	-0.48

Source: - Statistical Office of the SR, Ministry of Finance of the SR

In the first half of 2005, the average **nominal monthly wages** in the economy of SR increased on a year-to-year basis by 9.1%[14] (1.2 percentage point less than the same period of 2004). This relatively high nominal wage growth rate and the decelerated inflation rate resulted in an average real wage increase of 6.3% against the same period in 2004. Monthly indicators confirm the assumed gradual deceleration of the nominal wage growth dynamics; thus, wages could increase on average by 7.9% in 2005 (real wages by 5.1%). Given the relatively

[14] In the first quarter of 2005 the nominal wage growth was positively influenced by extraordinary lump-sum compensations in the manufacturing of refined oil products. Our calculations indicate that these compensations contributed approximately by 1 pp. to the wage growth in the 1st quarter of 2005.

low inflation rate and the prevailing mechanism of collective wage bargaining (based on previous inflation rates), a lower growth rate of around 5.8% to 6.5% is expected in the next years. Depending on the development of consumer prices, real wages could grow on average by 3.6% in the next years.

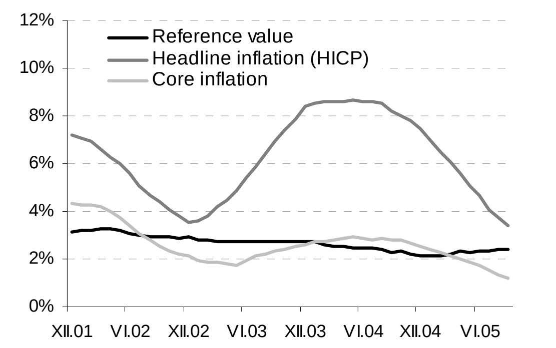
In the first half of 2005, the real wage growth was faster than the growth of real labour productivity. While in 2004 the real wage growth rate lagged behind the productivity growth by 2.7 pp., in the first half of 2005 a reverse relation was observed, with a difference of 3.6 pp. There is an evidence of the historically observed effect that significant changes in inflation influence the relation between wage and productivity growth. The year 2005 is specific since the inflation rate has dramatically dropped (7.5% in 2004; 2.8% in 2005), and the growth of nominal wages is only adjusting itself to this trend at a slow rate. In 2006-2010 there should be no significant changes in the inflation level, and therefore the efficient management of wage policy in both private and public sector should assure consistency between real wage development and the growth of productivity.

Inflation

In connection with the ambition to meet the Maastricht criterion for inflation in 2007, the NBS introduced, starting from 2005, inflation targeting under the ERM II regime, while the end-year inflation targets (HICP) have been set to 3.5% ± 0.5 pp for 2005, below 2.5% for 2006, and below 2.0% for 2007 and 2008.

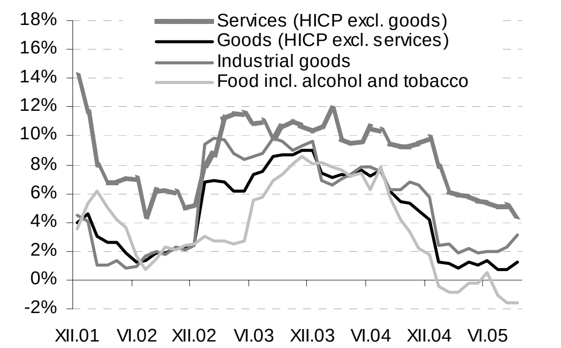
This year, consumer inflation continued the started trend without any radical administrative adjustments, and it reached its lowest levels ever (2.0%) in the summer. While the average year-to-year HICP inflation was 7.5% in 2004, in this year it is likely to slow down to 2.9%. In addition to moderate changes in regulated prices, this was contributed also to by a favourable development of food prices ex energies.

Inflation development



Note: 12-month moving averages
Source: -Statistical Office of the SR, Ministry of Finance

Total inflation of the SR by HICP



Source: Statistical Office of the SR, Eurostat

According to the expectations of the previous Convergence Programme, HICP inflation started to accelerate its approach to a reference level. The acceleration of nominal convergence in the price area was contributed to primarily by regulated prices that rose at a rate significantly lower at the beginning of this year than January of last year, but also by the continuing appreciation trend of the Slovak crown thanks to which the prices of other industrial goods ex energies have been dropping since the beginning of 2005. The expected gradual moderate appreciation of the crown, as a reflection of the differential in the growth of productivity against Eurozone and the improved current account balance, would continue to mitigate inflation over the next period.

An important role may be played by administrative interventions in the prices of energies for households, regulated by the independent Office for the Regulation of Network Industries, whose levels will primarily depend on the world prices of oil and oil products, as well as the crown to US dollar exchange rate. The recent oil price trends necessitated an increase in prices of gas and heat energy in October 2005, and this will result in an average inflation rate in 2006 higher than initially expected. Nevertheless, the NBS's inflation target for the next year should not be threatened, since the NBS elected end-year HICP inflation as the nominal anchor of its monetary policy. Furthermore, the unexpected increases in the price of oil, and the resulting unexpected rise in regulated prices, are defined under the inflation targeting regime as an exception for meeting of the inflation target. However, the future development of world prices of oil, and the consequential development of prices of energies and their potential secondary cost effects, continue to pose a risk.

Expected development of inflation

	2004	2005F	2006F	2007F	2008F	2009F	2006F
CPI (annual average)	7.5	2.8	3.3	2.0	2.0	2.4	2.6
HICP (annual average)	7.5	2.9	3.6	2.0	2.0	2.4	2.6
CPI (end-of-year)	5.9	4.1	2.2	1.9	1.9	-	-
HICP (end-of-year)	5.8	4.2	2.3	1.9	1.9	-	-

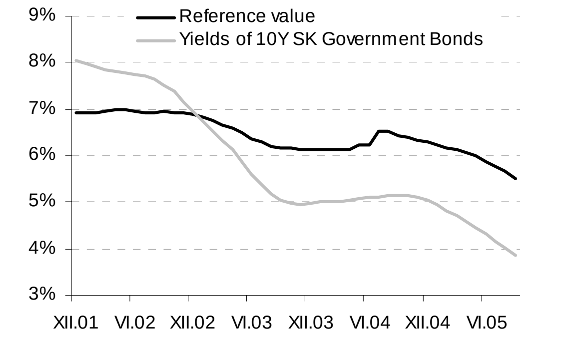
Source: Ministry of Finance of the SR

In 2006-2008, no significant deviation from the disinflation trend should be experienced, and therefore there should be no major threat to meeting the Maastricht criterion in the price area by 2007. The real convergence could, through the Balassa-Samuelson effect, contribute to higher inflation in the future, on the other hand, however, the expected moderate appreciation of the koruna may offset this effect. The rise of prices should also be mitigated by the development of a more competitive environment. It is important to ensure that wage-related negotiations will not bring about a significant increase in real wages in excess of the capabilities of the corporate sector. A key role will be played in this process by the increase of salaries in the public sector which has a benchmark effect on the private sphere. The most serious risk in the field of inflation is unambiguously deemed to be the rise in oil prices, since Slovakia's energy intensity is significantly higher than the EU average.

Interest rates

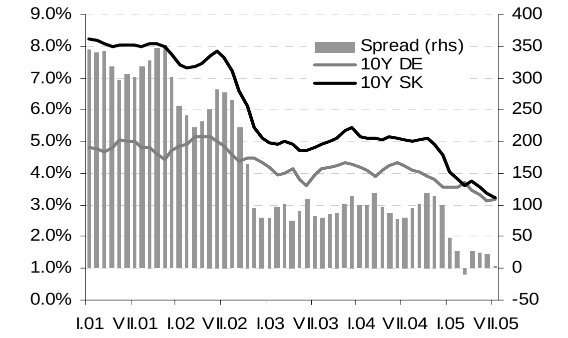
Limited inflation pressures at the beginning of the year enabled the central bank to continue the loosening of its monetary policy by reducing the prime interest rate (2W sterilisation repo rate) to 3.0%, which opened the door to further reductions in long-term interest rates. During the year, yields of 10-year government bonds dropped by 100 basic points, and safely settled on a level below the reference value of the Maastricht criterion. **The recent development further confirms that Slovakia should not encounter any difficulties in meeting the long-term interest rate criterion.** Though the financial market perceives the monetary policy, in terms of future perspectives, as neutral or even restrictive, and expects that interest rates have reached their bottom, a gradual increase in long-term interest rates in the SR should correspond with trends prevailing in the Eurozone. With regard to the improving perspectives for the revitalisation of their economies, it can be reasonably expected that yields of long-term Eurobonds will slightly rise and shift the reference value to a higher level.

Long-term interest rates



Note: 12-month moving averages
Source: Eurostat, Reuters

Interest rate convergence

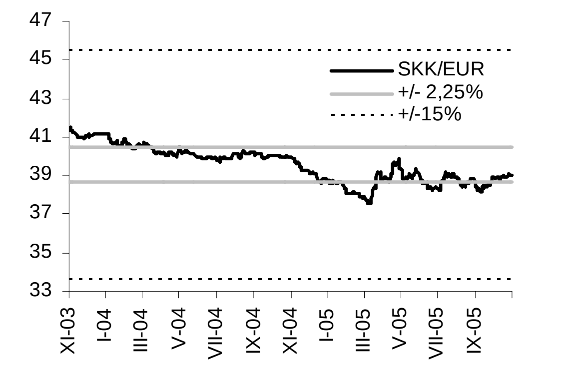


Source: Eurostat

Exchange rate

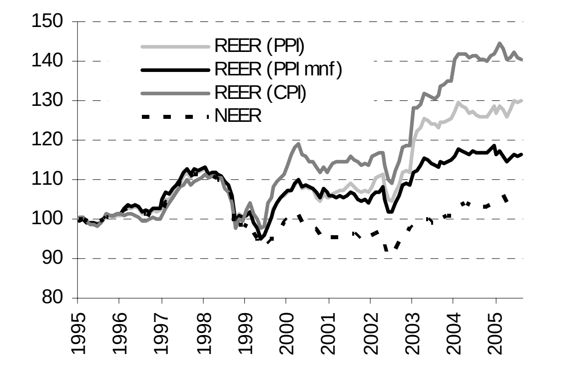
During the first three quarters of this year, the Slovak crown exchange rate floated within the 37.5 to 39.9 SKK/EUR range. The koruna further follows its appreciation trend, though its development over the year has been primarily determined by political events and the development of adjacent currencies within the region. The real appreciation of the currency, tied – as a matter of course – to the convergence process and the increase in competitiveness in recent years, is shown by the real effective exchange rate (REER)[15] development.

Development of the SKK/EUR Exchange rate



Source: Reuters

Development of NEER and REER



Source: Reuters, Ministry of Finance

Analysis of the equilibrium exchange rate shows that a rate above 39 SKK/EUR may be classified as an undervaluation of the currency that does not correspond to the development of macroeconomic fundaments. The expected development of macroeconomic indicators and consolidation in the fiscal policy area provide a sound basis for the favourable development of the SKK/EUR exchange rate. In the next years, a gradual real appreciation of the currency can be expected, supported primarily by the growth in labour productivity, as well as foreign direct investment inflows. The exchange rate development is subject to risks posed by the development of adjacent foreign exchange markets within the region and next year's

15 reflects the real appreciation or depreciation of the koruna against the representative currency basket

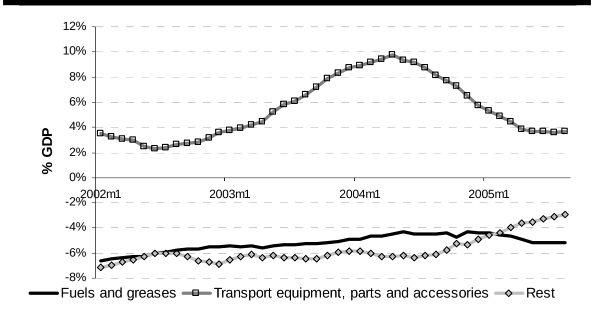
parliamentary elections. With a view to adopting the common European currency in 2009, at the end of November 2005 Slovakia joined the ERM II regime with a standard fluctuation band of +/- 15% around the central parity of 38.455 SKK /1 EUR.

II.4. Balance of Payments

The **balance of payments** prediction for the years 2005 to 2010 has been updated in line with its development during the first eight months of 2005, the updated domestic demand prediction and, in particular, the potential foreign demand on the part of the important trade partners of the SR. The update confirms the initial assumptions of significant improvement of the balance of payments by 2010.

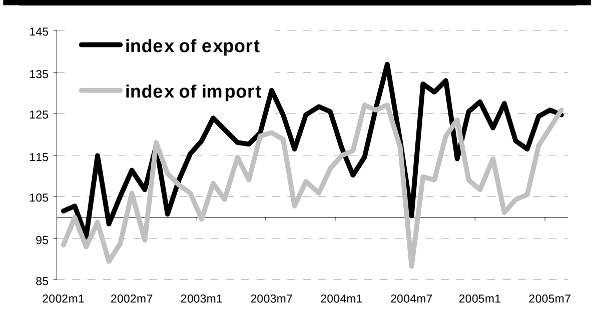
In line with the initially assumed trend, the foreign trade balance from the beginning of the year was worse than 2004, and the total turnover also sustained a serious decline. The worsening slightly exceeded initial expectations. However, the expected turn started in June. Monthly balance results are better than for the same period of 2004 when the export decline became obvious. The deficit should culminate in 2005, and in the next years we expect a gradual increase in the share of export in GDP, as well as a significant improvement in the balance that should gradually approach a virtually balanced position. The temporary worsening in the development of foreign trade in the recent period was caused by a temporary suspension of exports of the automotive industry (VW) connected with the preparation for the production of a new model on the one hand, and a stable increase in imports, both prevalent investment imports and imports covering consumption demand, on the other hand. The balance of payments deficit is expected to decrease to 0.8% of GDP by 2008, and a balanced or even positive position in 2010 cannot be excluded. The expected positive trend should reflect primarily growing exports in the automotive industry. The current foreign trade estimate figures have been slightly adjusted, however the main influential factors, as identified in the previous update of the Convergence Programme, remain unchanged.

12M cumulative exports of selected categories of goods (% of GDP)*)



Source: -Statistical Office of the SR, Ministry of Finance of the SR
**) 12M – 12 -month*

Year-to-year index of investment goods imports and exports, ex transport equipment



Source: Statistical Office of the SR, Ministry of Finance of the SR

The updated **balance of income** forecast for 2005 incorporates an increased outflow of funds resulting from the disbursement of dividends to foreign investors and the expected effect of a methodological change in the inclusion of reinvested profits into payments and the gross income of Slovak residents working abroad into balance of income revenues. The change in the **current transfers** forecast takes account of a more particular idea of contribution outflows into the EU budget and receipts from it, as well as a methodological change in the inclusion of the difference between the net and gross income of Slovak residents received abroad into current transfer payments.

Development of the balance of payments current account and its components (% of GDP)							
	2004	2005F	2006F	2007F	2008F	2009F	2010F
Balance of Goods	-3.4	-4.6	-4.1	-1.7	-1.1	-0.1	0.2
Export of Goods	67.1	67.9	69.2	75.2	78.2	79.2	80.0
Import of Goods	70.5	72.5	73.3	76.8	79.3	79.3	79.8
Balance of Services	0.7	0.7	0.7	0.6	0.6	0.6	0.6
Balance of Income	-1.0	-2.1	-2.4	-2.6	-2.5	-2.3	-2.2
Current Transfers	0.3	0.7	1.0	1.3	1.4	1.5	1.6
Current Account	-3.3	-5.2	-4.8	-2.3	-1.6	-0.4	0.3

Source:: Ministry of Finance of the SR

The balance of the **current account** of the **balance of payments** has been adjusted in line with the trends of the foreign trade deficit [16] and the balance of income deficit to -5.2% of GDP for 2005 and -4.8% of GDP for 2006. It is expected that the deficit will be safely covered by the financial account surplus based primarily on direct foreign investment inflows. The inflow of FDI into the SR (equity and reinvested profits) as the main driver of the growth of the potential product should culminate in 2006 to a level of nearly 7% of GDP, while in the next years it will probably not rise above 3% of GDP. After 2005, the balance should improve also due to a surplus in the service balance and contributions from the EU via current transfers; in 2008 – 2009 the current account balance may approach a balanced position.

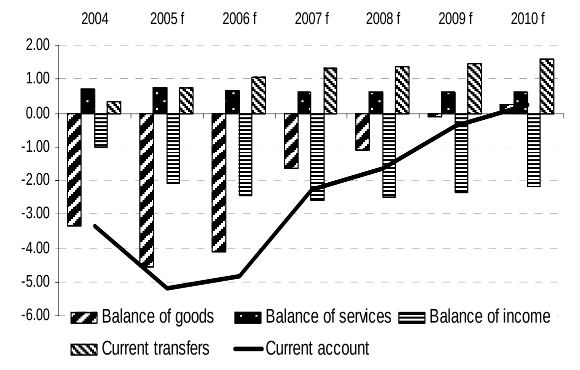
The outlined development of the SR's balance of payments current account may, however, be subject to a **possible risk** posed by e.g. the development of oil prices, the development of household consumption, or the development of the SR automotive industry exports. We suppose that an increase in **household consumption** by 1 pp might cause a worsening of the annual trade balance by 0.16% of GDP. An increase in the average **price of oil** by USD 10 (from 60 to 70 USD per barrel) would result in the worsening of the trade balance by approx. 0.23% of GDP. As far as forecasts of the **automotive industry's exports** are concerned, we have applied a conservative assumption of a rather high import intensity (85%), based on the average value added in the car manufacturing industry. If a higher level in the involvement of Slovak firms in the production process were achieved, and the import intensity would be reduced to 75%, it would have a positive effect on the trade balance, equalling to approx. 1% of GDP improvement. According to an estimate of the International Monetary Fund, the sustainable annual deficit in the current account balance of the SR may be 6% of GDP. This means that even with a pessimistic assumption that the deficit will, due to effects of the above mentioned risk factors, maintain its current level throughout the period concerned, there is a sufficiently wide, and every year increasing, band between the expected and the limit sustainable current account deficit (thanks to stable FDI inflows and contributions from the EU, the limit level can shift even higher).

In 2005 -2008 a stable inflow of "green-field" **foreign direct investments** is expected**,** primarily related, whether directly or indirectly, to the construction of important car manufacturing plants in Slovakia, as well as the entry of international investors into other industries (electrical and electronics industry, metal processing, wood-processing and paper industries). However, the amount of FDI will be also influenced by the successful completion of planned extension projects in production plants of those investors who have been established in the SR for a longer time. From a medium-term point of view, these

[16] The CA balance for January to June 2005 accounted for a deficit of 3.3% of the 2005 GDP estimate.

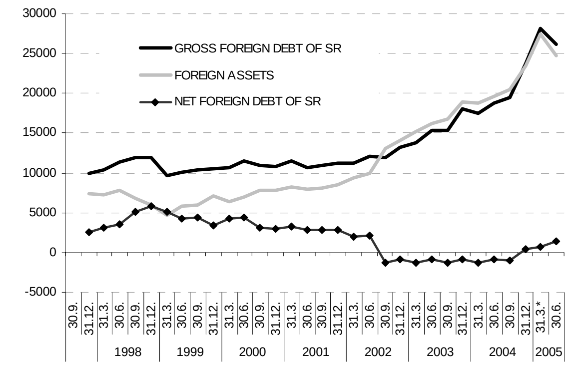
investments will contribute to the growth in labour productivity and, as a result, to the maintenance of the high competitiveness of the Slovak economy.

Projection of medium-term development of components of the SR's balance of payments current account (% of GDP)



Source: Ministry of Finance of the SR

Development of foreign indebtedness of the SR (Mil. USD)



Source: NBS, Ministry of Finance of the SR

As per 30 June 2005 the total **gross foreign debt of the SR** amounted to 26.22bn USD (58.9% of GDP), which implies a year-to-year increase of nearly USD 7.52bn. Thus, the share of total per capita gross foreign debt of the SR reached USD 4,874 as of end June. The year-to-year increase was caused almost exclusively by an increase in the short-term foreign debt of commercial banks through cash and deposits, loans and other liabilities. With regard to the rise in gross foreign debt it should be noted that a more suitable criterion for determining the country's international position would be its **net foreign debt** achieved by the subtraction of foreign assets from its gross foreign indebtedness. Assets amounted to USD 24.76bn as of 30 June 2005, which means that the net foreign indebtedness totalled USD 1.47bn, i.e. accounted for 3.3% of GDP (an increase of USD 1.07bn from 31 December 2004) and it does not pose any risk for the macroeconomic stability of the SR.

Unlike 2004, **the total foreign exchange reserves of the NBS** have been developing at a rather uneven rate in 2005. Their level culminated in March 2005, when it achieved USD 18.72bn, and since then, after a period of small fluctuations, achieved USD 15.8bn at the end of September 2005. They are able to cover imports of goods and services for approx. 5.3 months. Except for 2006 (supposed privatisation of the Slovak electricity company), exchange reserves will gradually decline due to an excess of repayments of older loans over new loan drawing, as well as lower proceeds from privatisation. Therefore, the average coverage of goods and service imports will probably drop from 4.7 months in 2006 to 4.3 months and 4 months in 2007 and 2008, respectively.

II.5. Risks of Forecast

In its forecasting process the SR Ministry of Finance mostly applies a conservative approach. Therefore, our forecast probably contains a higher amount of positive risks than negative risks. **Positive risks** can be expected mainly in three areas: labour market, automotive production and EU funds. As regards the labour market, a moderately higher rise of nominal (and real) wages as well as employment may be experienced. A faster start-up of the automotive production may result in a higher growth of GDP in 2006, without any growth decline in 2007, however. Such a development might result from a generally larger effect of the launch of automotive productions on GDP than we expected, as well as a higher level of involvement of Slovak firms in the final production (lower import intensity of the production). The third area where a positive surprise could be encountered is EU funds that may bring more jobs in the service sector and a higher growth of labour productivity.

Of course, our forecast has its **negative risks** despite our efforts to minimise them. Some potential negative risks are discussed in greater detail in Section IV where the impact of some shocks on economy and public finances are simulated by means of a macro-model. Such risks include a probably faster rise in interest rates, the development of exchange rates and the price of oil. For these indicators we used purely technical assumptions, and therefore their actual development may be different. Since the Slovak economy is very open, any possible worsening of external development would, to some extent, affect the growth of GDP. Though we are far from underestimating these risks, their occurrence is not expected to materially threaten the internal or external balance.

Forecasts of the SR MF are very close to forecasts of the European Commission for the SR:

Comparison between forecasts of the MF SR and the European Commission

	2005F	2006F	2007F
GDP growth (%)			
MF SR	5.1	5.4	6.1
EC	5.1	5.5	6.3
Employment (%)			
MF SR	1.8	0.9	0.8
EC	1.7	0.9	0.8
CPI (%, average)			
MF SR	2.8	3.3	2.0
EC	2.8	3.5	2.1
Current account deficit (% of GDP)			
MF SR	5.2	4.8	2.3
EC	6.2	5.5	2.8

Source: Ministry of Finance of the Slovak Republic
EC, autumn forecast

III. POSITION OF PUBLIC FINANCE

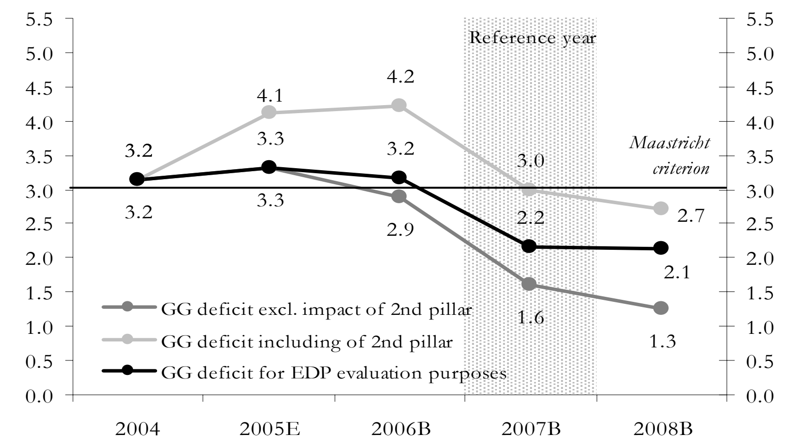
III.1. Policy Objectives and Strategy

This section contains a definition of both the medium-term and long-term fiscal objectives of the Government, and the political measures expected to enable meeting the objectives. The main conclusion is that the medium-term objectives will be met under the current legislative and institutional framework, while meeting the long-term objectives requires additional political measures, some of which are specified. The medium-term general government balance is affected by a number of factors that must be taken into account in the assessment of the consolidation rate. The general government balance net of these factors indicates the Government's real consolidation efforts. The Government has based its consolidation strategy on profound structural reforms; the consolidation of general government budgets does not involve any obviously one-off measures intended to optically improve the balance with a short-term effect.

The fiscal policy strategy is framed by two of the Government's specific medium-term objectives. The first medium-term objective of fiscal policy is a **reduction in the general government deficit, inclusive of the costs of launching of the second pension scheme pillar, to below 3% of GDP by 2007**. The second objective is the **achievement of the long-term sustainability of public finance by 2010.**

The first target is motivated by the common efforts of the Government and the NBS to meet Maastricht convergence criteria in 2007 and adopt the common currency euro in 2009. This objective remains unchanged despite the reform of the Stability and Growth Pact that allows Slovakia to include, subject to certain conditions (namely if the deficit is close to the reference value), 60% of the second pillar's revenue in the general government sphere. The reasons include the transition nature of the relief for the deficit judgement, and the primary superiority of the Government's long-term fiscal objectives. Furthermore, any loosening of fiscal policy would be in sharp contradiction to the recommendations of the Ecofin Council regarding the fiscal consolidation rate. The provision ensuing from the revised Stability and Growth Pact is presently perceived as a reserve for the event of unexpected negative fiscal shocks.

General government balance in years 2004-2008 (% of GDP)



** year 2005 excl. costs related to debt remission towards foreign countries* *Source: Ministry of Finance*

The Government's medium-term objectives are defined in the General Government Budget for years 2006-2008 and are, therefore, binding in nature. The budget is based exclusively on the effective legislative frameworks and future legislative changes already approved by the Government. In the case where future legislative changes are considered, these are described in the budget, and their impact on budget revenue and expenditure is explicitly quantified. The macroeconomic scenario on which the budget is based, as well as budgeted tax revenue are subject to supervision by the public experts. Macroeconomic and tax forecasts are subject to assessment by committees whose members include generally recognised domestic personalities. The budget explicitly contains statements of committee members regarding forecasts of the SR Ministry of Finance in terms of whether they are overestimated, realistic, or underestimated (for more details refer to the Annexe).

The Government's main fiscal objective is the creation of conditions for the long-term sustainability of public finance, which primarily means adjusting public budgets to the consequences of the population ageing. For this purpose, even the first Convergence Programme of Slovakia for years 2004-2010 contained a specific medium-term interim objective, this being the achievement of a virtually balanced cyclically adjusted general government balance by 2010. The cyclically adjusted deficit in 2010 assumed at that time was 0.7% of GDP; this Convergence Programme contemplates a deficit of 0.9% of GDP in the same year. This, however, does not imply a slow-down in public finance consolidation. The deficit increase will be fully charged to higher costs related to the adoption of the second pillar of the pension scheme against the previous year's assumptions.

The updated estimate of the Ministry of Finance of the Slovak Republic therefore contemplates a cyclically adjusted deficit of 0.9% GDP in 2010. This target falls within the deficit range of 0.5 – 1.0% GDP, set out as the medium-term target for Slovakia within the frame of the revised Growth and Stability Pact. Though the medium-term objective for Slovakia results from the transitive methodology which only takes into consideration the expected potential product growth and the initial public debt level, according to analyses by the MoF, the cyclically adjusted deficit of 0.9% in 2010 is sufficient also in terms of the long-term sustainability of public finance (for more details refer to Chapter VI).

This target, unlike the target for 2007, extends beyond the incumbency of the current Government, as well as the time horizon set by the approved budget. The achievement of this target is conditional on the adoption of measures extending beyond the current legislative framework after 2010. The Ministry of Finance counts upon two groups of measures. The first group includes specific parametrical adjustments in the pension scheme. These are an increased retirement age and a shift to an annual adjustment of pension amounts (old-age, disability, survivor's pensions) by the inflation rate[17]. Although these measures are not yet effective, they have been explicitly cited in the preparation of the pension scheme reform concept, and are generally counted upon for the future. These measures are explicitly indicated in both the present and last year's Convergence Programme of Slovakia.

The second group of measures relates to the fine-tuning of structural reforms and political accountability. The assumed finalisation of structural reforms is expected to enable a reduction in deficit to 0.9% of GDP by 2010, and to avoid the automatic constitution of a basis for future growth of public expenditure above the growth of public revenue, except for the effects of the population ageing. This should result in the fulfilment of prerequisites for

[17] for more details refer to the chapter concerning sustainability of public finance

the maintenance of the gross public debt amount below 60% of GDP during the entire period of the fiscal projection presented in this document (up to 2008).

The medium-term balance of the general government is affected by a number of factors that must be taken into account in the assessment of the consolidation rate, including a comparison with the previous Convergence Program of Slovakia. A majority of these factors adversely affects the medium-term public balance, though it has a positive impact on the economy as well as on the long term sustainability of public finance. The first factor is costs related to integration into the EU. The integration into the EU has very positive effects on Slovak economy, although it generates a certain pressure on the general government balance over a medium term. This analysis contemplates only the unambiguous costs of the EU integration, including transfers and contributions to the EU budget, and reduced revenue from customs duties and agricultural charges (for more details refer to Box 1). The adoption of the second pillar of the pension scheme will also result in a worsening of general administration balance over a medium term. Furthermore, the estimated amount of loss of general government revenue due to introduction of the capitalisation pillar has increased against the preceding Convergence Programme since this scheme was joined by a higher number of people than originally assumed. From the public finance perspective, however, an important fact is that the higher medium-term costs related to general government automatically imply a better position of public finance in the future since the implicit pubic debt will be significantly reduced. The last factor is the cyclical component of general government budgets, related to the economic cycle rather than Government's policy. In the case of Slovakia, however, this fact is negligible from a medium-term perspective. According to estimates by the MoF, the cyclical budget component will in 2006 alone amount to at least 0.1% of GDP. A positive output gap is estimated for this year, and therefore this year's cyclically adjusted deficit is higher than the actual deficit.

Consolidation efforts of the Government in 2004-2008 (% of GDP)

	2004	2005F	2006B	2007B	2008B
General government balance	3.2	4.9	4.2	3.0	2.7
one-off effects*	0.0	-0.8	0.0	0.1	0.0
SR' transfers to the EU	-0.5	-1.0	-1.0	-1.0	-0.9
impact of the 2nd pillar	0.0	-0.8	-1.3	-1.4	-1.4
cyclical budgetary component	0.0	0.0	0.1	0.0	0.0
Adjusted deficit (+) / surplus (-) of general government	2.7	2.3	2.0	0.8	0.3
Consolidation efforts (year-to-year change in balance)	**0.7**	**0.4**	**0.3**	**1.2**	**0.4**

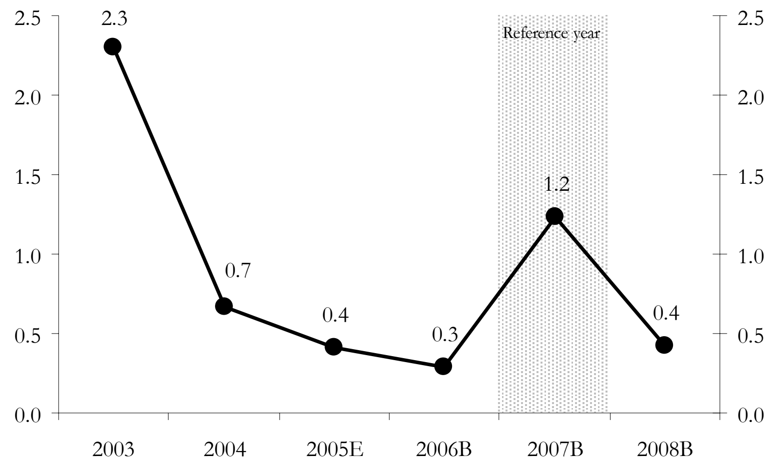
** 2005 – debt remission towards foreign countries*
2007 – revenue from the abolition of anonymous deposits

Source: Ministry of Finance

The adjusted general government balance will be generated by netting the actual balance of the above mentioned factors. A year-to-year change in this balance indicates the actual consolidation efforts of the Government. The average consolidation rate in 2005-2008 is slightly above the level recommended by the Council, i.e. 0.5% of GDP[18]. This is a sound consolidation rate in terms of the Government's both medium-term and long-term fiscal objectives; it does not threaten social cohesion, or the current relatively high economic growth.

[18] Countries in a position of an excessive general government deficit are required to achieve a year-to-year improvement in their cyclically adjusted balances, net of one-off and temporary measures, of at least 0.5% of GDP ("Specifications on the implementation of the Stability and Growth Pact", September 2005).

Consolidation efforts of the Government in 2003-2008 (% of GDP)



Source: Ministry of Finance

There are also other factors that should be taken in account in the assessment of the consolidation rate. The first factor is costs related to the public debt service (interest), other than fully connected with Government's economic performance in a current year. The second factor is costs related to the three large automotive plants that account for budget expenditure of SKK 20bn in years 2003-2007 (1.4% of GDP).

When assessing the consolidation rate, particular attention should be paid to what instruments the consolidation has been achieved by. The Government based its consolidation strategy on profound structural reforms. These were aimed at financial stabilisation of general government on the one side, and increased efficiency in economy and growth of potential product on the other side. As indicated by the below table, consolidation planned for 2007 is ambitious, but not at all unrealistic. In 2003 the deficit reduction reached the highest level, while the economic growth was lower than the estimate for 2007. Consolidation in 2007 should be supported also by the gradual increase in the retirement age.

Other factors affecting the consolidation efforts (% of GDP)

	2003	2004	2005F	2006B	2007B	2008B
Adjusted deficit (+) / surplus (-) of general government	**3.3**	**2.7**	**2.3**	**2.0**	**0.8**	**0.3**
Interest payments	-2.6	-2.2	-1.8	-1.9	-1.9	-1.9
Automotive plants	-0.2	-0.3	-0.6	-0.3	-0.1	0.0
Adjusted deficit (+) / surplus (-) of general government	0.6	0.2	-0.2	-0.2	-1.2	-1.6
Consolidation efforts - adjusted	**1.4**	**0.4**	**0.4**	**0.0**	**1.0**	**0.4**

Source: Ministry of Finance

Box 1 – Impact of the EU integration of Slovakia on general government balance

The integration with the EU has very positive effects on Slovak economy, though it generates a certain pressure on general government balance over a medium term. The SR Ministry of Finance quantifies the aggregate impact of cash flows after the integration on general government balance. This analysis aims solely at identifying a factor that does not result from Government's policy, and therefore should be considered in the judgement of the rate of consolidation of general government budgets.

Identification of the amount of impact of Slovakia's integration with the EU has its economic justification, however a specific calculation encounters methodological problems. These relate to a question to what extent government expenditure (such as co-funding of EU projects) may be deemed to be automatically determined by the country's integration with the EU. These considerations should take into account the fact that the Government would probably fund to some extent similar projects within the frame of development even if it didn't enter into the EU. At the same time it is questionable to what extent it would reduce other expenditure in order to achieve its consolidation targets. Finally, the use of EU funds means for a country a possibility rather than obligation. Therefore, from the transparency perspective it is important to ensure that similar calculations are accompanied by their methodology.

Pursuant to the estimate of the MoF, the integration with the EU has a negative impact on the financial management of general government over a medium term, accounting for min. 1.0% of GDP p.a. The major negative effect, accounting for 0.9%, is represented by transfers and contributions paid to the common budget of the EU that became a new expenditure item of the national budget. Another factor is loss of income from customs duties and agricultural charges, accounting for 75% of the aggregate revenue on them, as these belong to traditional own resources of the EU and are directly transferred to the EU budget. The remaining 25% are retained as a part of general government income for coverage of costs related to the collection of these. Positive impact on the budget comes only from the temporary compensatory payment in years 2004-2006, provided to new Member States for mitigation of effects of increased costs connected with the EU integration.

Impact of SR's integration with the EU on general government balance (% of GDP)

	2004	2005F	2006B	2007B	2008B
Impact on GG balance	**-0.5**	**-1.0**	**-1.0**	**-1.0**	**-0.9**
- transfers and contributions paid to EU budget	-0.6	-0.9	-0.9	-0.9	-0.9
- reduction in income from customs duties and agricultural charges (75%)	-0.1	-0.2	-0.1	-0.1	-0.1
+ compensatory payment	0.2	0.0	0.0	0.0	0.0

Source: Ministry of Finance

Due to the above arguments, the Ministry of Finance does not take into account of the negative impact of increased expenditures related to co-funding complementing EU funds in the quantification of costs of integration of the SR with the EU and the subsequent consolidation efforts. Though it is difficult to quantify the amount of additional costs related to the foregoing, the Ministry of Finance believes that the budget will be adversely affected over a medium term.

An important feature of consolidation plans is the likelihood of their fulfilment. An indicator may be a comparison between the budgeted deficit and the actual deficit of general government. The current Government has been very successful in this context. In years 2003 and 2004 public finance reported a deficit significantly lower than contemplated in the budget. In 2003 the deficit was 1.2% of GDP lower (though, in this year the ESA 95 methodology was introduced for the first time), and in 2004 0.9% of GDP lower. The updated estimate[19] for 2005 is 0.1% of GDP lower. For the sake of objectivity it should be added that this is partially connected with transfers of expenditures between years, that may pose a certain risk for the budgetary process from a medium-term perspective.

General government deficit (% GDP, ESA 95)			
	2003	2004	2005
Budgeted	-5.0	-4.0	-3.4
Actual	-3.8	-3.2	-3.3*

** updated estimate (excl. one-off impact of the debt remission towards foreign countries)* *Source: Ministry of Finance*

Positive evaluation should be afforded to reliability and transparency of Slovak data, as evidenced also by the fact that Eurostat did not rise any material objections against figures contained in the notification. Further improvement in this area should result from the accounting system reform aiming at full introduction of accrual principles into the general government's accounting.

III.2. Current Development and Budget Implications for Next Year

The SR Ministry of Finance thoroughly monitors the development of macroeconomic environment and public finance during a current year. For this purpose the Ministry prepares a regular quarterly material[20] aimed at analysing the development and judging whether or not the budgeted deficit of general government as a share in GDP will be met. If a risk of exceeding the deficit is identified, the material contains a proposal for measures.

The current development in year 2005 confirms the original assumptions applied in the budgetary process; in a majority of indicators it is better, and therefore it creates favourable environment for the meeting of fiscal objectives. **General government deficit budgeted for year 2005 was 3.4% of GDP excl. cost related to the pension reform; the current estimated is slightly lower – 3.3% of GDP[21]**. The Government publicly communicated its intention to set the fiscal objective for years 2005 – 2006 as general government deficit excl. costs related to the pension reform. This is due to the uncertainty concerning the number of insured who would decide to join the second pillar of the pension scheme (they are allowed to make their decision by mid 2006), which directly determines the amount of costs. Finally, the Government decided in this year to release some countries (Syria, Iraq, Sudan) from their debts that originated during the era of Czechoslovakia within the frame of international aid. This will increase the expected deficit for notification purposes by 0.8% of GDP to 4.1% of GDP.

As regard the general government constituents, a major contribution to the improvement of general government balance will come the national budget. On the contrary, a major contribution to the worsening of the deficit will originate from the financial management of the Social Insurance Agency, amounting to SKK 7bn. As regards the various factors, these may be classified into those improving, and those worsening the deficit. The former include primarily net savings on interest cost of the state debt (SKK 7.2bn), a higher tax revenue

[19] Pursuant to the "Report on Macroeconomic Development and Development of Public Finance of SR for Three Quarters of 2005, and Prediction till Year End", October 2005
[20] see Note 17
[21] The current tax collection in 2005 has been developing slightly better than the assumption applied in the general government budgetary process for years 2006 – 2008. Therefore, the tax collection represents a moderate positive risk for the budget.

(SKK 4.5bn), higher non-tax revenue and dividend (SKK 6.3bn), and higher savings on social benefits (SKK 1.5bn). The deficit was adversely affected mainly by the above mentioned financial management of the Social Insurance Agency (SKK 7.0bn), investment incentives for automotive plants (SKK 3.2bn), and the motorway construction (a lower rate of drawing EU funds, substituted by domestic funds amounting to SKK 2.0bn).

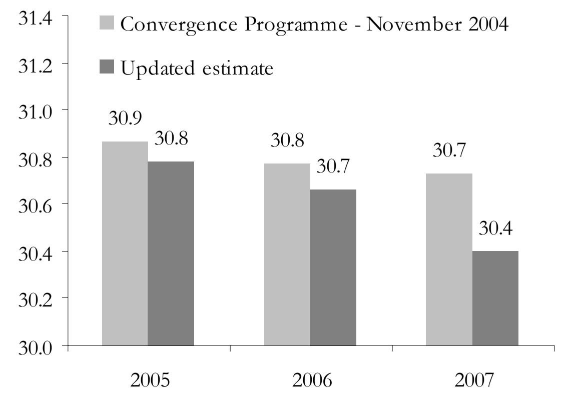
The current development of economic environment does not pose any adverse risk for the fulfilment of medium-term fiscal objectives. Though a sound economic growth is expected, the macroeconomic basis of the budget are perceived by the professional public as realistic, or even conservative. Likewise, the current fiscal development does not pose any material risk for the medium-term development of public finance. A majority of expenditure that was higher than the budget resulted from political decisions made during the year, aimed primarily at development projects, that were framed by the budget target for 2005. Thus, no underestimate or overestimate of revenue was involved. The only more serious concern is the financial management of the Social Insurance Agency that is expected to achieve revenue lower, and expenditure higher, than the budget. However, this risk was identified as soon as mid 2005, and therefore the Social Insurance Agency's budget prepared for years 2006-2008 already reflects, to some extent, the unfavourable development in this year.

Positive economic development is usually reflected in improved collection of tax revenue. In such case it is appropriate that the Government does not use any revenue in excess of a budget for covering expenditure (especially current expenditure) but for accelerated consolidation, i.e. for deficit reduction. In this context – alike the case of this country - one question is appropriate: whether any such revenue exists, and how it is used.

In the case of Slovakia, two facts are relevant. First, as the low table shows, though budget revenue for 2006-2008 is really improved against the last-year's budget for 2005- 2007 (or The Convergence Programme), social contributions worsened. The net effect on the budget is even slightly negative since total tax and contribution revenues declined by 0.1% of GDP in 2005 and 0.3% of GDP in 2007. Second, the Government may use the higher tax revenue for consolidation only to a limited extent. This is due to the structure of the tax revenue improvement, which is to a major extent contributed to by the individual income tax. However, starting from 2005 (fiscal decentralisation), a major portion of it constitutes revenue of self-government entities (93.8%), and only a relatively small portion flows into the national budget (6.2%). Self-government entities enjoy a relatively high autonomy in deciding on the use of their revenues. Therefore, the MoF's budget contemplates that the self-government system will achieve balanced balance during the entire budgeted period, and therefore the higher tax revenue will be reflected in an equivalently higher level of expenditure.

Total tax burden – taxes and social contributions (% of GDP, ESA95)

	2005	2006	2007
Convergence Programme – November 2004			
Taxes	17.4	17.3	17.3
Social contributions	13.5	13.5	13.4
Total tax burden	30.9	30.8	30.7
Updated estimate			
Taxes*	17.7	17.5	17.4
Social contributions	13.1	13.2	13.0
Total tax burden	30.8	30.7	30.4
Change			
Taxes	0.3	0.2	0.1
Social contributions	-0.4	-0.3	-0.4
Total tax burden	-0.1	-0.1	-0.3



** Comparison with the Convergence Programme of November 2004: taxes were reduced by the 2% transfer for public utility purposes*

Source: Ministry of Finance

III.3. Structural Balance (cyclical component of deficit; one-off and temporary measures)[22]; Fiscal Position

We applied multiple approaches in the estimation of structure of fiscal balance. Application of various techniques enables a comparison between, as well as timely identification of, potential risks that might not be avoidable with election of a single technique. The MoF's approach (a modified OECD version) was presented in previous Convergence Programmes. Alternatives include the OECD-preferred methodology and the ECB's approach where average elasticities for Eurozone were considered. Eventually we applied a streamlined approach – we searched for a trend component in the share of each tax in GDP.

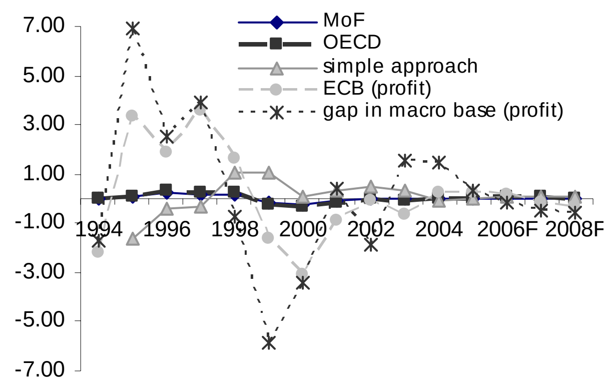
Approaches to the quantification of structural balance:	
OECD's approach	The approach applied by *OECD* to the cyclical component employs an estimate of elasticities of selected revenue categories, and thereby takes account of any changes in the tax revenue structure, as the case may be. On the expenditure side it takes account of the unemployment rate trend. The elasticity estimates express two relations - the impact of the tax category and the pertaining macroeconomic base, and a relation between the macroeconomic base and GDP. The cyclical revenue component is a sum of the various "cyclical items"; a similar method is applied to the expenditure component. Structural balance is the difference between structural revenue and structural expenditure.
ECB's approach	The *ECB's approach* notes changes in the aggregate demand structure and the revenue distribution structure. It assumes that the various macroeconomic bases are (or may be) in different cycle phases, and impact intensities may differ. Unlike the OECD's approach, its searches for a deviation in pertaining macroeconomic bases and their balanced values rather than in the aggregate gross domestic product. Tax elasticity is calculated over the macro-base.
Macroeconomic base based approach	The *macroeconomic base based approach* employs the same assumptions as the ECB approach. However, compared to the ECB's approach, it assumes unit tax elasticity with regard to a pertaining macroeconomic base.
Share of taxes in GDP	The *share of taxes and selected expenses in GDP* is a relatively simple concept. Its principal philosophy lies in directly incorporated relation between tax and gross domestic product. The cyclical component is a difference between the actual ratio and its "trend" development.

Source: Ministry of Finance, ECB OECD

[22] In addition to the two measures referred to in the previous section, no other significant measures (able of exceeding 0.1% of GDP) are contemplated.

It can be stated each approach identified a cyclical balance with comparable development. Fluctuations in macroeconomic base gaps (compared to output gap) automatically contributed to the more noticeable volatility of the cyclical component (periods preceding 2004). Starting from 2004, all methodologies report the same development. The following sections will contemplate a structural balance with elasticities consistent with OECD's calculations and a output gap estimated according to the MoF.[23].

Cyclical GG balance according to the presented methodologies (% of GDP)



Source: Ministry of Finance

A relatively small output gap contributes to the cyclical budgetary component which is negligible in view of the total general government deficit. Therefore, public budgets face structural problems. Starting from 2007, continuing consolidation of public finance will allow for a surplus in the cyclically adjusted primary balance (excl. costs related to the pension reform).

Cyclical development (% of GDP)

	ESA code	Year 2004	Year 2005F	Year 2006F	Year 2007F	Year 2008F
1. GDP growth (%)		5.5	5.1	5.4	6.1	5.6
2. Net borrowing (-)/lending (+)*	EDP B.9	-3.2	-3.3	-2.9	-1.6	-1.2
3. Interest payments	EDP D.41+FISIM	-2.2	-1.8	-1.9	-1.9	-1.9
4. Growth of potential GDP (%) (1)		5.4	5.1	5.0	6.2	5.8
Contributory components:		0.0	0.0	0.0	0.0	0.0
- labour		0.5	0.5	0.5	0.5	0.5
- capital		0.7	0.9	1.2	1.3	1.5
- total productivity factor		4.2	3.7	3.3	4.4	3.8
5. Output gap		-0.1	-0.1	0.3	0.2	0.0
6. Cyclical component		0.0	0.0	0.1	0.0	0.0
7. Cyclically adjusted balance (2-6)		-3.1	-3.3	-2.9	-1.6	-1.3
8. Cyclically adjusted primary balance (7-3)		-0.9	-1.5	-1.0	0.3	0.7

**in 2005 excl. debt remission towards foreign countries*

Source: Ministry of Finance

The following table provides a summary of structural primary balance quantifications based on various approaches

[23] Though we believe in more disaggregated approaches, based on a presumption that macroeconomic bases may have differing cycles, for the future.

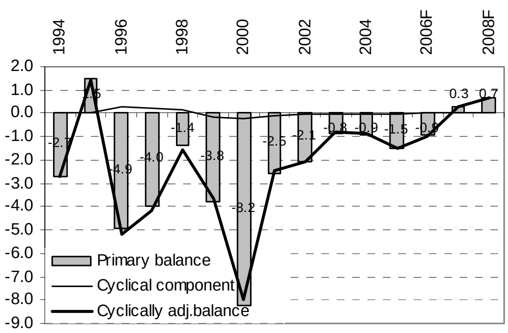
GG structural primary balance estimates based on the various methodologies (% of GDP)

Approach	2004	2005	2006	2007	2008
OECD	-0.9	-1.5	-1.0	0.3	0.7
MoF	-0.9	-1.5	-1.0	0.3	0.7
Macroeconomic bases*	-2.4	-1.9	-0.8	0.8	1.3
ECB*	-1.1	-1.8	-1.1	0.5	1.0
Streamline approach	-0.8	-1.5	-1.1	0.2	0.6

** for corporate income tax profit base* *Source: Ministry of Finance*

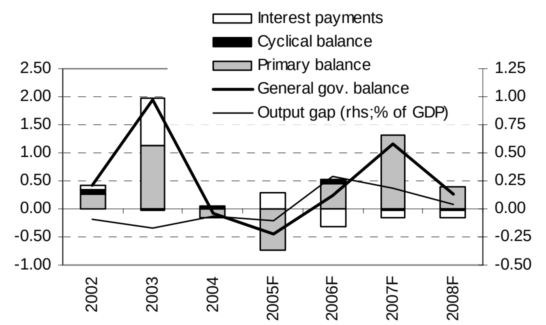
The first graph represents structural problems of public finance and Government's consolidation plans for the next period. However, the deficit development pursuant to the ESA 95 methodology entails typical one-off effects of transition economy, such as bank privatisation and restructuring, which diminishes its analytical evidencing capacity. In the second graph, the contribution of the primary balance to budget consolidation creates favourable basis for a future reduction in the share of public debt in GDP. A change in general government balance and output gap will be subject to the same trend in the next period, and therefore the Government's consolidation efforts will not have anti-cyclical effects on the development of economy.

Cyclically adjusted balance of general government finances (% of GDP)



Source: Ministry of Finance

Annual changes of budgetary position of general government finances and contrib. of primary, cyclical balance and interest to deficit (p.p.)



Source: Ministry of Finance

The current top priority of the fiscal policy is to facilitate, through consolidation of public finance, sustainable economic growth with low inflation, low interest rates, stable exchange rate and expectations of entities regarding future economic policy. Consolidation is perceived as credible policy, and therefore it positively affects the offer side of economy and, as a result, offsets the reduced contribution to the aggregate demand.

Fiscal impulse is a simple analytical concept measuring the contribution of public budgets to a year-to-year change in the aggregate demand. It provides information on whether he Government's fiscal policy is expansive or restrictive one. Combined with output gap, it characterises the fiscal policy in terms of whether it contributes to stabilisation of economy or, on the contrary, has pro-cyclical behaviour.

In accordance with the principal concept the cyclically adjusted balance has been netted of two effects. The first one is costs related to the implementation of the second pillar of the pension scheme that do not (or do to a negligible extent) affect the aggregate demand. The second one is relations towards the European Union's budget. Transfers to the EU budget do not increase the aggregate demand but, on the other side, though receipts from EU will not worsen the deficit (they appear on both revenue and expenditure sides), they have an expansive effect. A year-to-year change in the structural balance quantified as described above represents a fiscal impulse (refer to line 9 of the Table). The fiscal impulse calculation in the second case was based on cyclically adjusted primary balance (unlike the first scenario, in addition to the aforesaid effects also net interest payments were taken in account). Eventually we adjusted the cyclical balance (adjusted for EU relations and costs related to the pension reform) only for interest payments (line 11 of the Table). For the sake of clarity we present a table with a more detailed calculation of fiscal impulse on compiled an accrual basis.

Fiscal impulse (% of GDP, ESA 95)

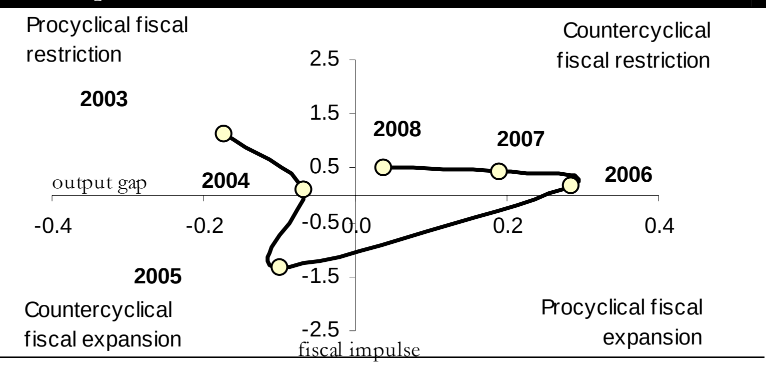
	2004	2005F	2006B	2007B	2008B
1. Net borrowing (-)/lending (+)*	-3.1	-4.1	-4.2	-3.0	-2.7
2. Launching 2nd pillar of pension reform	0.0	0.8	1.3	1.4	1.4
3. Cyclical component	0.0	0.0	0.1	0.0	0.0
4. Cyclically adjusted balance (1+2-3)	-3.1	-3.3	-2.9	-1.6	-1.3
5. Effect of relations with EU	0.0	0.9	1.3	2.2	2.1
6. Cyclically adjusted balance CABAEU(4-5)	-3.1	-4.2	-4.2	-3.8	-3.3
7. Net interest payments	-1.7	-1.5	-1.6	-1.6	-1.7
8. Cyclically adjusted primary balance CAPBAEU (6-7)	-1.4	-2.8	-2.6	-2.1	-1.6
*9. Fiscal impulse** CABAEU*	0.3	-1.1	0.0	0.4	0.5
*10. Fiscal impulse** CAPBAEU*	0.1	-1.3	0.2	0.4	0.5
*11. Fiscal impulse*** CAPIBAEU*	0.0	-1.6	0.1	0.4	0.5

Notes: * excl. debt remission towards foreign countries, but plus costs related to the 2nd pillar
** (+ restriction, - expansion)
*** Fiscal impulse is calculated only over interest payment s made

Source: Ministry of Finance

The results indicate that in 2005 fiscal policy is expansive, though it has no destabilising effects on economy, while in the next years it will be restrictive, aiming at avoidance of overheating of economy. Thus, it can be stated that in years 2005 through 2008 fiscal policy will have stabilising behaviour, **contributing to the smoothing of the economic cycle. Therefore, consolidation and stabilisation objectives of the Government are aligned.**

Fiscal impulse*



* according to CAPBAEU

Source: Ministry of Finance

III.4. General Government Debt Level and Development

The Government's consolidation efforts and the sound economic development manifest themselves in stabilisation of the gross and net general government debt over a medium term. **End 2008, gross general government debt will account for 36.2% of GDP and net general government debt 34.7% of GDP,** which is far below the Maastricht criterion level. In terms of its structure, general government debts declines below the share of risk state guarantees, which is a result of Government's policy in this area (for more details refer to Section VII.2).

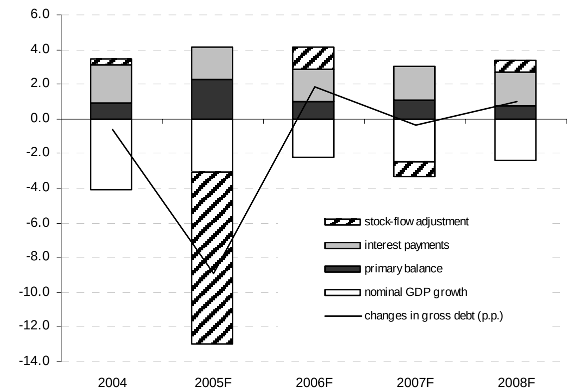
General government debt indicators

		2004	2005F	2006F	2007F	2008F
Gross debt (SKK mil.)		564,106	481,247	544,228	580,260	640,111
of which: state guarantees		40,863	29,421	22,759	13,860	12,721
Net debt (% of GDP)[24]	(2-1)	30.9	31.5	32.6	33.7	34.7
Liquid financial assets (% of GDP)	(1)	11.7	2.1	3.0	1.5	1.6
Gross debt (% of GDP)	(2)	42.6	33.7	35.5	35.2	36.2
Change in gross debt (p.p.)		-0.6	-8.9	1.9	-0.3	1.0
nominal GDP growth		-4.0	-3.1	-2.2	-2.5	-2.4
primary balance		0.9	2.3	1.0	1.1	0.8
interest payments		2.2	1.8	1.9	1.9	1.9
stock-flow adjustment		0.3	-9.9	1.2	-0.8	0.7
p.m.						
ARDAL loan from Treasury (SKK mil.)		*18,248*	*115,200*	*107,611*	*102,951*	*80,000*
Implicit interest rate (%)	**)*	*5.7*	*4.6*	*6.2*	*5.8*	*5.9*

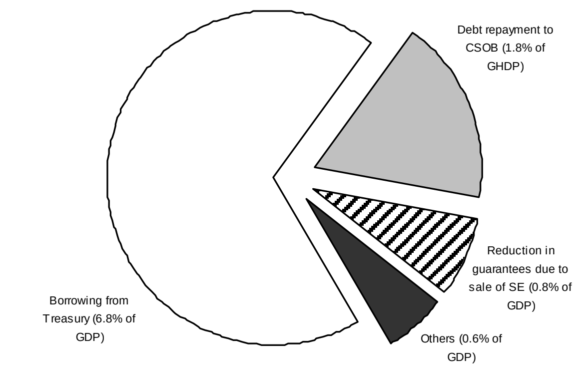
**) The growth of the implicit interest rate after 2005 results not only from the expected growth of interest rates but also by state's loans from the Treasury (refer to the text)that have reduced the reported gross debt but not interest payments to the same extend.* *Source: Ministry of Finance*

The dynamics (year-to-year changes) of gross general government debt is, under conditions prevailing in Slovakia, to a large extent influenced by the stock-flow adjustment, particularly in 2005, when is accounts for 9.9 of GDP only. This item results from application of a different methodology in the gross general government debt reporting (cash basis) and the general government deficit reporting (accrual basis). This means that the stock-flow adjustment describes, in line with its designation, those year-to-year changes in gross debt that are not attributable to the deficit alone[25].

Contributions of factors to the changein general government gross debt (p.p.)



Stock-flow adjustment in 2005



Source: Ministry of Finance

---

[24] For purposes of the calculation of net debt only cash in accounts was considered. With consideration of claims of the State Fund for Housing Development and claims against the EU net debt would be probably 2% of GDP lower.

[25] For purposes of the analysis dynamics of debt the Table shows general government deficits inclusive of costs related to the 2nd pillar of the pension scheme and changes in receivables.

The total amount of the stock-flow adjustment in years 2005-2008 is affected by multiple factors. The most important factor is credit relationships within general government. Starting from 2004, the agency responsible for the state debt management (ARDAL) began to borrow temporarily free funds directly from general government entities that keep such funds in the Treasury. Thus, the Government does not need to issue adequate amounts of securities that would increase gross debt, but borrows funds from the Treasury. This factor leads to a significant one-off reduction in gross debt in 2005. The transaction, however, entails a neutral impact on net debt since liquid assets (cash) of general government entities decrease by an amount equivalent to Government's borrowings from the Treasury. In next years this transaction will not have such significant effect since liquid financial assets will have a declining trend. It will become gradually necessary to replenish liquid assets of general government, particularly state financial assets, and this will result in a higher deficit of the state budget. This is because national financial assets will be used for funding the transfer to the Social Insurance Agency intended to cover the loss of revenue from social contributions ensuing from the implementation of the 2nd pillar of the pension scheme.

The most significant impact on the change in gross debt comes from the stock-flow adjustment factor in 2005, when it accounts for 9.9% of GDP. Its total amount is primarily determined by three non-accrual cash and accounting operations. The first one is the above mentioned borrowing from the Treasury against ARDAL (6.8% of GDP). The second one is repayment of debt to CSOB (1.8% of GDP)[26]. The last operation – of accounting nature only - is reduction of risk guarantees for the Slovenske Elektrarne (Electricity Company). Due to privatisation of this entity the guarantees are not classified as risk ones any longer; currently, the debt of Slovenske Elektrarne (Electricity Company) is being restructured.

Borrowings from the Treasury against ARDAL will concurrently reduce the difference between net debt and gross debt, since liquid financial assets of general government will decline. In the future, changes in gross and net debt should better reflect the development of general government balance under the ESA 95 methodology; the impact of the stock-flow adjustment should decrease. This is due to the fact that financial assets should be relatively low on the one hand and the approaching completion of the privatisation process on the other hand.

Proceeds from privatisation (% of GDP)

2000	2001	2002	2003	2004	2005F	2006F	2007F	2008F
4.3	3.6	14.7	1.0	0.4	0.0	2.0	0.0	0.0

Source: Ministry of Finance

Sensitivity analysis

The following table presents a comparison between interest payments of general government for the basic scenario and the risk scenario at unfavourable development of the exchange rate and interest rates. Is should be emphasised that even the basic scenario is based on conservative assumptions. **The risk scenario** is specified (alike previous Convergence Programmes) as 5% appreciation of Slovak currency, and an increase in interest rates of 1 percentage point, above the basic scenario levels in each forecasted year. The aggregate risk for public finance amounts to around 0.5% of GDP and should be sufficiently covered by the conservative approach applied in the basic scenario quantifications.

[26] In 2004 Slovakia lost in long-term litigation in respect of a debt to CSOB. A repayment deadline for a portion of the debt was set to beginning 2006, however Slovakia intends to repay the full amount of the debt in 2005.

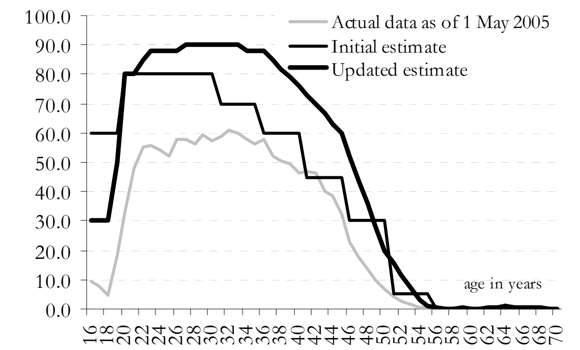
General government interest payments (% GDP, ESA 95)	2005F	2006F	2007F	2008F
Basic scenario	1.8	1.9	1.9	1.9
Risk scenario	2.0	2.1	2.2	2.1
- difference	0.2	0.2	0.3	0.2

Source: Ministry of Finance of the SR

III.5. Budget Consequences of Important Structural Reforms

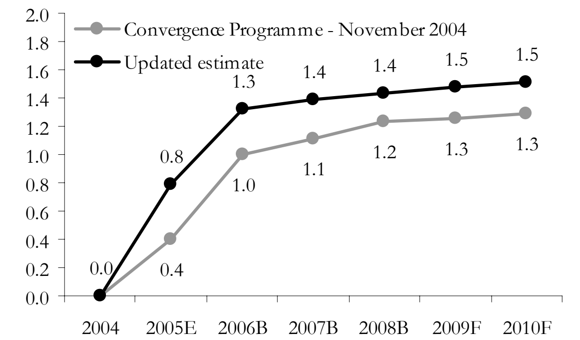
The Convergence Programme of November 2004 assumed that during 2005 and 2006 the second pillar would be joined by 51% of labour force. Given the assumed age structure and gradual entry of savers during the year the impact of the second pillar was estimated as 0.4% of GDP in 2005. Based on interim data on numbers of 2nd pillar participants it can be expected that the 2nd pillar will be joined by 65% of labour force, and a half of them joined during the first three months of 2005. The current estimate of the 2nd pillar's impact rose by 0.4% of GDP in 2005, and 0.2% to 0.3% of GDP over medium term.

Share of saver in the total number of employed, structured by age categories (%)



Source: Social Insurance Agency, Ministry of Finance

Adverse impact on public finance revenue due to the launch of the 2nd pillar (% of GDP)



Source: Ministry of Finance

Since citizens are allowed to enter the second pillar of the pension reform during the period from the beginning of 2005 to 30 June 2006, uncertainty regarding the actual number of citizens participating in the 2nd pillar affected also the fiscal objective planning (years 2005 and 2006 in particular). As a result of this uncertainty, the Government set our targets for 2005 and 2006 in the area of general government deficit without the impact of the pension reform, which is in line with the decision of Eurostat of September 2004 (Eurostat adopted a transition period for implementation of the decision on classification of pension systems of March 2004, lasting till March 2007). The general government budget for years 2006-2008 defined the deficit target for the reference year 2007 as 3.0% of GDP, inclusive of full costs related to the pension reform. This target was already presented in the first Convergence Programme in may 2004, which implies that the increased estimate of costs related to the launch of the 2nd pillar **was reflected in the deficit decrease expressed excl. these costs.** Any further increase in costs related to the 2nd pillar in 2007 will have to be offset by better financial management of general government. In the event of unexpected impacts the revised Stability and Growth Pact allows for a provision for purposes of meeting Maastricht criteria by enabling, subject to certain prerequisites, inclusion of up to 60% of 2nd pillar receipts in 2007 to the general government sphere (a necessary prerequisite is that the deficit must be close to the reference value).

Impact of the 2nd pillar on general government balance (% of GDP)	2004	2005F	2006B	2007B	2008B
Convergence Programme – May 2004	**-4.0**	**-3.9**	**-3.9**	**-3.0**	**-2.3**
GG balance ex impact of the 2nd pillar	-4.0	-3.4	-3.0	-2.0	-1.1
Impact of the 2nd pillar	0.0	-0.5	-0.9	-1.0	-1.2
Convergence Programme – November 2004	**-3.8**	**-3.8**	**-3.9**	**-3.0**	**-2.5**
GG balance ex impact of the 2nd pillar	-3.8	-3.4	-2.9	-1.9	-1.3
Impact of the 2nd pillar	0.0	-0.4	-1.0	-1.1	-1.2
Updated estimate	**-3.2**	**-4.1**	**-4.2**	**-3.0**	**-2.7**
GG balance ex impact of the 2nd pillar*	-3.2	-3.3	-2.9	-1.6	-1.3
Impact of the 2nd pillar	0.0	-0.8	-1.3	-1.4	-1.4
Change against CP of November 2004	**0.6**	**-0.3**	**-0.3**	**0.0**	**-0.2**
GG balance ex impact of the 2nd pillar	0.6	0.1	0.0	0.3	0.0
Impact of the 2nd pillar	0.0	-0.4	-0.3	-0.3	-0.2

**in 2005 ex the one-off effect of debt remission towards foreign countries* *Source: Ministry of Finance*

The increase in costs related to the implementation of the 2nd pillar also causes a problem in the meeting of the medium-term fiscal target of the SR, i.e. general government deficit of 0.5% to 1.0% of GDP. Compared to the Convergence Programme of November 2004, indicatively assuming the 2010 deficit to be 0.7% of GDP, the update is 0.2% of GDP worse. This, however, is not a result of a lower rate of consolidation, but a reflection of the higher costs related to the 2nd pillar of the pension reform.

The rising loss of general government revenue causes a decline in the Government's liability to pay pension benefits in the future. The high outflow of contributions towards the second pillar reduces implicit debt, and the latter is being transformed to explicit debt. The impact of the 2nd pillar on the implicit debt amount will gradually rise, depending on amounts of contributions paid to the 2nd pillar and a reduction in pension benefit claims from the 1st pillar. The increase in outflow of contributions compared to the initial estimate will reduce implicit debt by approx. 4.0% of GDP, which accounts for expenditure savings of 6.5% of GDP by 2050.

IV. SENSITIVITY ANALYSES AND COMPARISON WITH PREVIOUS UPDATE

IV.1. Alternative Scenarios and Risks

Given the fact that the impact of political situation and natural disasters has accompanied every economic forecast, and is practically unpredictable, attention will be focused solely on specification and judgement of the most likely risks of economic nature.

The most recent development confirms justification of simulations and discussions concerning risks originally indicated in the Convergence Programme of the SR - effects of higher appreciation of the exchange rate, a growth of foreign demand that is lower than initially expected, and a higher growth of labour productivity. Recently, the price of oil shows itself to be a potential threat to the economic growth, and therefore we have paid a greater attention to it. Model-based simulations of partial effects provided an idea of their magnitudes, extents and spread over time and the consequential importance of each type of risk if it had isolated effects. Quantification of the impact on public finance should be, however, perceived as technical estimates since our macroeconomic model used for simulations has modelled the public sector on a more aggregated level. Anyway, it is able of providing reasonable estimates indicating potential risks for the general government budget.

The first scenario of the variant development of economy simulates **gradual strengthening of the nominal exchange rate of koruna** during 2006 to a level 5% lower than the initial scenario's estimate, and permanent retention of this level. Such variant may occur in the event of changed investment preferences, or when financial market participants have expectations that are permanently better than economic fundaments. Another assumption of the simulation is that the central bank will not intervene to the disadvantage of koruna. Concurrently, the adoption of euro is not considered for years 2009-2010.

The strengthening of koruna should reduce inflation, which will enable also reduction of interest rates. Lower interests will encourage private consumption which is to a large extent satisfied by imports from abroad, since the production side of economy has not changed. Lower competitiveness and increase consumption imports will increase the current account deficit by nearly 1 percentage point in 2006. The lower performance of economy will increase unemployment and decelerate the nominal wage growth. Since inflation will have a declining tendency, the drop in real wages will be only moderate. The combined effect of declined interest rates and declined real wages will first have a positive, and later on a negative impact on private consumption. Though koruna will experience nominal appreciation, the gradual decline of inflation will cause return of the real exchange rate to the baseline scenario's value. Thus, economy will gradually return to its former scenario in real values, but with changed nominal values. Public finance deficit will slightly rise (-0.3% of GDP) due to a rate of decline in revenue (-4%) higher than that in expenditure (-3%).

It has turned out, for example, that an exchange rate appreciation [27] theoretically higher that the assumed rate would accelerate the disinflation process, encourage decrease in interest rates and, as a consequence, consumption would rise together with imports (unless there is a change in the production side of economy), with weakened competitiveness as a result. This would lead to a negative impact on the payment balance and the current account deficit, the growth of GDP, unemployment and nominal wages. An important memento is a negative impact on external balance with a longer duration. The above simulation therefore points at the great importance of proper determination of the central parity upon entry into ERM II and, in particular, the conversion exchange rate upon entry into Eurozone.

A performance level of SR's trade partners lower than assumed, causing **deceleration of** SR's **exports,** may adversely affect SR's economy. In this simulation we assume a 3% decrease in the real foreign demand level. In this **second scenario** we again assume that the shock is persistent, and the central bank is able of immediate identification of its presence. A loss of export production will increase the current account deficit, and thereby generate weakening pressure on koruna. Consequently, GDP will decline, while potential product will stay on the same level. A negative output gap will create a room for reductions in interest rates. Wages will drop, though the decline in private consumption will be lesser than the drop in wages due to the aforesaid decrease in interest rates. The decline in consumption and investments will reduce imports, and this will gradually reach a level equal to that of the declined exports and, as a consequence, the current account deficit to GDP will reach the initial scenario's level. The koruna depreciation effect will culminate in the third year after the shock, when real GDP will be 1.3% lower than the basic scenario. At the same time,

[27] The NBS intervenes against a high volatility of exchange rate and a trend that is significantly off the development of macroeconomic fundaments.

investments will decrease by 3.3% and consumption by 0.2%. This shock will adversely affect also public finance. The general deceleration in economy will bring about a loss of revenue (approx. 3.5%); this will also mitigate the reduction in expenditure, but at a lower rate (2%), and therefore the deficit will rise by 0.3% of GDP against the basic scenario.

A positive risk is **a higher growth of total productivity** (simulated increase of 0.5%) that may occur after launch of production in new and modern plants held by international owners. It is rather difficult to predict the growth of productivity; a method of extrapolation of historical data to the future is often applied. However, in a small transition economy like Slovakia, one-off shocks may significantly accelerate the growth of productivity. A good example may be the production restructuring at an automotive plant of an important exporter. The model simulations demonstrate than an increase in the growth of total productivity will improve country's competitiveness, and proportionately also the total potential product level. However, growth of productivity can be realistically contemplated only in the tradable sector. Under assumption that the tradable sector represents a half of value added generated in Slovakia the growth of the tradable sector would be 1% per annum. A faster growth of potential products as GDP will generate negative output gap. This will facilitate reduction of interest rates; though this will have a short-term effect of moderately weakened nominal exchange rate, it will encourage private consumption and investments in the next period. Increased competitiveness will promote exports and slightly weaken imports. Though the increased consumption will lead to a moderate increase in imports, the general effect on trade balance will be positive – the ratio of current account deficit to GDP will decline. The started growth of GDP will be accompanied by growth of demand for money as well as goods, services and labour force. This also means rise of employment and wages, but also possibility of an increase in inflation and interest rates. Since their growth will be probably approximately proportional, the change in nominal exchange rate will mean delayed response to the decrease in the current account deficit. This slight strengthening, however, will not be able of full offsetting the weakening experienced in initial periods. The aggregate effect of the aforesaid shock may mean a very slight encouragement of private consumption, rise of GDP to a level 1.2% higher than the basic scenario, and 0.3 pp improvement of the current account deficit. The improvement of GDP will be accompanied by improvement of public finance deficit by 0.3 pp of GDP. Public finance will further increase in result of combination of the positive impact on both sides: revenue would rise 0.1% against the basic scenario, and expenditure would drop 0.3%.

During the second half of 2005 the **price of oil** showed out to be one of serious potential sources of threats to the economic growth on the global level. A significant increase in the price would affect also development of price indicators in Slovakia, but - what is more important – this price shock has not materially affected the development of real economy so far. However, this effect can not be underrated in the future. Furthermore, the price of oil may affect Slovak economy also indirectly, though weakening the growth in EU countries.

In our simulation we evaluated the impact of an increase in the price of oil of USD 10 per barrel (from USD 60 to USD 70 per barrel[28], which accounts for 16.7%) at unchanged USD/SKK exchange rate. Under this scenario prices of fuels, gas and, as a consequence, heat for households would rise. Their cumulative effect on the growth dynamics of consumer prices (CPI) would be approx. 0.7 to 0.8 pp. Of course, if the price permanently retains this level, its effect on inflation will be depleted, and the effect of deceleration of EU and SR

[28] This scenario indicates that rapid rise of prices in this year represents significant real costs for economy. Fortunately, both world economies and the SR absorbed this rise of the price of this commodity without slowing the economy growth or even bringing economy into recession.

economies due to weakened demand will become predominating. Since the price of oil represents a global problem, we simulated its impact on Slovakia within the context of the global economy development (multi-country model).

Rise of inflation due to the rising prices of oil and oil products will force the central bank to increase interest rate in order to mitigate secondary effects. The higher inflation will reduce real income and together with a higher interest rate will cause a decline in household consumption. The higher interest rate will have a similar negative impact also on investments. Real economy will undergo general deceleration. This deceleration will adversely affect the current account deficit. Similarly, the price shock will be negatively reflected also in public finance deficit. The latter will be adversely impacted by lower revenue and concurrent higher expenditure.

Impact of changes in certain forecast assumptions on development of relevant economic indicators
Relative change in values of the variables against the original scenario
(in % unless indicated otherwise)

	Household consump-tion	Gross investments	GDP	Number of unemployed (thousand person)	Inflation (CPI)	Short-term interest rates	Nominal SKK/EUR exchange rate	Current account (% of GDP)	General government deficit (% of GDP)
Scenario 1: 5% appreciation of koruna									
2005	0	0	0	0	0	0	0	0	0
2006	0.4	-0.9	-0.5	0.1	-0.6	-0.5	-5.0	-0.7	0.2
2007	0.2	-2.5	-1.2	0.5	-1.7	-0.2	-5.0	-0.8	-0.2
2008	-0.2	-3.3	-1.3	0.6	-2.9	-0.2	-5.0	-0.5	-0.3
2009	-0.3	-3.0	-1.0	0.6	-0.9	-0.6	-5.0	-0.3	-0.3
2010	-0.2	-2.4	-0.6	0.4	0.9	-0.8	-5.0	-0.2	-0.1
Scenario 2: 3% drop in foreign demand									
2005	0	0	0	0	0	0	0	0	0
2006	-0.3	-1.8	-0.9	0.2	0.0	0.0	0.5	-0.1	-0.2
2007	-1.1	-2.8	-1.3	0.7	-0.4	-0.1	1.1	0.0	-0.4
2008	-1.4	-2.9	-1.3	0.8	-0.9	-0.2	0.5	0.0	-0.5
2009	-1.5	-3.1	-1.3	0.8	-0.9	-0.6	0.0	0.0	-0.4
2010	-1.4	-2.9	-1.1	0.7	0.9	-0.8	-0.9	0.0	-0.3
Scenario 3: 0.5% p.a. acceleration of productivity growth									
2005	0	0	0	0	0	0	0	0	0
2006	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.0	0.0
2007	0.0	0.3	0.2	0.0	0.0	0.0	1.0	0.1	0.0
2008	0.0	0.8	0.5	-0.1	-0.1	-0.1	1.6	0.2	0.1
2009	0.0	1.3	0.8	-0.2	-0.2	-0.1	2.0	0.3	0.2
2010	0.1	1.9	1.2	-0.3	0.9	-0.3	2.4	0.3	0.3
Scenario 4: USD 10 increase in the price of oil (from USD 60 to USD 70/barrel)									
2005	0	0	0	0	0	0	0	0	0
2006	-0.4	-0.4	-0.2	0.0	0.3	0.6	-0.3	-0.5	-0.3
2007	-1.2	-1.2	-0.5	0.2	0.6	0.8	0.7	-0.5	-0.5
2008	-1.4	-1.3	-0.5	0.3	0.8	0.5	0.9	-0.5	-0.4
2009	-1.3	-1.2	-0.4	0.3	0.9	0.1	0.9	-0.6	-0.3
2010	-1.2	-0.9	-0.2	0.2	0.9	0.2	0.9	-0.6	-0.2

Source: Ministry of Finance

Short-term impact of prices of oil

Our basic forecast assumes that the price of oil should stabilise at a level of USD 60 per barrel over a medium term. In the previous simulation we assumed a USD 10 increase in the price to USD 70 per barrel, at unchanged USD/SKK rate. We evaluated the impact of this increase with the help of a big macroeconomic model, able of simulating a direct effect of this price shock on economy, as well as an indirect effect through deceleration of growth in adjacent economies.

In this section we will attempt to apply an alternative method of quantifying effects of this shock on selected indicators via microanalyses. The oil price increase effect is quantified as (1) a contribution to the growth of consumer prices (CPI) and prices of industrial producers (PPI), (2) trade balance result, and (3) for indicative purposes as change in GDP.

CPI and PPI

The simulated increase in prices of oil would either directly increase prices of refinery products such as petrol, diesel and gas, and indirectly also the price of heat (for both households and businesses). The rate of increases in all these products would not, however, be as high as the increase in oil, since oil is only an input raw material in their production and as such constitutes only a part of production costs. We determined the proportion between increases in prices of oil and its derivates (petrol, diesel) by means of econometric estimates over historical data. In the case of gas and heat we applied expert judgement. By using weights of products in the consumption basket and weights in the calculation of the industrial producer index we estimated that the increase in the price of oil (16.7%) would contribute 0.7 pp to the CPI increase and 1.5 pp to the PPI increase.

Trade balance

Slovakia is dependent on import of oil and oil products from abroad, and its trade balance in these commodities is negative. Consumption of oil products in the domestic market is to a major extent satisfied by the production of the local dominating producer of refinery products. However, its production capacities are significantly higher than the domestic market's absorption capacity, and therefore a relatively large portion of its production is exported. Furthermore, new, more efficient oil processing technology has been launched recently, which enables production of higher amounts of petrol and diesel from the given amount of oil. Nearly all this new production capacity is subsequently exported. Therefore, the installation of the new technology led to a reduction in deficit of foreign trade with oils.

It shows out that with the increasing prices of oil (petrol and diesel) the Slovak refinery plant is able (willing or motivated) to increase its exports. Since the positive relation between the price of oil and exported amounts of petrol and diesel (in tons) may not be counted upon for the future with certainty, our simulations contemplate two scenarios. In the first scenario we applied a conservative assumption of constant import volumes and basically evaluate only the impact of price changes on the amount of the deficit of international trade in fuels [29]. The second scenario is based in an optimistic assumption that the increase in the price of oil will result in an increase in petrol and diesel export volumes[30].

[29] The applied oil import and export volumes correspond to actual figures for 2004.

[30] At the same time, a slight increase in oil imports will be experienced, required for covering the increased production of petrol and diesel.

If we omitted the assumption of an increase in the refinery's export capacity, the aforesaid increase in the price of oil would result in trade balance worsening of SKK 3.5bn. With the optimistic variant the price of oil could cause such increase in real export of fuels that would offset the payment balance loss caused by the price changes, and only moderately (SKK +0.2bn) affect the trade balance. In either case we do not assume any changes in the domestic fuel demand. Results of the simulations of oil price effects (linked with natural gas prices) should be understood as boundaries within which the real effect of oil price increases will probably fluctuate.

GDP

The impact of the oil price on GDP has been estimated only as a price shock effect with unchanged nominal values of macroeconomic variables. In reality, however, a certain upward nominal correction (adjustment) would occur, and the real effect would not be so negative. Furthermore, we assume that the price shock will have no other consequences on interest rates, exchange rates, or other monetary and fiscal controlling tools. Therefore, this estimation of impacts on GDP is only indicative, and it basically represents the worst possible impact on economy. Therefore, it is better to use results of a macroeconomic model that is able of better capturing these links, and a more realistic simulation of shock effects. Despite this limitation, the price shock would negatively affect the real economy, and with the above assumed growth of consumer prices and industrial producer prices the total GDP deflator would rise approx. 1 pp. With unchanged nominal values, the real growth of GDP would drop 1.1 p.p.

Impact of the oil price on trade balance

Scenario 1: Constant export and import amounts					
	Brent USD 60		Brent USD 70		**Difference**
	mil. ton	mil. Skk	mil. ton	mil. Skk	mil. Skk
Import - oil	5.86	65000	5.86	75343	10343
Import – petrol and oil	0.61	10513	0.61	12020	1507
Export - oil	0.11	1203	0.11	1394	191
Export – petrol and oil	3.28	56788	3.28	64895	8107
Trade balance deficit		17522		21074	**-3552**
Scenario 2: Increased export and import amounts					
	Brent USD 60		Brent USD 70		**Difference**
	mil. ton	mil. Skk	mil. ton	mil. Skk	mil. Skk
Import - oil	5.86	65000	5.89	75705	10705
Import – petrol and oil	0.61	10513	0.61	12022	1509
Export - oil	0.11	1203	0.11	1394	191
Export – petrol and oil	3.28	56788	3.49	69025	12237
Trade balance deficit		17522		17307	215

Source: Ministry of Finance of the SR

IV.2. Comparison with the previous update

The current update confirms previous development trends of macroeconomic and fiscal parameters presented in the last-year's Convergence Programme of the SR. The actual development of domestic economy and external environment over the previous period necessitated certain adjustments in figures, however these are not significant, or have rather a positive effect on the further process of real and nominal convergence of the SR. Some corrections or, on the contrary, retention of former estimates reflected the conservative nature of assumed macroeconomic projections. We will endeavour to maintain this nature of predictions also in the future in order to avoid excessive generation of threats to the fulfilment of fiscal objectives due to too optimistic estimates of the development of macroeconomic environment.

The 2005 update carries also higher estimates of the economic growth, primarily due to effects of a more favourable development of wages and domestic demand. Other years reflect inflow of other investments, particularly in the automotive sector. The growth of Slovak economy will continue to achieve high, though sustainable levels. Certain reserves in the price development estimation enabled retention of the total inflation rate projection on an unchanged level in 2005. It turns out that that the higher growth of economy could slightly promote the fulfilment of fiscal intentions, with a positive effect of reduction of public finance deficit and, with a certain time lag, also a reduction in the debt ratio.

The positive difference in the gross debt against the last update results from adoption of the Treasury and use of public sector assets for the funding of liabilities. For further explanation refer to the section concerning public debt.

Table 6: Comparison between the previous forecast and the update

	ESA code	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
Real growth of GDP (%)						
Previous update		5.0	4.5	5.1	5.4	
Actual data and current update		5.5	5.1	5.4	6.1	5.6
Difference		0.5	0.6	0.3	0.7	
General government balance (% of GDP)	EDP B.9					
Previous update		-3.8	-3.4	-2.9	-1.9	
Actual data and current update*		-3.2	-3.3	-2.9	-1.6	-1.3
Difference		0.6	0.1	0.0	0.3	
General government gross debt (% of GDP)						
Previous update		43.0	44.2	45.3	45.5	
Actual data and current update		42.6	33.7	35.5	35.2	36.2
Difference		-0.4	-10.5	-9.8	-10.3	

**in 2005 ex the one-off effect of debt remission towards foreign countries* *Source: Ministry of Finance*

V. QUALITY OF PUBLIC FINANCE

V.1. Policy Strategy

Consolidation of public finance is the Government's focal medium-term objective. Consolidation objectives are important from the financial stability perspective, though the Government is also well aware of the key importance of the qualitative aspect of public finance. Successful continuation of the fulfilment of medium-term objectives enables focus on just this issue. Therefore, a political priority for next periods is improvement of efficiency and effectiveness of the use of public resources, and orientation of these towards promotion of potential growth of economy. However, the Government also recognises that a greater focus on qualitative aspects of public finance must not compromise fiscal consolidation.

In 2004, the Government launched an all-embracing tax reform which had the key significance in terms of improving quality of general government revenue. In the upcoming period attention will be focused on the expenditure side. Starting from 2003, when multi-year (3 year) and the programmed budgeting was introduced, the budgetary philosophy has entirely changed. It can be stated that the three-year budgeting has already brought its benefits in the form of introduction of medium-term expenditure frameworks. These have a significant guidance influence on political discussions involved in the budget updating process by regulating any claims for expenditure increases. Efficient operation of the programme-based budgeting will probably need a longer term to show out. In order to achieve objectives pursued through it, all general government constituents, not only the SR Ministry of Finance, will have to adopt its philosophy. This requires improvement of their analytical, managerial and implementation capacities, which is a matter of longer-term efforts.

V.2. Revenue-Side Development

In 2004, Slovakia underwent an essential tax reform [31] that not only rose discussions at home, but also attracted attention from abroad, where it enjoyed exceptionally positive reactions. The tax reform was formulated with a view to establishing a modern tax system in Slovakia, able of **motivating people to work more, or actively search for jobs, and businessmen to invest and thereby create new jobs.** Thus, the tax reform contributed to dynamic and sustainable growth of economy which is the key prerequisite for improvement of the population's standard of living, for principal legislative changes refer to Box 2.

Changes in numbers of income tax rates (%)

	2003	2004
Individual income tax	2; 2.25; 2.5; 2.75; 10; 20; 28; 35; 38	19
Corporate income tax	15; 18; 25	19
Withholding income tax	1; 5; 10; 15; 20; 25	19

Source: Statistical Office, Ministry of Finance

Box 2 – Tax Reform in 2004:

- ✓ adoption of a uniform 19% income tax rate (for both individuals and corporate entities); reduction of the number of rates from 18 to 1;
- ✓ unification of VAT rates on the 19% level (from previous 14% and 20%);
- ✓ rise of excises to a level moderately above levels required by EU;
- ✓ abolition of dividend taxation;
- ✓ abolition of real estate transfer tax (till 2005);
- ✓ abolition of legacy and donation taxes;
- ✓ adoption of a higher deductible sum for a taxpayer, and a child tax bonus; and
- ✓ abolition of a number of exceptions, deductible items and special regimes in the income taxation.

The tax reform concept was based on the equitability, efficiency and simplicity principles. The primary purpose of the reform was not reduction of the total tax burden, though this eventually dropped, according to estimations of the MoF, by 0.5% of GDP (this drop was

[31] The Ministry of Finance of the SR prepared an economic analysis ("First Year of Tax Reform or 19% at work", September 2005) concerning effects of the tax reform on public finance, economic environment and taxpayers. The material is available in English (www.finance.gov.sk/en).

exactly in line with Government's intents – due to the tax reform the budgeted general government deficit rose from 3.4% to 3.9% of GDP in 2004). Thus, the reform took account of Government's medium-term consolidation objectives, as well long-term sustainability of public finance. The principal objective of the reform was improvement of both dynamic and static allocation efficiency in economy rather than tax burden redistribution. The main feature of the tax reform was not only flat tax in terms of the uniform tax rate alone, or transfer of the tax burden from direct taxes to indirect taxes, or from capital to labour. The reform actually lay in reduction of various exceptions, exemptions and special regimes.

The Government is well aware of that social sustainability of reforms and public finance is an important dimension of their qualitative aspect. Though the tax reform was primarily focused on growth of efficiency and economic growth, great attention was paid to social impact. The social sustainability of the tax reform as well as the other reforms implemented in the SR was largely contributed to by the sound economic growth that helped to mitigate some social consequences of reforms.

The following table summarises the static and dynamic views of the net income growth in main types of workers, inclusive of risk groups (workers with low income and families with children). The static view examines only the impact of the tax reform, and the first column indicates the growth of net income of taxpayers resulting solely from changes in income tax and employee contributions[32]. In the second column the static analysis is extended to the impact of indirect taxes that reduced net income by approx. 2 p.p. (effect of the increase in indirect taxes on inflation rate). The dynamic view contains also a year-to-year income increase in economy and total inflation, i.e. it means real growth of net after-tax income. The table indicates that among all examined groups worsening was experienced only by individuals receiving average wage, but only under the static view. Other groups benefited from the reform even under the static analysis, and all groups benefited under the dynamic view thanks to the sound growth of economy and wages, with the biggest improvement observed among families with a non-working wife and two children.

Change in net income in 2004 (%)

	STATIC PERSPECTIVE		DYNAMIC PERSPECTIVE
	income tax and contributions	income tax and indirect taxes	real growth of income (%)
INDIVIDUAL receiving			
minimum wage	3.5	1.4	**3.1**
average wage	-0.4	-2.4	**0.9**
3-fold average wage	6.5	4.5	**8.3**
FAMILY			
Employed (average wage) + 2 children	2.7	0.7	**3.9**
Employed (average wage) + non-working spouse + 2 children	7.8	5.7	**8.9**
Employed (average wage) + spouse (average wage) + 2 children	2.9	0.9	**5.9**

Source: Financial Policy Institute

[32] Social contributions paid by employee rose from 12.8% to 13.4% in 2004, while employer contributions dropped from 38.2% to 35.2%. The static analysis applies a strong assumption that the entire increase in employee contributions was reflected in the decrease in net wage, and the entire decrease in employer contributions was reflected in a reduction in their total costs of labour.

V.3. Expenditure-Side Development

The general government budget for years 2006 – 2008 confirms the Government's direction indicated in the previous CP. The binding effect of the first multi-year general government budget for years 2005-2007 was the basic prerequisite for continuation of consistent and effective fiscal policy. In addition to necessary consolidation, the approved budget improves efficiency of used public resources and allocation of these to areas perceived by the Government as top priorities.

The current draft of the general government budget for years 2006-2008 reflects priorities formulated in Minerva programme which is based on the "Competitiveness Strategy of Slovakia by 2010", approved by the Government in February 2005. This document represents the National Lisbon Strategy which is gradually reflected in all other documents and initiatives of the Government for this period in a manner assuring its full compatibility with the Strategy and aiding its fulfilment. Individual action plans have been prepared for the high-priority areas, and approved by the SR Government in July 2005.

The National Lisbon Strategy of Slovakia is based on two pillars. The first one is fine-tuning of structural reforms and maintenance of their results; the other one is development of knowledge economy. Just the structural reforms implemented in years 2003-2004 primarily contributed to the overall fiscal consolidation and reduction of general government deficit from 7.8% of GDP in 2002 to 3.2% of GDP in 2004. Currently, conditions for development of what is referred to as 'knowledge economy', as covered by the specific Government's project Minerva, are being established. Its objective is development of four priority areas:

1. Human capital and education
2. Information society
3. Science, research and innovations
4. Business environment

A clear vision of the target state by 2010 was formulated for each of the areas. Simultaneously, it also defined principal basic objectives corresponding to that vision and main policies and steps by which the objectives may be achieved. The objective of the fiscal policy, with regard to the objectives and priorities set, is to facilitate development of market economy, minimisation of interventions from the state, and balanced budget; avoidance of an increased extent of public reallocations in economy and facilitation of its further reduction though systematic elimination of inefficient activities. On the contrary, in accordance with Government's objectives further efforts will be exerted in order support selected areas by targeted public expenditure rather than through tax exemptions. In the social area, the SR Government will promote a policy encouraging responsibility of an individual and his family for the solution of their situation, and for the creation of adequate social and economic background. The implemented reforms establish real preconditions for the population of Slovakia to have access to good-quality health care and fair old age pensions in the future, reflecting their real activity during their economically active lives.

Although the main purpose of the National Lisbon Strategy is facilitation of fast and long-term economic growth, its support must not be based on policies excessively burdening the environment.

The implementation of the above objectives will be based primarily on use of public resources and resources obtained from the EU, in addition to public sector resources[33]. Even within the general government budgetary process, expenditure in areas that do not correspond to the National Lisbon Strategy are reduced, and expenditure in priority areas increased. One effective tool for the attainment of this objective is implementation of the programmed budgeting that was first applied in 2004. A much stronger emphasis is put on the use of structural funds, the Cohesion Fund and other expenditure schemes of the EU focused on competitiveness, innovations and the building of transport infrastructure. Implementation of the National Lisbon Strategy, however, must not threaten the medium-term fiscal consolidation plan which is necessary for attainment of long-term sustainability of pubic finance.

The implementation of measures leading to efficient allocation of public resources is gradual, and therefore immediate results must not be expected. Success of the project *per se* will depend on the general support and implementation within general government structures. One important component will be also a proper procedure for evaluation of implemented measures, including internationally comparable statistic standards.

Alike the EU level, also the use of public expenditure in Slovakia is monitored through the "COFOG" functional classification. At present, only national budget expenditure is budgeted in this manner, but data for entire general government are insufficient. Historical data are available only for year 2003, and these are insufficient for an analysis of expenditure development trends. The MoF has been taking further steps seeking improvement of usability of this classification. The purpose is COFOG monitoring at a level of at least 2 towns.

[33] In this context, the key factor will be proper prioritisation within the National Strategic Reference Framework for Years 2007 and 2013.

General government revenue and expenditure balance in years 2002-2008 (% GDP, ESA 95)

	2002	2003	2004	2005B	2005E	2006B	2007B	2008B
TOTAL REVENUE	**38.4**	**36.1**	**35.7**	**37.1**	**37.0**	**36.9**	**37.1**	**36.4**
Tax revenue	**19.0**	**18.1**	**18.0**	**17.4**	**17.8**	**17.6**	**17.5**	**17.4**
Personal income tax	3.4	3.3	2.8	2.4	2.7	2.6	2.7	2.8
- income from dependent activity	2.9	3.0	2.3	2.1	2.3	2.3	2.3	2.4
- income from self-employment	0.5	0.3	0.5	0.2	0.4	0.3	0.3	0.3
Corporate income tax	2.7	2.8	2.5	2.1	2.5	2.5	2.5	2.6
Withholding income tax	0.9	0.8	0.4	0.5	0.3	0.3	0.3	0.3
Property taxes	0.5	0.5	0.5	0.3	0.5	0.4	0.4	0.4
Value added tax	7.6	6.7	7.8	8.4	7.9	7.9	7.9	7.8
Excise taxes	3.1	3.1	3.3	3.3	3.5	3.3	3.3	3.2
Road tax	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes from international trade and transactions	0.4	0.3	0.1	0.1	0.0	0.0	0.0	0.0
Taxes on specific services (municipalities)	0.3	0.3	0.3	0.2	0.3	0.3	0.2	0.2
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security contributions	**14.4**	**13.9**	**12.8**	**13.5**	**13.1**	**13.2**	**13.0**	**12.8**
Social Insurance Agency	8.4	8.2	8.1	8.4	8.1	8.3	8.2	8.0
Health Insurance Companies	5.1	4.8	4.7	5.1	5.0	4.9	4.8	4.7
National Labour Office	0.9	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	**4.8**	**4.1**	**4.2**	**4.0**	**4.3**	**3.9**	**3.5**	**3.2**
out of which interests	0.7	0.8	0.6	0.4	0.4	0.3	0.3	0.2
Grants and transfers	**0.2**	**0.0**	**0.7**	**2.2**	**1.8**	**2.3**	**3.1**	**3.0**
out of which: from EU	0.0	0.0	0.6	2.2	1.8	2.2	3.1	3.0
TOTAL EXPENDITURE	**46.2**	**39.9**	**38.9**	**40.4**	**41.1**	**39.8**	**38.8**	**37.7**
Current expenditure	**38.6**	**36.5**	**35.6**	**36.4**	**36.1**	**35.6**	**34.8**	**33.9**
Gross wages	**7.5**	**7.4**	**6.9**	**7.0**	**7.1**	**7.2**	**6.9**	**6.8**
- Wages	5.6	5.5	5.2	5.3	5.3	5.3	5.2	5.1
- Employer social security contributions	1.9	1.9	1.7	1.8	1.8	1.8	1.8	1.7
Goods and other services	**5.0**	**5.2**	**5.6**	**5.4**	**5.5**	**5.4**	**5.0**	**4.8**
- Use of EU funds	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1
- Other	5.0	5.2	5.6	5.3	5.4	5.3	4.9	4.7
Grants and transfers	**22.3**	**21.3**	**20.9**	**21.7**	**21.7**	**21.1**	**20.9**	**20.4**
- Agricultural subsidies	0.8	0.7	0.8	1.0	0.9	1.0	1.0	1.0
- Transport subsidies	0.4	0.7	0.7	0.7	0.7	0.7	0.7	0.6
- Support for housing	0.4	0.4	0.3	0.3	0.3	0.3	0.2	0.2
- Active labour market policy	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3
- Health care	4.9	4.7	4.7	4.9	4.8	4.7	4.7	4.6
- Sickness benefits	0.8	0.7	0.4	0.4	0.4	0.3	0.3	0.3
- Old-age and disability pensions	7.7	7.4	7.5	7.5	7.7	7.6	7.4	7.3
- Unemployment benefits	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2
- State social benefits and aid	3.0	2.7	2.1	2.3	2.2	2.1	2.0	1.9
- Soc.security contrib. on behalf of certain groups	2.2	2.2	1.7	1.9	1.8	1.8	1.8	1.8
- Transfers to the EU budget	0.0	0.0	0.6	0.9	0.9	0.9	0.9	0.9
- Transfer of 2% of income tax to the third sector	0.0	0.0	0.1	0.0	0.1	0.1	0.1	0.1
- Other	1.4	1.2	1.5	1.2	1.3	1.1	1.3	1.3
Interest repayments	**3.8**	**2.6**	**2.2**	**2.4**	**1.8**	**1.9**	**1.9**	**1.9**
Capital expenditure	**7.6**	**3.5**	**3.3**	**4.0**	**5.1**	**4.1**	**3.9**	**3.8**
Capital asset acquisition	3.2	2.5	2.7	2.6	2.7	2.0	1.5	1.3
Capital transfers*	4.5	1.0	0.6	1.4	2.3	2.2	2.4	2.4
General government balance*	**-7.8**	**-3.8**	**-3.2**	**-3.4**	**-4.1**	**-2.9**	**-1.6**	**-1.3**
Impact of 2nd pillar	0.0	0.0	0.0	-0.4	-0.8	-1.3	-1.4	-1.4
GG balance incl. of impact of the 2nd pillar	**-7.8**	**-3.8**	**-3.2**	**-3.8**	**-4.9**	**-4.2**	**-3.0**	**-2.7**

** incl. of debt remission towards foreign countries accounting for 2.1% of GDP in 2002 and 0.8% of GDP in 2005E* *Source: Ministry of Finance*

Compared to the previous Convergence Programme, no significant changes able of essentially changing the view of pubic finance have occurred. Total public expenditure excl. EU funds will drop 3.7% of GDP in 2008 against 2004.

Current expenditure

In 2005, a 3.7 % decrease in the general government sector's headcount against 2002 is envisaged (a part of this decrease results from the transfer of powers within the frame of privatisation). This drop in the headcount has manifested itself in a reduction in staff expenses of 0.5% of GDP by 2005. The current level of these expenses will gradually stabilise at a level of approx. 7.0% of GDP, provided that further decrease of 0.3% of GDP is expected by 2008 due to a high growth of economy. Thanks to the headcount reduction and the savings in expenditure related to gross wages, the Government was able of assuring more efficient and targeted use of these funds.

In 2006 and the following years gross wages will reflect changes in the remuneration system for teachers, professional soldiers and judicial officers. In the case of teachers, the Government has been pursuing its commitment to achieve a level of wages in regional education systems equal to the average wage, which means a higher valorisation rate equal to the nominal GDP growth. The aim is to make the school system more attractive for young and beginning teachers. Concurrently, a 3.0% annual year-to-year reduction in the headcount is envisaged. The judiciary system is one of the areas where the growth in wage expenditures ensues not only from the remuneration system, but also an increase in the headcount. Compared to 2002, the headcount rose by nearly 30%, provided that the main reason was a need to facilitate faster and more efficient performance. Higher gross wages are also assumed in the budget for universities (+14%).

The development of subsidies and transfers, compared to the preceding Convergence Programme, has remained unchanged. These will drop by 1.2% of GDP against 2005 by 2008, and therefore yield the highest contribution to fiscal consolidation.

As regards agricultural subsidies, the Government prefers an approach that is adequate to the national budget's resources and, at the same time, politically acceptable. The level of direct payments (including transfers from the rural development programme) will reach 54% of average of EU, which accounts for SKK 7.6bn. Further increases in total subsidies in excess of 1% of GDP are not assumed.

Almost 50% public expenditure savings in the area of the housing support in 2002-2008 was achieved through a revision of the method of granting, and amounts of, subsidies. The main source of consolidation in this area may be deemed to be the reduction of the state premium in building saving schemes, and a decrease in expenditure related to subsidisation of interest rates on granted mortgage loans. Savings were achieved mainly thanks to the general drop in interest rates in the market, enabling a significant reduction in the extent of provided aid.

Stabilisation of the health care system, and mainly the amount of resources available at health insurance companies and measures adopted on the expenditure side caused a decline of 0.2% of GDP in expenditure of health insurance funds against the previous Convergence Programme. The current development indicates that financial management of health insurance companies was balanced, or with a moderate surplus, which means that a majority of expenditure was dependent on resources available from social security contributions. The decline in expenditure does not mean public finance savings since it is accompanied with an equal drop on the revenue side.

A slight increase in pension benefit expenditure relates to the legislative changes of 2004 and the system adjustments effective as of 1 July 2005. As of beginning 2004, high interest in both early and regular pensions was manifested, provided that some pensioners continued their employments. The expenditure is further increased by pensions afforded to citizens continuing to work even after they became eligible for pensions (a 6% increase per year worked). After stabilisation of legislation and reduction of the number of new pension recipients due to the increased retirement age, starting from 2008, a drop of 7.3% of GDP in expenditure is expected. The above figures are inclusive of expenditure on pensions for military corps (approx. 0.3% of GDP p.a.).

Expenditure on state social benefits and aid is a significant source of consolidation. The positive macroeconomic development in general, and the growth of employment and the benefit reform in particular, caused a significant reduction in expenditure, accounting for 0.9% of GDP, by 2004. Presently, some measures have been reviewed with a view to improving efficiency and specific addressing of the provided aid. Therefore, such dramatic decline is not expected to continue; on the contrary, the amount of aid should remain stable, thus regulating the positive macroeconomic development.

For the first time we report in the Convergence Programme an amount of taxes remitted by both natural and legal persons for a specific purpose. As of 2002 (in respect of the taxation period of 2001), individuals were allowed, and companies as of 2004, to remit 2% of income taxes paid by them to registered third-sector organisations.

In addition to the general drop in interest rates, the relatively high savings on interest payments (a decrease of 0.6% of GDP against the budget) in 2005 resulted also from active management of state debt by the Debt and Liquidity Management Agency, cooperating with the Treasury. Concentration of free funds in Treasury accounts, together with lower interest rates on financial markets will remain enablers of reduced interest expenses that will stabilise on a 1.9% of GDP level. Compared to 2002, this means a 50% (1.9% of GDP) reduction.

Capital expenditure

The capital expenditure level is envisaged to be close to 4.0% of GDP. The actual amount of these will depend on Slovakia's ability to utilise funds incoming as post-integration aid from the EU, directed primarily to the motorway and speedway construction, and modernisation of railway corridors, as well as an increasing number of environmental projects. In 2005 - 2008, 47% of funds from the EU are assumed to be used for capital expenditure.

The 2006-2008 budget assumes a drop in expenditure on acquisition of capital assets, and adequate transfer of expenditure on capital transfers. This is due to the establishment of the National Motorway Company on 1 May 2005, which is classified off the general government sector, and its purpose is construction of road infrastructure.

VI. SUSTAINABILITY OF PUBLIC FINANCE

The process of consolidation of public finance in Slovakia has been successful. Since 2002, general government deficit has been reduced from 7.8% of GDP to 3.2% of GDP in 2004. Another important milestone will be reduction of the deficit to 3.0% of GDP by 2007 (including costs relating to the launch of the 2nd pillar of the pension reform), aiming at satisfaction of Maastricht criteria for integration of the SR into Eurozone. Thus, the direction of fiscal policy by 2007 has a clearly determined framework.

The character of fiscal policy after 2007 was first presented in the Convergence Programme of Slovakia in May 2004. It contained specification of three pillars upon which fiscal policy should rest from a long-term perspective: transparency, effectiveness, and responsibility. Acceptance of the last principle required formulation and announcement of the following objective: **achieve long-term sustainability of public finance by 2010.**

VI.1. Policy Strategy

The Ministry of Finance has defined long-term sustainability of public finance as capability to maintain general government deficit on a level not higher than 3% GDP, and net public debt on a level not higher than 60% of GDP during periods of most severe demographic problems around 2055. The first general government budget for years 2005-2007 and the Government-approved budget for years 2006-2008 seem to have established realistic foundations for the fulfilment of this objective.

Measures will need to be implemented on two levels:

- structural reforms (in particular parametrical changes in the first pillar of the pension system and avoidance of disproportional demand in the health care system)
- reduction in general government deficit.

The approved reduction of general government deficit is the first and principal means for implementation of a responsible fiscal policy. The consolidation of public finance *per se* should not attempt to provide solutions for everything. Expenditure on pension benefits, health care and long-term care will be the main reasons behind the rise of public expenditure, high deficits, and a dramatic increase in general government debt over the next five decades. Implementation of a responsible fiscal policy, successful from not only a short-term perspective, but also over long-term periods, the reduction of deficit must be complemented by such structural reforms that are able of yielding savings in general government expenditure over a long-term period. The inter-generation equitability and social adequacy principle must be maintained, however.

The responsibility principle involves endeavours to assure equitability not only within one generation but also between generations. In other words, responsible approach is one assuring that the burden of high indebtedness (both explicit and implicit) is not passed to next generations, and each generation creates sufficient resources to cover its common needs (inclusive of capital consumption - depreciation). Government bond issues aimed at financing capital expenditure are justifiable since they yield some benefits also for next generations. This principle is particularly important in terms of the population ageing since non-reform systems would, even with seemingly acceptable deficits at present, mean a time bomb of high deficits for the next generation.

Slovakia has taken a number of important steps towards attaining long-term sustainability. General government deficit has been significantly reduced, general government debt stabilised, and important reforms have been implemented, primarily in the pension security area.

Subsequent part presents long-term projections of public expenditure that are sensitive to the demographic development, and the development of deficit and general government debt.

The currently effective legislation, together with the approved general government budget for years 2006-2008 have yielded a significant improvement in the public finance position against the past, though its is not sufficient for assurance of long-term sustainability of public finance. An analysis carried out by the Ministry of Finance indicates that **this requires attainment of a general government deficit level of 0.9% of GDP (including the 2nd pillar) by 2010.** This medium-term target can be reached by two ways: reasonable indexation of public expenditure at a strong economic growth and adjustment of parameters of the PAYG pillar of the pension scheme. **Another prerequisite is – in line with the reform concept definition – increase of the retirement age to 65 after 2010, with indexation of pensions at a pensioner inflation rate only.**

VI.2. Long-term Budget Forecasts with Regard to Population Ageing

Long-term projections involve a significant portion of uncertainty regarding the future development. In such projections, the key role is played primarily by demographic and macroeconomic assumptions. All assumptions employed result from discussions within the Ageing Working Group (AWG), or have been adopted from relevant institutions (Eurostat, Infostat). Mutual coordination of all institutions concerned assured consistency and mutual linkage of assumptions. Since the time horizon for projections included in this material is 2080, while a majority of agreed assumptions, inclusive of those demographic, relates to the period of time by 2050 only, the MoF applied its own assumptions for this period. Their specifications are described in appropriate chapters.

Demography

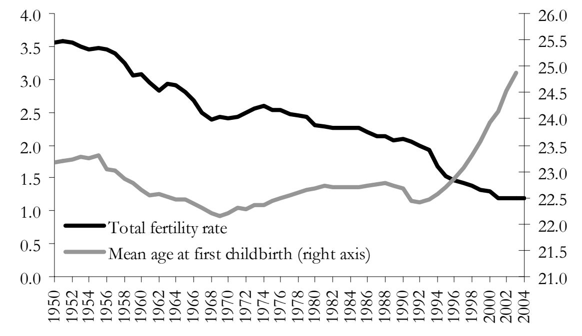
Demographic assumptions till 2050 are based on the Eurostat projection (EUROPOP2004) that serves as the basic scenario for the AWG group. For purposes of its analysis simulating the development of public finance up to 2080 (demographic problems in the SR are supposed to culminate around 2055), the Ministry of Finance employed its own assumptions that, in a majority of cases, smoothly follow up those of EUROPOP2004.

Demographic assumptions									
	The Slovak Republic							EU-15 average	
Baseline scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2080**	**2004**	**2050**
Population (thousand)	**5,380**	**5,347**	**5,271**	**5,186**	**5,001**	**4,738**	**4,003**	**-**	**-**
aged 0 to 14	944	801	751	703	632	609	578	-	-
aged 15 to 64	3,815	3,887	3,658	3,405	3,163	2,741	2,323	-	-
aged 65 and over	620	658	861	1,078	1,206	1,388	1,102	-	-
Life expectancy (M)	69.7	70.9	73.1	75.3	76.7	77.7	80.0	76.0	82.0
Life expectancy (F)	77.8	78.7	80.3	81.8	82.7	83.4	84.7	81.7	86.7
Fertility rate	1.19	1.18	1.33	1.52	1.59	1.60	1.70	1.60	1.66
Migration balance (thousand)	-2.3	-2.4	1.2	5.1	5.0	4.7	17.1	-	-
Net migration (% of pop.)	-0.04	-0.05	0.02	0.10	0.10	0.10	0.43	-	-
Low scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2080**		
Population (thousand)	5,380	5,291	5,059	4,779	4,371	3,856	-	-	-
Fertility rate	1.10	0.97	1.07	1.30	1.39	1.40	-	1.56	1.41
Migration balance (thousand)	-4.3	-4.5	-4.7	-3.6	-3.3	-2.9	-	-	-
High scenario	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2080**		
Population (thousand)	5,380	5,404	5,488	5,649	5,795	5,960	-	-	-
Fertility rate	1.28	1.40	1.67	1.91	1.99	2.00	-	1.63	1.91
Migration balance (thousand)	-0.4	-0.7	6.5	15.4	15.9	16.4	-	-	-

Source: Eurostat (Europop 2004), Ministry of Finance

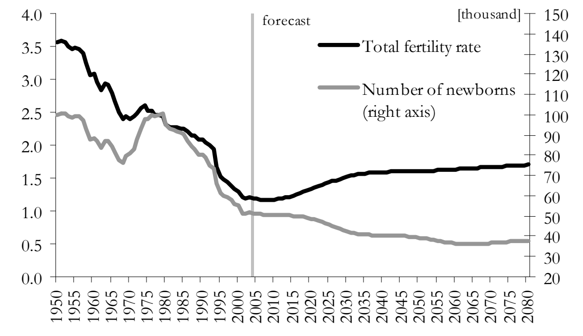
The total fertility rate in the SR has been on decline[34] since 1950, when it reached a level of 3.5 child per woman. In 2003, the total fertility was 1.2 which is far below the EU15 average of 1.6. The reasons behind this include the change in social situation in the country and consequent postponement of maternity to a later age.

Total fertility rate and mean age at first childbirth (1950 – 2004)



Source: Infostat

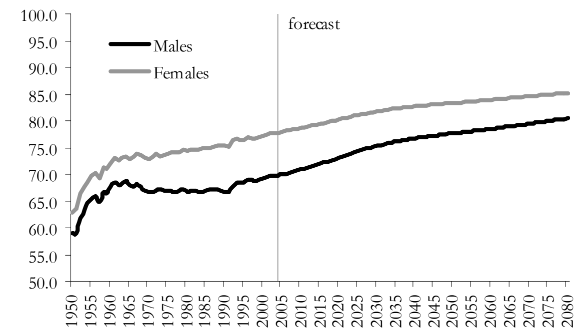
Projection of total fertility and number of alive newborns – baseline scenario



Source: Infostat, Eurostat (Europop 2004), Ministry of Finance

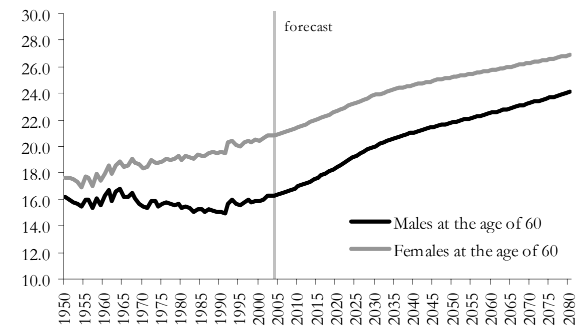
In 2003, the average length of life in Slovakia was 69.8 years of men and 77.6 years of women. Within the EU25 countries these are the fourth lowest figures. Therefore, a significant rise and approach to the European average are expected in the next decades. In 2050, the average length of life in Slovakia is supposed to go up 8 years of men and 5.8 years of women.

Life expectancy at birth



Source: Infostat, Eurostat (Europop 2004), Ministry of Finance

Life expectancy at the age of 60



Source: Infostat, Eurostat (Europop 2004), Ministry of Finance

Probably the most significant question concerning the future development of population is the effect of migration. The EUROPOP2004 projection assumes that Slovakia will be a country sending emigrants to Western countries in the next years. Similarly to other new EU Members States, this effect will be limited over a medium and long term, since these countries will also experience the population ageing, and a decline in the population at a productive age. Therefore, it can be reasonably expected that a significant inflow of migrants into the SR will be observed at a later stage.

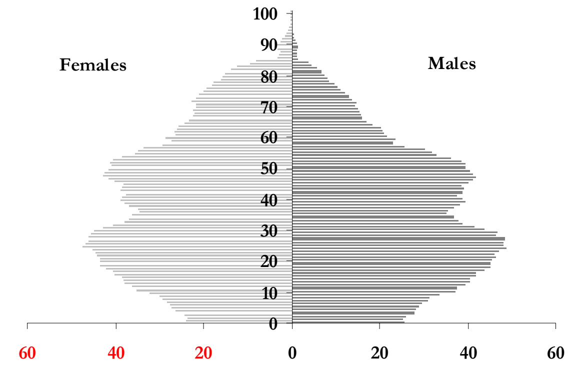
Combination of the above mentioned assumptions will result in a quite dramatic drop in the population of Slovakia from the current 5.4 million to approx. 4.7 million by 2050 (-12%). A

[34] The average number of alive newborns per women during its entire reproduction age (15-49 years), subject to maintenance of the fertility level of the year concerned and zero mortality.

similar situation can be observed also in the neighbouring countries (CZ, HU, PL), and even more noticeable reduction in population, of 16 to 19%, in Estonia, Lithuania and Latvia.

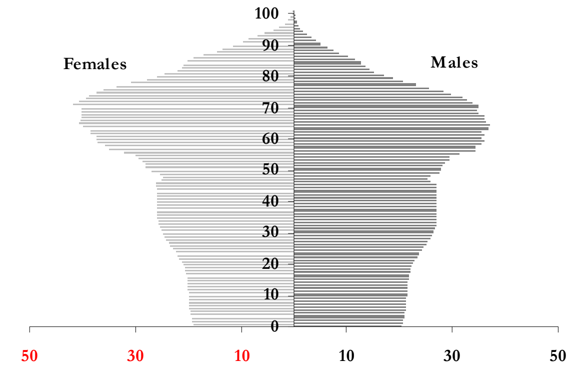
The population reduction will be accompanied by the ageing effect. Presently, working age population, including those born in strong fertility years 1960 – 1985, will gradually come to the retirement age. The demographic crisis will culminate in 2055 when the ratio between the population aged 65+ and the working population (15-64) will reach the highest level. In other, very simplifying words, while 6 citizens at working age population must “take care” of one at a post-productive age at present, in 2050 one pensioner will be “covered” only by two.

Population structure in 2004 (thousand persons)



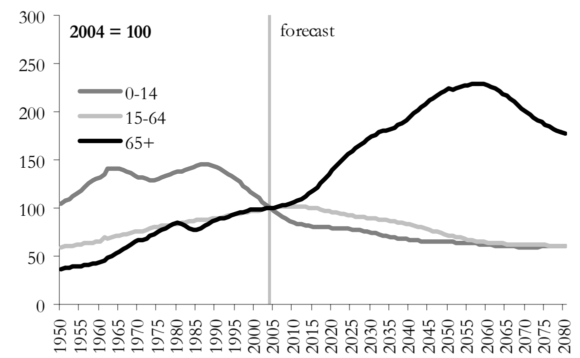
Source: Infostat, Eurostat (Europop 2004), Ministry of Finance

Population structure in 2050 (thousand persons)



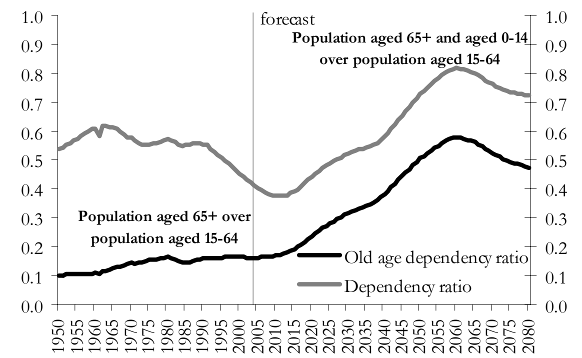
Source: Infostat, Eurostat (Europop 2004), Ministry of Finance

Trends in age groups



Source: Infostat, Eurostat (Europop 2004), Ministry of Finance

Dependency ratios



Source: Infostat, Eurostat (Europop 2004), Ministry of Finance

Macroeconomic assumptions

In addition to demographic assumptions, also those macroeconomic are very important, and these are mostly based on the expected real and nominal convergence of the SR to the EU15 average.

The participation rate[35], determined according to the OECD methodology referred to as “Cohort Component methodology”. The participation rate calculations took account of legislative changes resulting from the launch of the pension reform in 2004. The Ministry of

[35] Participation rate expresses what part of population of a given age category belongs to the labour force.

Finance's basis scenario assumes gradual rise of the retirement age from the approved 62 years to 65 years (in line with the pension reform concept), starting from 2013. Since this retirement age change applies primarily to those aged 55 to 64, these age groups experienced a significant increase in the participation rate. The remaining age groups saw only a moderate increase. Furthermore, an increase in the participation rate will be observed in years 2050-2080 when it will be necessary – due to further rise of the expected length of life – to increase the retirement age level again.

Growth of the participation rate may be observed in a majority of European countries, primarily as a result of modification of their pension schemes. The high increase in the participation rate in Slovakia is also contributed by the below facts:

- increased retirement age;
- a high ratio of population with secondary–level education against European benchmarks;
- the current participation rate in women aged 25 to 54 is more than 10 percent point higher than the EU average;
- optional continuation of employment along with receiving pension benefits;
- a very low current ratio of part-time employments.

Development in the labour market (%)

	The Slovak Republic								EU-15 average	
	2003	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**2080**	**2003**	**2050**
Participation rate (males)										
15-24	45.4	46.0	46.5	46.1	44.3	45.2	45.2	45.0	51.7	53.0
25-54	94.1	94.4	95.3	96.1	96.2	96.0	95.9	96.4	92.5	94.4
15-54	80.7	81.2	83.3	86.7	86.3	85.0	84.8	84.6	-	-
55-64	48.9	49.8	59.6	65.2	76.4	74.7	73.7	79.4	54.8	67.7
65+	2.9	2.7	3.2	6.2	9.9	10.3	9.7	17.7	-	-
15-64	76.8	77.3	79.6	82.8	84.4	82.4	81.9	83.5	78.7	81.5
Participation rate (females)										
15-24	37.5	38.5	39.9	39.6	38.3	39.0	39.0	39.0	44.7	46.1
25-54	84.6	85.1	87.5	89.6	90.8	90.1	89.5	90.0	74.4	82.6
15-54	72.0	72.8	76.2	80.5	81.1	79.4	78.7	78.5	-	-
55-64	12.7	14.2	26.5	46.7	63.6	62.4	61.6	70.0	34.0	56.2
65+	1.7	1.7	2.8	5.6	7.3	7.8	7.1	16.9	-	-
15-64	63.4	64.1	67.2	73.6	77.4	74.8	74.0	76.6	62.1	70.6
Total participation rate 15 -64	**70.1**	**70.7**	**73.4**	**78.2**	**80.9**	**78.6**	**78.0**	**80.1**	**70.4**	**76.1**
Unemployment rate (15 -64)	**17.5**	**18.1**	**15.2**	**9.7**	**7.0**	**7.0**	**7.0**	**7.0**	**8.2**	**6.0**
Employment rate (15 -64)	**57.8**	**57.9**	**62.6**	**70.5**	**75.2**	**73.1**	**72.5**	**74.5**	**64.6**	**71.5**

Source: European Commission (AWG), Ministry of Finance

Combination of the medium demographic forecast variant and the expected participation rate imply a relatively noticeable reduction in labour force in years 2015 to 2050 (of above 25%) which is probably a conservative scenario.

Unemployment rate and employment rate (%)

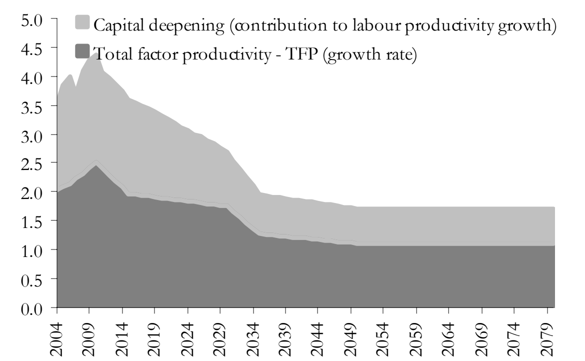
Source: European Commission (AWG)

Labour force and number of employed (thousand persons)

Source: European Commission (AWG)

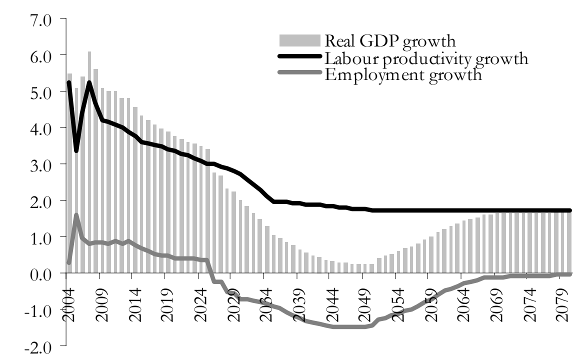
The unemployment rate was calculated on the basis of the 7% average level of structural unemployment in EU-15 countries. Due to a high unemployment in 2004, the structural unemployment level will be reached in Slovakia only in 2024. Then this level becomes fixed for the next periods.

Growth of labour productivity and its components



Source: European Commission (AWG)

Economic growth (%)



Source: European Commission (AWG)

A result ensuing from these assumptions is a strong growth of real GDP over the next 30 years (not below 3.0%). In the next period, the growth will be negatively affected by a decline in employment starting from 2026 and lasting by the end of the period in question.

Upon integration into Eurozone, the price level will slightly rise due to the Balassa – Samuelsson effect. Over a long term, however, inflation will reflect the inflation target of 2% set by the European Central Bank.

Legislative assumptions

The basic scenario of the MoF assumes, **in addition to the currently effective legislation, further increase of the retirement age up to the level of 65 years (from 2050 to 2080 gradual shift to 67 years in accordance with the expected length of life), and modification of the indexation of afforded pensions in accordance with the rise of consumer prices (after 2010).**

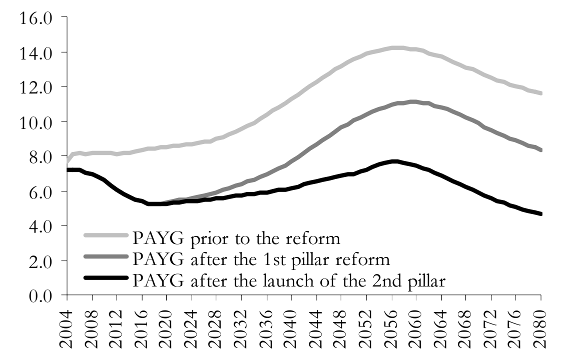
The AWG scenario is based on the legislation approved until end 2004, however it also takes account of the current general government budget for years 2006-2008.

Projections of selected expenditure

Pension expenditure

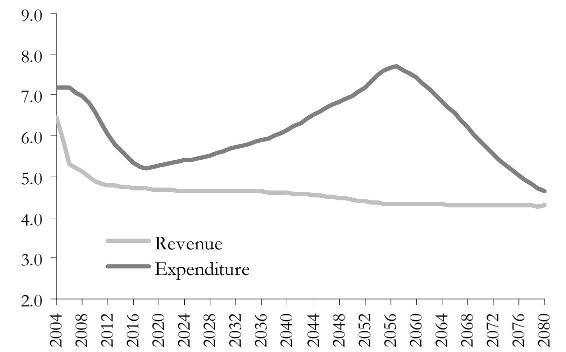
The projections were carried out using the World Bank's PROST model. The growing number of pensioners in the future will evolve pressure upon the pension scheme, which is the reason that necessitated the radical pension reform. Below graphs represent likely scenarios in the area of pension expenditure.

Social security expenditure (% of GDP)



Source: Ministry of Finance

Revenue and expenditure of the Social Insurance Agency after the full pension scheme reform (% of GDP)



Source: Ministry of Finance

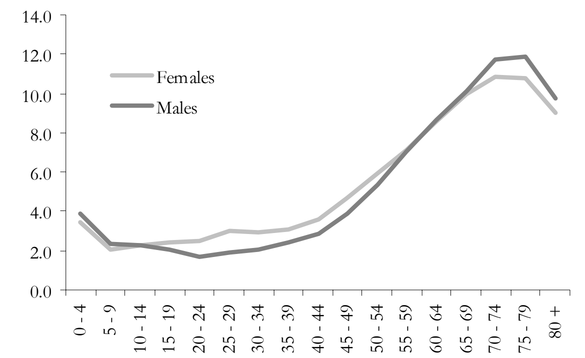
The first graph underlines the importance of the pension reform in terms of long-term sustainability. The light-grey line shows that without the reform pension expenditure would rise by 6.4% of GDP by 2055. The first pillar – continuous pillar – reform, together with the increased retirement age (65 years) and introduction of indexation according to CPI will reduce this burden to approx. 3.6% of GDP (the line in the middle). The introduction of the second (capitalisation) pillar will produce a negative effect on public finance in a form of loss of revenue, but these expenses are distributed over multiple generations. In this case public expenditure on pensions will rise only by 0.4% of GDP by 2055.

The AWG scenario relies on the legislation approved till end 2004, the retirement age risen to 62 years, and pension indexation according to wages and inflation.

Health care expenditure

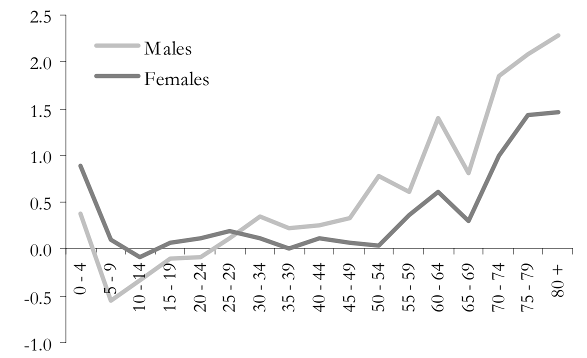
Recalculations carried out by the MoF count upon the cost profile shown in the graph also for the future. For the sake of objectiveness it should be added that there are a few empirical evidences in the literature according to which costs are high primarily two to three years before death (death-related costs), which could indicate that the Ministry's calculations are slightly overestimated. On the other hand, however, it should be also stated that there are other important factors affecting health care expenditure: population's health condition, economic growth, development of new technologies, or the health service organisation and funding.

Health care expenditure in 2004, expressed as per capita share in GDP (%)



Source: Statistical Office of the Slovak Republic

Year-to-year (2004/2003) change in expenditure per patient in a particular age group (SKK ths.)



Source: Statistical Office of the Slovak Republic

In addition to the above mentioned factors the care of elderly citizens will also require a higher amount of funds, and the MoF's scenario does not explicitly contemplate this category. The result of the simulations is that with the health system reform public expenditure would rise by only 1.5% of GDP over a long-term.

Education expenditure

The current level of expenditure on education is approx. 3.9% of GDP. Future years will bring about a radical decrease in the number of pupils in the regional school system. Despite that the MoF does not contemplate a reduction in expenditure on the school system after 2008 (the time when the regional school system reform should manifest itself in a form of higher efficiency of the system), since the SR wishes to promote the investment in human resources from a long-term perspective. This should be significantly contributed to also by private resources in the university-level school system.

The projection based on AWG assumptions incorporates a change in expenditure depending on the number of students – the impact of demography only. It does not contemplate a policy directed towards rising expenditure on education. The reduction in expenditure by 2050, based solely on demographic effects, is expected to amount to 1.2% of GDP. Compared the MoF's scenario assuming a stable level of expenditure, the preceding shows out what extent of improvements in the quality of education can be expected with a stable, unchanged level of expenditure on education.

Expenditure on unemployment aid

The reduction in unemployment from 18.1% to the structural unemployment level of 7% will be reflected in reduced expenditure on aiding citizens without work. The calculation assumes indexation of the average per unemployed expenditure according to the growth of nominal wages since the amount of aid is determined by previous earnings of an unemployed.

Child allowance and tax bonus

Thanks to a number of changes in the social area and the launch of the tax reform as of 1 January 2004, a new system of aiding parents of dependent children has been adopted. The aid consists primarily of child allowances of SKK 540 per child, irrespective of parent's earnings.

In addition, under the tax reform, working parents may reduce their tax liability by SKK 450 (SKK 540 as of 1 January 2006) per dependent child. Further types of aid, such as child birth allowance etc., have not been contemplated in the calculations. In both cases, indexation by nominal wage was assumed.

Results

With the above assumptions and projections the MoF prepared two scenarios aiming at demonstration of long-term effects of fiscal policy. The first scenario presents the opinion of the Ministry of Finance and the possible way to achievement of long-term sustainability of public finance by 2010. The second scenario relies upon the AWG assumptions only, however it takes account of the updated general government budget for years 2006-2008.

Basic scenario = Responsible scenario

This scenario is referred to as responsible because it indicates the required consolidation of public finance that should, in conjunction with the already advised measures (increased retirement age and changed indexation of pensions), assure long-term sustainability of public finance by 2010.

Assumed development of public finance by 2080 – basic scenario (% of GDP)

	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050	2060	2070	2080
Tax revenue	18.0	17.8	17.6	17.5	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.4	17.4
tax bonus	-0.4	-0.4	-0.5	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Social security contributions	12.8	13.1	13.2	13.0	12.8	12.8	12.8	12.8	12.8	12.8	12.8	12.8	12.8	12.8
2nd pillar contributions	0.0	0.8	1.3	1.4	1.4	1.5	1.5	1.8	1.9	2.0	2.1	2.2	2.2	2.2
Other revenue	5.0	6.5	6.1	6.7	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2
REVENUE TOTAL	**35.7**	**37.3**	**36.9**	**37.1**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**
Current expenditure	**35.6**	**36.2**	**35.7**	**34.8**	**33.9**	**33.0**	**32.1**	**29.8**	**29.8**	**30.5**	**31.9**	**33.5**	**32.6**	**31.1**
Pension scheme	7.2	7.2	7.2	7.0	7.0	6.8	6.6	5.3	5.6	6.2	7.0	7.4	5.9	4.6
Health care	4.7	4.8	4.7	4.7	4.6	4.6	4.7	5.1	5.5	5.9	6.1	6.2	5.9	5.6
Unemployment benefits	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
School system	3.7	3.9	3.8	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Child allowances	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other expenditure	19.1	19.5	19.2	18.6	18.0	17.2	16.5	15.4	14.7	14.4	14.7	15.8	16.7	16.7
wages	6.9	7.1	7.2	6.9	6.8	6.5	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
goods and services	5.6	5.5	5.4	5.0	4.8	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
interests	2.2	1.8	1.9	1.9	1.9	1.9	1.8	0.7	-0.1	-0.3	0.0	1.1	2.0	2.0
other	4.4	5.2	4.7	4.7	4.5	4.3	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Capital expenditure	**3.3**	**5.3**	**4.1**	**3.9**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**
TOTAL EXPENDITURE	**38.9**	**41.5**	**39.8**	**38.7**	**37.7**	**36.7**	**35.8**	**33.6**	**33.6**	**34.2**	**35.7**	**37.3**	**36.4**	**34.8**
DEFICIT	-3.2	-4.1	-2.9	-1.6	-1.3	-0.3	0.6							
DEFICIT (incl. PAYG pillar shortfall)	**-3.2**	**-4.9**	**-4.3**	**-3.0**	**-2.7**	**-1.8**	**-0.9**	**1.1**	**0.9**	**0.2**	**-1.4**	**-3.0**	**-2.1**	**-0.6**
Primary balance	-0.9	-3.1	-2.3	-1.0	-0.7	0.1	0.9	1.8	0.8	-0.1	-1.3	-1.9	-0.1	1.5
GROSS DEBT	**42.6**	**33.7**	**35.5**	**35.2**	**36.2**	**35.5**	**34.0**	**11.4**	**-2.0**	**-6.0**	**1.5**	**23.3**	**38.9**	**37.5**
NET DEBT	**30.9**	**31.5**	**32.6**	**33.7**	**34.7**	**34.0**	**32.4**	**9.9**	**-3.5**	**-7.5**	**0.0**	**21.8**	**37.3**	**35.9**

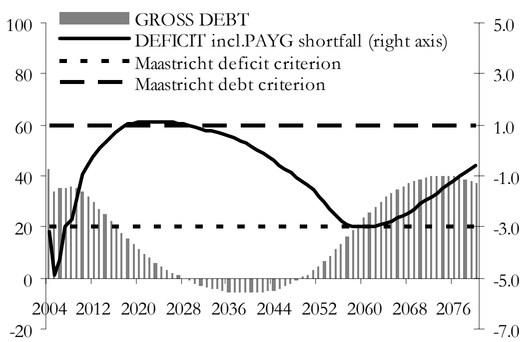
Source: Ministry of Finance

Notes:
1) since 2010 we assume the GDP growth level to equal to that of potential growth
2) wage indexation by inflation +1% (2009-2010)
3) wage indexation by inflation (2009-2010)
4) indexation of other expenditure by inflation (2009-2010)
5) gross debt is calculated through deficit (ESA 95) + outflow to the 2nd pillar (as of 2009)
6) net debt is calculated as Gross Debt minus cash in accounts
7) the average interest rate applied in the interest cost of debt calculation was 5.5%.
8) primary balance is calculated with interest paid
9) expenditure on the pension scheme are exclusive of expenditure on pensions of military forces of the SR

The result indicate that further consolidation of public finance in years 2009 through 2010 will assure (via legislative changes and indexation of expenditure) long-term sustainability of public finance if deficit, inclusive of costs related to the pension reform, does not exceed 1% of GDP. Without further profound changes (save the 1st pillar of the pension scheme), public finance will be prepared to resist pressures caused by the population ageing. The key moment in the pursuit of such development is therefore attainment of nearly balanced public finance performance at the end of the present decade, or beginning of the following one, which is concurrently the main prerequisite for efficient reduction of public debt.

It should be noted in interpretation of these results that this is a simulation, and gross debt has negative values in some years. Of course, this does not necessarily mean that such situation will occur. In reality, gross debt will be higher, while public finance assets will rise (with unchanged net debt, however).

Development of debt and deficit in responsible scenario (% of GDP)



Source: Ministry of Finance

AWG scenario

The AWG scenario is fully based on assumptions agreed upon within this group. One important things is that this scenario counts upon the current legislation (future reforms are not contemplated), and does not take in account any consolidation beyond the three-year horizon of Convergence Programmes. AWG group has an ambition to work out, based on the joint methodology, a projection of all expenditure related to the population ageing. At the time of preparation of the current Convergence Programme only preliminary data on expenditure on the school system (AWG projection) and a projection of expenditure on pensions supplied by the Ministry of Finance were available. The remaining expenditures were therefore projected according to the MoF's methodology.

Assumed development of public finance by 2050 – AWG scenario (% of GDP)

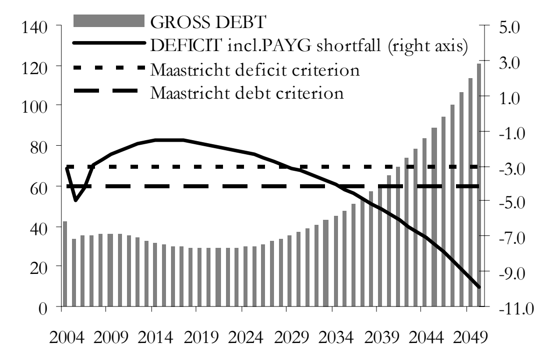
	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050
Tax revenue	18.0	17.8	17.6	17.5	17.4	17.4	17.4	17.4	17.4	17.4	17.4
tax bonus	-0.4	-0.4	-0.5	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3
Social security contributions	12.8	13.1	13.2	13.0	12.8	12.8	12.8	12.8	12.8	12.8	12.8
2nd pillar contributions	0.0	0.8	1.3	1.4	1.4	1.5	1.5	1.8	1.8	1.9	2.0
Sundry revenue	5.0	6.5	6.1	6.7	6.2	6.2	6.2	6.2	6.2	6.2	6.2
REVENUE TOTAL	**35.7**	**37.3**	**36.9**	**37.1**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**	**36.4**
Current expenditure	**35.6**	**36.2**	**35.7**	**34.8**	**33.9**	**33.5**	**33.3**	**32.7**	**34.1**	**36.6**	**40.5**
Pension scheme	7.2	7.2	7.2	7.0	7.0	6.7	6.7	7.0	7.7	8.2	9.0
Health care	4.7	4.8	4.7	4.7	4.6	4.6	4.7	5.1	5.5	5.9	6.1
Unemployment benefits	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
School system	3.7	3.9	3.8	3.6	3.6	3.5	3.3	2.6	2.6	2.7	2.8
Child allowances	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Other expenditure	19.1	19.5	19.2	18.6	18.0	17.9	17.9	17.6	17.9	19.3	22.2
wages	6.9	7.1	7.2	6.9	6.8	6.8	6.8	6.8	6.8	6.8	6.8
goods and services	5.6	5.5	5.4	5.0	4.8	4.8	4.8	4.8	4.8	4.8	4.8
interestst	2.2	1.8	1.9	1.9	1.9	1.9	1.8	1.5	1.8	3.3	6.1
other	4.4	5.2	4.7	4.7	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Capital expenditure	**3.3**	**5.3**	**4.1**	**3.9**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**
TOTAL EXPENDITURE	**38.9**	**41.5**	**39.8**	**38.7**	**37.7**	**37.2**	**37.0**	**36.5**	**37.8**	**40.3**	**44.3**
DEFICIT	-3.2	-4.1	-2.9	-1.6	-1.3	-0.8	-0.6				
DEFICIT (incl. PAYG pillar shortfall)	**-3.2**	**-4.9**	**-4.3**	**-3.0**	**-2.7**	**-2.3**	**-2.2**	**-1.8**	**-3.3**	**-5.8**	**-9.9**
Primary balance	-0.9	-3.1	-2.3	-1.0	-0.7	-0.5	-0.3	-0.3	-1.4	-2.5	-3.8
GROSS DEBT	**42.6**	**33.7**	**35.5**	**35.2**	**36.2**	**36.0**	**35.7**	**28.7**	**36.6**	**65.1**	**120.6**
NET DEBT	**30.9**	**31.5**	**32.6**	**33.7**	**34.7**	**34.5**	**34.2**	**27.2**	**35.1**	**63.6**	**119.1**

Source: Ministry of Finance of the SR

Notes:
1) since 2010 we assume the GDP growth level to equal to that of potential growth
2) gross debt is calculated through deficit (ESA 95) + outflow to the 2nd pillar (as of 2009)
3) net debt is calculated as Gross Debt minus cash in accounts
4) the average interest rate applied in the interest cost of debt calculation was as 5.5%.
5) primary balance is calculated with interest paid only
6) expenditure on the pension scheme are exclusive of expenditure on pensions of military forces of the SR
7) expenditure on the school system take account of the budget by 2008 and cover also pre-school facilities

The results clearly indicate that that pursuant to these assumptions the SR will have a relatively good position by 2030. Satisfaction of the Maastricht criterion, i.e. a deficit not exceeding 3% of GDP by 2007, is not sufficient for assuring long-term success of fiscal policy. A lack of activity after 2008 would pay back by debt and deficit rising to unbearable levels, thus making future generations to implement radical reforms or higher taxation.

Development of debt and deficit in AWG scenario (% of GDP)



Source: Ministry of Finance

Fiscal gaps

Fiscal gaps (% of GDP)				
		Gross debt 60.0	Deficit -3.0	Deficit 0.0
2030	2002	2.7	3.9	5.3
	2004	*-0.1*	*0.7*	*2.1*
	2007	*-1.7*	*-0.6*	*0.9*
	2010	*-3.3*	*-2.0*	*-0.5*
2055	2002	5.5	6.4	7.1
	2004	*1.9*	*2.5*	*3.1*
	2007	*0.7*	*1.3*	*1.9*
	2010	*-0.7*	*-0.1*	*0.6*

Source: Ministry of Finance

One useful indicator in analyses is fiscal gap that represents a value by which primary balance should change (through increased taxes or decreased "non-interest" expenditure) in order to achieve the target pursued within a predefined period of time.

The MoF chose 2030's and year 2050 that corresponds to a period with the highest pressure upon general government expenditure. Long-term sustainability indicators were, in line with the definition of sustainability, the amount of gross debts (60% of GDP as target; net debt is lower than gross debt in this case) and general government deficit not exceeding 3% of GDP (inclusive of the loss of revenue due to introduction of the 2nd pillar of the pension reforms). Meeting of principles of the Stability and Growth Pact requires, however, balanced financial management of general government, and therefore the MoF calculated fiscal dept even despite this definition of long-term sustainability.

Presented results indicate that without additional consolidation (starting from 2004) revenue would need to be permanently increased, or expenditure decreased, by 3.1% of GDP. On the contrary, with ongoing consolidation in line with the general government budget for years 2006 – 2008, reasonable indexation of expenditure in years 2009-2010, and the proposed parametric changes in the pension scheme Slovakia will achieve long-term sustainability of public finance in 2010.

Indicators of long-term sustainability of public finance

Other indicators applied by the European Commission in its evaluations and comparisons of the development of public finance in EU25 countries are based on a similar principle:

1. *S1 indicator* – this is identical to the fiscal gap concept discussed in the previous section.
2. *S2 indicator* – this expresses the amount by which primary balance needs to change (alike fiscal gap and S1) so that the current value of future primary balances equals to the current gross debt level.

RPB (Required Primary Balance) - this indicator is a follow-up of S2 indicator since it just transforms the result onto a different level. It describes what the average level of primary balance should be in the next five years in order to assure the long-term sustainability defined by S2 indicator.

Indicators of long-term sustainability of public finance (% of GDP)				
		S 1	S 2	RPB
2030	2004	*-0.1*	*2.5*	*0.4*
	2007	*-1.7*	*1.3*	*0.8*
	2010	*-3.3*	*-0.2*	*1.3*
2050	2004	*1.6*	*2.5*	*0.5*
	2007	*0.3*	*1.4*	*1.0*
	2010	*-1.1*	*0.0*	*1.5*
2080	2004	*2.4*	*2.8*	*0.7*
	2007	*1.2*	*1.7*	*1.2*
	2010	*-0.2*	*0.3*	*1.7*

Source: Ministry of Finance

These indicator calculations also indicate that with additional consolidation by 2010 and modification of the pension scheme Slovakia will be prepared to face challenges of the changing demographic structure of population. S1 and S2 indicators are close to zero, while the required primary balance level corresponds to the current estimate till 2015.

VII. INSTITUTIONAL ASPECTS OF PUBLIC FINANCE

Effective national-level fiscal rules, institutions and procedures are an important prerequisite for causing public budgets in accordance with Government's fiscal targets and achieving satisfaction of EU-level fiscal rules. In order for the Government to achieve its fiscal targets, budgetary discipline must be efficiently assured, which means primarily bringing the development on the expenditure side of a budget fully under control. The purpose of this section is discussion of institutional aspects of public finance facilitating fulfilment of Government's fiscal objectives. It is focused mainly on two areas: The first one is description of institutions facilitating fulfilment of fiscal objectives within a budget period. The second one is policies and institutions expected to contribute to consolidation of public finance over a longer term.

VII.1. Institutions within Budget Period

Financial management of general government during a budgetary year is framed by three acts and mechanisms contained in them: The State Budget Act for a budget year, the General Government Budgetary Rules Act, and the Territorial Self-government Budgetary Rules Act. Moreover, the Ministry of Finance monitors the economic and fiscal development in general government by means of a four-year material submitted for negotiation to the Government and, in the case of a mid-year report, also to the Parliament.

State Budget Act for a budget year

The State Budget Act for a budget year enables the Government to adjust the total state budget expenditure during the year not more than the limit amount defined in the Act. While in 2002 such provision did not exist, in 2003 the allowable state budget expenditure increase was limited to 15%. In 2004, the allowable state budget expenditure increase limit was 5%, in 2005 1%, and the draft state budget for 2006 enables an excess of the total state budget expenditure of not more than 1%. Pursuant to the Act, an increase in the state budget expenditure, as referred to above, is subject to non exceeding the budgeted state budget deficit. It means that the total expenditure may be increased only insofar as they are covered by an increase in revenue. This also means that any state budget revenue exceeding the budgeted level by more than 1% must be used for reduction of the state budget deficit.

General Government Budgetary Rules Act

The General Government Budgetary Rules Act provides the principal regulatory framework for financial management of general government entities. It sets out rules for the preparatory stage of the general government budgetary process (budget draft, budget provisory), as well as the budget implementation stage (heavy budget restrictions, budget provisions, expenditure binding).

The span of a general government budget prepared on an annual basis is three budget years, i.e. the relevant budget year and two subsequent budget years. Though budget revenue and expenditure indicators in respect of such subsequent years are not binding, the Government approves a general government budget by means of its resolution. This assures adherence to both revenue and expenditure frameworks over a medium-term in accordance with the Government-approved draft since implementation of any changes is subject to Government's re-approval.

Another legal regulation is an obligation of proponents submitting acts for discussion by the SR Government or the SR National Council during a budget year to indicate and justify their assumed financial effects on the general government budget. Assumed expenses must be quantified in respect of the current year and the three subsequent budget years and, concurrently, proposals for covering any negative budgetary impacts, as the case may be, must be submitted. Proponents are required to negotiate any financial impacts in advance with the Ministry of Finance. Furthermore, acts with financial consequences for the general government budget where funding can not be provided for during the budget year may come into effect not sooner than 1 January of the next budget year.

General government balance in GDP pursuant to the ESA 95 methodology plays a central role in the entire budgetary process. The Government approves baselines for the next year's general government budget usually by April of the current budget year. These baselines include also determination of the general government balance to GDP ratio. This figure serves as basis for the entire budgetary process, since in the discussion on the draft national budget no proposals generating an increase in the general government balance to GDP ratio, as approved by the Government within the frame of general government budget baselines, are allowed. Likewise, budgets of other general government entities (the Social Insurance Agency, the National Property Fund, etc.) that are discussed and approved separately during a budget year must respect the general government balance to GDP ratio approved by the Government within the frame of baselines.

In the event of a failure to reach political consensus and approve the state budget act before the end of the current budget year, "budget provisory" is implemented. In such case the budget-based financial management is governed by the state budget act for the preceding budget year, provided that state budget expenditure in each month during such budget provisory must not exceed one twelfth of the total budget expenditure of the preceding budget year. This assures that fiscal policy does not become loosened, but rather the contrary.

The general government budget implementation stage is subject to heavy restrictions applying throughout the general government sector. These are aimed at avoidance of new liabilities and an inadequate increase in the existing liabilities in the current budget year as well as subsequent budget years that might adversely impact general government debt. The Act restricts entry by general government entities into contracts non-covered by the budget (especially at the end of a budget year). Furthermore, the Act essentially restricts receipt of loans and provision of sureties across the entire general government sector. A general government entity other than a municipality or a higher territorial unit (self-government) practically must not accept loans or borrowings.

A certain level of flexibility has been introduced within the capital expenditure budgeting, aiming at promotion of efficiency in the use of public resources. The budget chapters may automatically transfer their unused expenditures from a current budget year to the following budget year. The chapters are only bound by an obligation to report their intent to transfer fund to the next year to the Ministry of Finance not later than 20 November of a current year. The purpose is to increase efficiency of investments in the public sector in terms of avoiding any inefficient use of funds by the chapters (especially at the year end) just for the sake of not losing this opportunity. On the other hand, it is apparent that the higher efficiency compromises the extent of Government's and MoF's control over the development of the state budget deficit in a current budget year.

State budget is subject to "expenditure binding" institute. If a budget organisation fails to fulfil its financial revenue plan set out for the current year, a certain amount of its planned expenditure is bound. This means a reduction in funds available for financing its activity which assures maintenance of the planned state budget balance.

Territorial Self-Government Budgetary Rules Act

Principal provisions of general government budgetary rules apply also to self-government entities constituting a part of general government. However, the self-government has a specific position within general government, ensuing from a relatively large extent of autonomy in decision-making. Therefore, a separate regulatory mechanism for municipalities and higher territorial units has been established.

Self-government entities must split their budget into a regular budget and a capital budget, provided that they are required to prepare a balanced or surplus-generating regular budget. It means that the "golden rule" of financial management is applied on the self-government level in Slovakia. As regards the total indebtedness, municipalities and higher territorial units are subject to two explicitly defined rules. The total amount of debt of a self-government entity must not exceed 60% of its actual current revenue of the previous budget year, and the sum of annual debt repayments, inclusive of interest, must not exceed 25% of its actual current revenue of the previous budget year.

Report on Current Macroeconomic Development and Development of Public Finance of SR , and Prediction till Year End

The Ministry of Finance monitors the development of macroeconomic environment and public finance during a current year. For this purpose the Ministry of Finance regularly prepares a quarterly material and submits it for negotiation to the Government and, in the case of a mid-year report, also to the Parliament. This material is aimed at analysing the development and judging whether or not deficit of general government, budgeted as a share in GDP pursuant to the ESA 95 methodology, will be met. The material contains an explicit list of all items on the revenue/expenditure side that worsen/improve general government deficit against the approved budget, or the previous material, update, respectively. It explicitly identifies causes of difference in the development of revenue and expenditure against the budget, whether these are due the development of economic environment or discretionary political decisions. If the risk of exceeding the deficit is identified, the material contains a proposal for measures.

The material comprises two main parts. The first one analyses the current macroeconomic development and, based on it, works out an estimate for the rest of the year. The second part of the material is structured by the various general government constituents and analyses the development of their revenue and expenditure. The main focus is on tax revenue where the direct link to the economic environment concurrently represents the major risk for the fulfilment.

The extent of comprehensiveness of the review of the development of general government as whole is determined by availability of information for each constituent. Reasonably detailed, timely, and reliable data are available on a cash basis for main general government constituents in terms of the fulfilment risk. These include the state budget, the Social Insurance Agency, and the National Property Fund. Other constituents are expected to meet the budget, unless additional information is available.[36]

Certain negative risk is posed by the development in the health service (receivables and payables), information which become available with a bigger time lag; this is, however, reduced by gradual introduction of heavy budget restrictions across the sector. On the contrary, a positive risk lies in that some funds of budget chapters may remain unused, including expenditure on EU project co-funding. This phenomenon explains a relatively large portion of the improved final deficit of general government against the approved budget in years 2003 and 2004. From the medium-term perspective, however, this risk may be turn to a negative direction since co-funding claims do not lapse when unused, but pass to next years when the absorption capacity of subsidy beneficiaries improves.

VII.2 Institutions within Long-term Sustainability of Public Finance

Fiscal rules and discipline oriented towards a medium-term horizon do not provide a sufficient guarantee for sound development of public finance over a long term. There are no EU-level or Slovakia's national-level fiscal rules taking account of long-term risks (the population ageing in particular) so far. Nevertheless, there are institutional aspects that may be important from this perspective. In the case of Slovakia we have identified three such aspects: the area of state guarantees, the use of proceeds from privatisation, and financial management of entities standing off general government but within public finance.

State guarantees

In the past, state guarantees constituted an area where hidden public debt used to accumulate. Without the use of the ESA 95 methodology these were perceived within the general government's budgetary process as a suitable tool for aiding unreformed state-owned businesses, while public finance balance seemed to be optically better than the reality.

Since 2002, the situation has significantly changed. The State Debt and State Guarantees Act was adopted, which presently contains two key provisions in respect of granting new guarantees. The first one is a rule that guarantees may be granted during a current year only up to the balance of guarantees as of the end of the preceding year. This means that the total

[36] One example is drawing a large loan by a municipality in 2005.

amount of guarantees may only decline in the future. The second, stricter provision is quite fresh: it came into effect together with an amendment to the State Debt and State Guarantees Act in September 2005. It provides for inclusion of guarantees into the budgetary process. Any guarantees to be granted must be officially planned and recorded in the national budget approved by the Parliament. It means that any change in the granting of guarantees made in the course of a year is subject to approval of not only the Government bust also the Parliament. In general, it can be stated that this amendment practically terminated the granting of state guarantees in Slovakia.

Current Government's policy in the area of guarantees is even stricter than allowed by the Act. Since 2003, no new state guarantee has been granted in Slovakia, and none is planned within the budget horizon by 2008, which is reflected in a dramatic reduction in the share of guarantees in the total public debt referred to in section III.4.

Financial management of entities standing off general government but within public finance

The national account methodology ESA 95 treats public corporations as entities off the general government sector, but within non-financial and financial businesses. Simultaneously, these entities are owed by the state, and therefore they are components of public finance. This means that though their possible indebtedness is not directly reflected in general government balance during a period, their bad financial management may adversely affect general government balance and debt in the moment when an aid from the state is needed in order to prevent their financial bankruptcy. Moreover, an aid may be needed because the state must not allow total financial collapse of these sectors since it would bring about a huge adverse impact on the entire economy and the social situation of population. Slovakia has a big negative experience with this, when a sum accounting for 12% of GDP was recently needed for revitalisation of the banking sector.

The most frequent cause of bad financial management of state-owned businesses is usually long-term provision of services (costs) not covered by adequate revenue (receipts). This is how state-owned business very inefficiently substitute Government's social policy through providing hidden subsidies to citizens, thus distorting relative prices and resource allocations in economy. Since in addition it is assumed that the state will eventually cover the risk of financial collapse, businesses are not motivated to more efficient financial management.

There are three main entities, or sectors, in Slovakia that accumulated the hidden public debt. These include Slovenské Elektrárne (Electricity Company), Železnice SR (Railway Company) and health service facilities. A great part of Government's reforming efforts after 2002 was focused on this field[37]. Measures seeking financial consolidation and promotion of efficient financial management were concentrated on relieving certain entities (the railway company and health service facilities) from their debts, alignment of prices of services with reality (adjustment of regulated prices and establishment of independent regulatory authorities), and privatisation; the comprehensive health service reform constituted a separate chapter. All these reforms have been successfully implemented, or currently are in their finalisation stage (privatisation of the electricity company and the freight railway transport).

[37] Reforms in these areas were described in detail in the last year's Convergence Programme and the Cardiff Report of 2004.

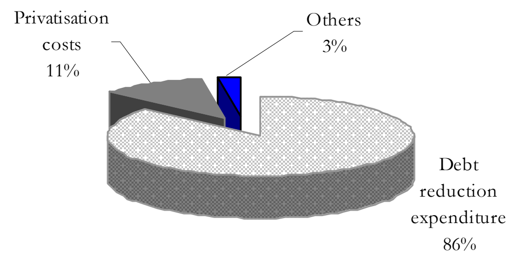
Use of proceeds from privatisation

Proceeds from privatisation are one-off revue; they reduce public finance assets, and therefore should not be used for current consumption or problematic Government's development projects. If general government's financial management results in deficits and accumulation of public debt, the most efficient use of proceeds from privatisation is repayment of old debts. If a country, in addition, faces adverse demographic development, the debt repayment may facilitate absorption of costs related to the population ageing and long-term sustainability of public finance. This practice is in line with recommendations of the Council of Europe.

In years 2003-2004 the Government used proceeds from privatisation primarily for repaying old debts and covering new ones (state debt repayment; releasing state-owned businesses from debts; reserve for the 2nd pillar of the pension scheme; increasing national financial assets). 86% of the total proceeds from privatisation were used for these purposes. The second component of expenditure was necessary costs incurred in the privatisation, accounting for 11%, and only a minor portion (3%) was used for other purposes.

Amount and use of proceeds from privatisation during 2002-2004 (SKK billion)

	2002	2003	2004
Proceeds from privatisation	161.3	11.7	5.4
Debt reduction expenditure	138.9	10.0	5.2
Expenses related to privatisation	17.9	1.7	0.2
Other	4.5	0.0	0.0



Source: Ministry of Finance

The current government is well aware of the importance of responsible use of any proceeds from privatisation also in the future, and therefore endeavours to cover this area within the legislation. Since 1991, the Act on conditions for transfers of state funds to other persons has been in effect.. It incorporates also determination of the use of proceeds from privatisation for specifically identified areas. However, there are a relatively large number of such areas, one of them being development projects. In this year a act concerning the use of receipts from sale of national property has been prepared pursuant to a Government's resolution. The act strictly confines the use of proceeds from privatisation to three areas. The first one is funding of costs related to the pension reform; the second one is reduction of state debt and fulfilment of state guarantees; and the third area is coverage of expenses and liabilities of the National Property Fund managing the privatisation process. Unfortunately, the Parliament failed to approve – with a close voting score (2 votes missing) – this act; however, the Government will further endeavour to push this change forward.

ANNEXES

Annex 1 – Indicative Estimate by 2010

Estimate by 2010	Unit	2004	2005F	2006F	2007F	2008F	2009F	2006F
GDP, constant prices 1995	%	5.5	5.1	5.4	6.1	5.6	5.1	5.0
Final household consumption	%	3.5	5.2	4.5	4.8	4.4	4.2	4.1
Final general government consumption	%	1.1	1.8	4.2	2.9	3.0	2.9	2.8
Gross fixed capital formation	%	2.5	8.5	7.6	7.4	4.0	4.0	5.5
Export of goods and services	%	11.4	7.5	9.6	16.0	10.5	7.6	7.4
Import of goods and services	%	12.7	7.9	9.2	13.1	9.7	6.9	7.1
Average annual inflation rate	%	7.5	2.8	3.3	2.0	2.0	2.4	2.6
Current account balance (BoP)	GDP %	-3.3	-5.2	-4.8	-2.3	-1.6	-0.4	0.3
Average number of employees (as of LFS)	%	0.3	1.8	0.9	0.8	0.8	0.8	0.8
Average unemployment rate (as of LFS)	%	18.1	16.4	15.9	15.7	15.4	14.9	14.4
Average real monthly wage per employee	%	2.5	5.1	3.6	3.7	3.7	3.5	3.5
Average SKK/EUR exchange rate	SKK	40.0	38.5	37.6	36.8	36.4	36.0	36.0
GG revenues (ESA 95)*	GDP %	35.7	37.3	36.9	37.1	36.4	36.4	36.4
GG expenditures (ESA 95)*	GDP %	38.9	41.5	39.8	38.8	37.7	36.7	35.8
GG balance (ESA 95)*	GDP %	-3.2	-4.1	-2.9	-1.6	-1.3	-0.3	0.6

* excluding the impact of the 2nd pillar; GG - general government

Source: Ministry of Finance of the SR

Annex 2 – Macroeconomic Forecasting Committee

Aiming at enhancing the transparency and objectiveness of macroeconomic forecasts, the SR MF again addressed members of the Macroeconomic Forecasting Committee. The Committee carried out updating reviews of forecasts of all member institutions and reviews of MF SR's forecasts in October 2005. The MF SR's medium-term forecast was perceived by a majority of Committee members as realistic:

Evaluation of MF SR's forecast in Macroeconomic Forecasting Committee

MF Committee member	Characteristic of Forecast
NBS	realistic
VÚB	realistic
Infostat	realistic
ING Bank	realistic
Tatrabanka	realistic
SLSP	moderately conservative
SAV	realistic 49%, conservative 27%, optimistic 24%

Source: Macroeconomic Forecasting Committee

Average forecasts of selected indicators of SR economy prepared by members of Macroeconomic Forecasting Committee (without MF SR) and forecasts of MF SR

No.	Indicator	Unit	Current year 2005 Com-mitee	Current year 2005 MF SR	Forecast 2006 Com-mitee	Forecast 2006 MF SR	Forecast 2007 Com-mitee	Forecast 2007 MF SR	Forecast 2008 Com-mitee	Forecast 2008 MF SR
1	GDP; in current prices	SKK billion	1 434.2	1 432.4	1 554.4	1 552.9	1 688.2	1 674.4	1 816.0	1 788.5
2	GDP; real growth	%	5.2	5.1	5.6	5.4	6.3	6.1	5.3	5.6
3	Final consumption of households; real growth	%	5.4	5.2	5.1	4.5	5.2	4.8	4.8	4.4
4	Final consumption of households; nominal growth	%	8.3	8.3	8.0	7.8	7.6	6.8	7.1	6.5
5	Average monthly wage in the economy of SR; nominal growth	%	8.2	8.0	7.0	7.0	6.5	5.8	6.0	5.8
6	Average monthly wage in the economy of SR; real growth	%	5.4	5.1	4.0	3.6	4.3	3.7	3.7	3.7
7	Average growth of employment, as of LFS	%	1.8	1.8	1.0	0.9	0.9	0.8	0.8	0.8
8	Average growth of number of registered employees	%	1.8	1.9	1.1	0.9	1.0	0.8	0.8	0.8
9	Average unemployment rate, as of LFS	%	16.5	16.4	15.7	15.9	15.1	15.7	14.7	15.4
10	Consumer price index (average growth)	%	2.9	2.8	3.1	3.3	2.2	2.0	2.2	2.0
11	Producer price index (average growth)	%	3.7	4.4	2.8	3.3	2.3	1.5	2.1	1.5
12	Current account balance (% of GDP)	%	-5.2	-5.2	-4.4	-4.8	-2.6	-2.3	-1.9	-1.6
13	Final consumption of general government (real growth)	%	2.4	1.8	3.6	4.2	2.7	2.9	2.7	3.0
14	Gross fixed capital formation (real growth)	%	8.8	8.5	9.3	7.6	6.5	7.4	6.0	4.0
15	Exports of goods and services (real growth)	%	7.0	7.5	9.2	9.6	13.5	16.0	9.1	10.5
16	Imports of goods and services (real growth)	%	7.6	7.9	9.1	9.2	11.6	13.1	8.7	9.7

Source: *Macroeconomic Forecasting Committee*

Annex 3 – TAX REVENUE FORECAST COMMITTEE

One year after the establishment of the Macroeconomic Forecasting Committee, also the Tax Revenue Forecasts Committee was founded. This step significantly contributed to enhancement of transparency in the compilation of general government revenue. During a Committee session in October 2005, Committee members expressed their opinions in respect of the medium-term tax revenue development forecast, and evaluated it as realistic.

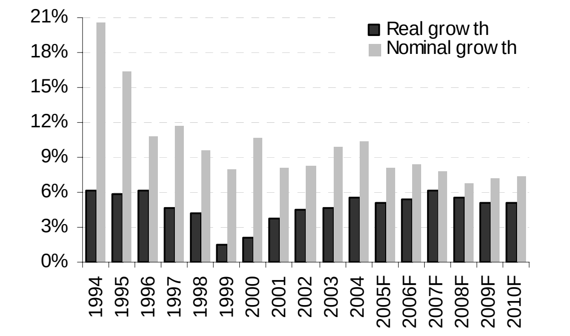
Evaluation of MoF's Forecast in Tax Revenue Forecasts Committee

TRF Committee member	Characteristic of Forecast
NBS	realistic
Infostat	realistic
ING Bank	realistic
Tatra banka	realistic
SLSP	realistic

Source: Tax Revenue Forecasts Committee

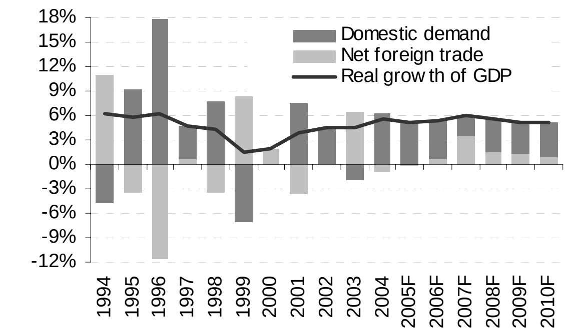
Annex 4 - Graphs

Growth of gross domestic product in %



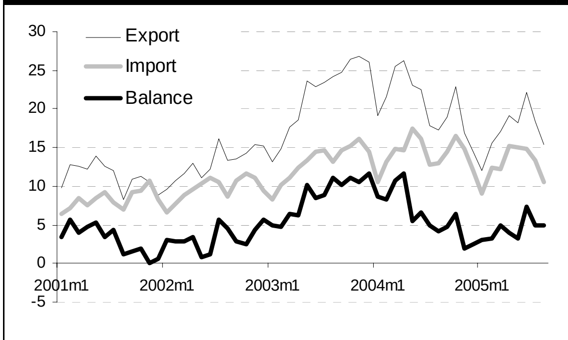
Source: Statistical Office of the SR, Ministry of Finance of the SR

Contributions to growth of GDP in pp



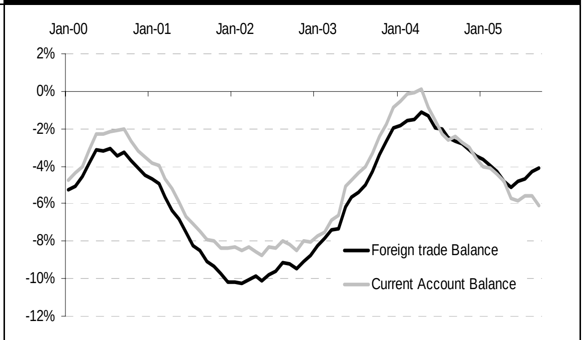
Source: Statistical Office of the SR, Ministry of Finance of the SR

Export, Import and Trade Balance of motor vehicles, their parts and accessories (bil. SKK)



Source: -Statistical Office of the SR, Ministry of Finance of the SR

Foreign trade balance and balance of current account (% of GDP) – 12 months cumulative



Source: -Statistical Office of the SR, Ministry of Finance of the SR

Economic activity according to LFS

Source: Statistical Office of the SR, Ministry of Finance of the SR

Real wage and labour productivity

Source: Statistical Office of the SR, Ministry of Finance of the SR

Annex 5 – Required Tables

Table 1a: Macroeconomic Summary

	ESA code	2004 Actual	2004 growth rate	2005 growth rate	2006 growth rate	2007 growth rate	2008 growth rate	2009 growth rate	2010 growth rate
1. Real GDP	B1*g	826.5	5.5	5.1	5.4	6.1	5.6	5.1	5.0
2. Nominal GDP	B1*g	1,325.5	10.3	8.1	8.4	7.8	6.8	7.2	7.3
Components of GDP									
3. Final household consumption	P.3	416.4	3.5	5.2	4.5	4.8	4.4	4.2	4.1
4. Final general government consumption	P.3	158.8	1.1	1.8	4.2	2.9	3.0	2.9	2.8
5. Gross fixed capital formation	P.51	202.8	2.5	8.5	7.6	7.4	4.0	4.0	5.5
6. Change in inventories and net acquisition of valuables (of GDP)	P.52 + P.53	18.6	2.2	3.5	3.0	0.8	1.1	1.3	1.5
7. Export of goods and services	P.6	806.3	11.4	7.5	9.6	16.0	10.5	7.6	7.4
8. Import of goods and services	P.7	792.0	12.7	7.9	9.2	13.1	9.7	6.9	7.1
Contributions to real growth of GDP									
9. Domestic demand total		-	2.7	5.1	5.0	4.9	3.8	3.7	3.9
10. Change in inventories and net acquisition of valuables	P.52 + P.53	-	3.6	0.3	-0.2	-2.2	0.4	0.2	0.3
11. External balance of goods and services	B.11	-	-0.8	-0.2	0.6	3.3	1.4	1.2	0.8

Source: Statistical Office of the SR, Ministry of Finance of the SR

Table 1b: Price development (ESA95)

	ESA code	2004 Actual	2004 growth rate	2005 growth rate	2006 growth rate	2007 growth rate	2008 growth rate	2009 growth rate	2010 growth rate
1. GDP deflator		1.604	4.6	2.8	2.8	1.6	1.2	2.0	2.2
2. Private consumption deflator		1.771	7.0	3.0	3.2	1.9	2.0	2.2	2.3
3. HICP[1]		-	7.5	2.9	3.6	2.0	2.0	2.4	2.6
4. Public consumption deflator		1.623	6.4	4.1	3.3	1.7	1.8	2.2	2.3
5. Investment deflator		1.614	3.5	3.0	2.9	1.4	1.6	1.8	1.9
6. Goods and service export deflator		1.263	-2.1	0.4	0.5	-0.2	0.1	0.9	1.0
7. Goods and service import deflator		1.330	-1.7	1.5	0.3	-0.7	0.2	0.3	0.9

Source: Ministry of Finance of the SR

Table 1c: Labour market indicators (ESA95)

	ESA code	2004 Actual	2004 growth rate	2005 growth rate	2006 growth rate	2007 growth rate	2008 growth rate	2009 growth rate	2010 growth rate
1. Number of employed		2 056	-0.3	1.5	0.8	0.7	0.8	0.8	0,8
2. Number of hours worked (thousand hour)		3 566 895	1.9	1.6	-0.9	2.5	1.4	1.4	1,8
3. Unemployment rate (%)		18,0	0.6	-1.8	-0.5	-0.2	-0.3	-0.5	-0,5
4. Productivity of labour per person		-	5.9	3.5	4.6	5.3	4.7	4.2	4,2
5. Productivity of labour per hour worked		-	3.5	3.4	6.4	3.5	4.1	3.6	3,2
6. Employee compensations (SKK million)	D.1	532 111	7.7	8.2	6.0	6.5	6.7	6.9	7,0

Source: Statistical Office of the SR, Ministry of Finance of the SR

Table 1d: Sector balance (ESA95, % of GDP)

	ESA code	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
1. Net loans granted / received from rest of world	B.9	-3.0	-4.8	-4.4	-1.9	-1.3	-0.1	0.6
out of that::								
- Goods and services		-2.7	-3.8	-3.5	-1.0	-0.5	0.5	0.8
- Primary receipts and transfers		-0.7	-1.4	-1.4	-1.3	-1.1	-0.9	-0.6
- Capital account		0.3	0.4	0.5	0.4	0.3	0.3	0.3
2. Net loans granted / received	B.9/EDP B.9	-3.2	-5.3	-4.9	-2.3	-1.6	-0.7	-0.5
3. Net loans received / granted – general government	B.9	0.2	0.5	0.6	0.5	0.3	0.7	1.1
4. Statistical difference		0.1	0.0	0.0	0.0	0.0	0.0	0.0

Source: Statistical Office of the SR, Ministry of Finance of the SR

Table 2: Development of general government budget [38]

	ESA code	Year 2004 SKK mil.	Year 2004 GDP %	Year 2005 GDP %	Year 2006 GDP %	Year 2007 GDP %	Year 2008 GDP %
Net lending (EDP B.9) by sub-sector							
1. General government [1]	S.13	-41,776	-3.2	-4.1	-2.9	-1.6	-1.3
2. Central government	S.1311	-47,477	-3.6	-4.0	-4.3	-3.1	-2.8
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	3,185	0.2	-0.1	0.1	0.1	0.1
5. Social Insurance Agency	S.1314	2,516	0.2	0.0	1.3	1.5	1.5
General government (S13)							
6. Total revenue	TR	495,893	37.4	37.8	37.6	37.9	37.2
7. Total expenditure	TE[1]	537,669	40.6	41.9	40.5	39.5	38.5
8. Net lending/borrowing	EDP B.9	-41,776	-3.2	-4.1	-2.9	-1.6	-1.3
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	29,607	2.2	1.8	1.9	1.9	1.9
pm: 9a FISIM		-	-	-	-	-	-
10. Primary balance [2]		-12,169	-0.9	-2.3	-1.0	0.3	0.7
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		249,529	18.8	18.6	18.3	18.3	18.2
11a. Taxes on production and imports	D.2	168,110	12.7	12.8	12.6	12.4	12.2
11b. Current taxes on income, wealth, etc.	D.5	81,296	6.1	5.8	5.8	5.9	6.0
11c. Capital taxes	D.91	123	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	164,550	12.4	11.9	12.0	11.9	11.7
13. Property income	D.4	21,485	1.6	1.7	1.4	1.3	1.1
14. Other (14=15-(11+12+13))		60,329	4.6	5.5	5.8	6.5	6.2
15=6. Total revenue	TR	495,893	37.4	37.8	37.6	37.9	37.2
p.m. Tax burden (D.2+D.5+D.61+D.91-D.995)[3]		405,409	30.6	29.9	29.8	29.5	29.3
Selected components of expenditure							
16. Collective consumption	P.32	184,951	14.0	13.5	13.7	13.1	12.8
17. Total social transfers	D.62 + D.63	222,583	16.8	17.0	16.8	16.4	16.1
17a. Social transfers in kind	P.31 + D.63	84,072	6.3	6.4	6.3	6.3	6.2
17b. Social transfers other than in kind	D.62	138,511	10.4	10.6	10.4	10.1	9.8
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	29,607	2.2	1.8	1.9	1.9	1.9
19. Subsidies	D.3	29,313	2.2	2.4	2.4	2.3	2.3
20. Gross fixed capital formation	P.51	33,332	2.5	2.5	1.9	1.5	1.3
21. Other (21=22-(16+17+18+19+20))		37,883	2.9	4.6	3.9	4.2	4.1
22=7. Total expenditure	TE	537,669	40.6	41.9	40.5	39.5	38.5
Pm: compensation of employees [4]	D.1	118,506	8.9	7.4	7.6	7.3	7.2

[1] Excl. impact of the 2nd pillar *Source: Ministry of Finance*

[2] Primary balance is calculated as (EDP B.9, item 8) + (EDP D.41 + FISIM , item 9)

[3] Inclusive of those collected by the EU and adjustments for unrecoverable taxes and social security contributions (D.995)

[4] Since 2005 the impact of updates of the statistical register of entities included in the general government sector (re-classification relating primarily to health service facilities)

[38] Total shares of revenue and expenditure in GDP are not consistent with the table in section V.3 due to differing methodologies of consolidation between MoF and Statistical Office of the Slovak Republic (in the tax area in particular).

Table 3: General government expenditure by function-based classification (% of GDP)

	COFOG code	Year 2003	Year 2008
1. General public services	1	5.2	
2. Defence	2	1.8	
3. Public order and safety	3	2.0	
4. Economic affairs	4	5.1	
5. Environmental protection	5	0.7	
6. Housing and community amenities	6	1.1	
7. Health	7	2.3	
8. Recreation, culture and religion	8	1.0	
9. Education	9	4.3	
10. Social protection	10	15.7	
11. Expenditure total [1]	**TE**	**39.2**	

[1] Due to the data updating in period T+12, revised set of data for 2003 and actual data for 2004 are not available.

Source: Ministry of Finance

Table 4: General government debt developments (% of GDP)

	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
1. Gross debt	42.6	33.7	35.5	35.2	36.2
2. Change in gross debt ratio	-0.6	-8.9	1.9	-0.3	1.0
Contributions to changes in gross debt					
3. Primary balance	0.9	2.3	1.0	1.1	0.8
4. Interest expenditure	2.2	1.8	1.9	1.9	1.9
5. Stock-flow adjustment	0.3	-9.9	1.2	-0.8	0.7
of which:					
- Differences between cash and accruals	-	-	-	-	-
- Net accumulation of financial assets	-0.4	0.0	-2.0	0.0	0.0
of which:					
- *privatisation proceeds*	-0.4	0.0	-2.0	0.0	0.0
- Valuation effects and others*	0.7	-9.9	3.2	-0.8	0.7
p.m. implicit interest rate on debt	5.7	4.6	6.2	5.8	5.9
Other relevant variables					
6. Liquid financial assets	11.7	2.1	3.0	1.5	1.6
7. Net financial debt (7=1-6)	30.9	31.5	32.6	33.7	34.7

**Out of the various stock-flow adjustment factors, only privatisation proceeds have been explicitly indicated. Other factors have been aggregated in "Valuation effects and others", inclusive of differences between the cash and the accrual methodologies.*

Source: Ministry of Finance

Table 5: Cyclical development (% of GDP)

	ESA code	Year 2004	Year 2005F	Year 2006F	Year 2007F	Year 2008F
1. GDP growth (%)		5.5	5.1	5.4	6.1	5.6
2. Net borrowing (-)/lending (+)*	EDP B.9	-3.2	-3.3	-2.9	-1.6	-1.2
3. Interest payments	EDP D.41+FISIM	-2.2	-1.8	-1.9	-1.9	-1.9
4. Growth of potential GDP (%) (1)		5.4	5.1	5.0	6.2	5.8
Contributory components:		0.0	0.0	0.0	0.0	0.0
- labour		0.5	0.5	0.5	0.5	0.5
- capital		0.7	0.9	1.2	1.3	1.5
- total productivity factor		4.2	3.7	3.3	4.4	3.8
5. Output gap		-0.1	-0.1	0.3	0.2	0.0
6. Cyclical component		0.0	0.0	0.1	0.0	0.0
7. Cyclically adjusted balance (2-6)		-3.1	-3.3	-2.9	-1.6	-1.3
8. Cyclically adjusted primary balance (7-3)		-0.9	-1.5	-1.0	0.3	0.7

**in 2005 excl. debt remission towards foreign countries* *Source: Ministry of Finance*

Table 6: Comparison between the previous forecast and the update

	ESA code	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
Real GDP growth (%)						
Previous update		5.0	4.5	5.1	5.4	
Current update		5.5	5.1	5.4	6.1	5.6
Difference		0.5	0.6	0.3	0.7	
General government balance (% of GDP)	EDP B.9					
Previous update		-3.8	-3.4	-2.9	-1.9	
Current update*		-3.2	-3.3	-2.9	-1.6	-1.3
Difference		0.6	0.1	0.0	0.3	
General government gross debt (% of GDP)						
Previous update		43.0	44.2	45.3	45.5	
Current update		42.6	33.7	35.5	35.2	36.2
Difference		-0.4	-10.5	-9.8	-10.3	

**in 2005 excl. the one-off effect of debt remission towards foreign countries* *Source: Ministry of Finance*

Table 7: Long-term sustainability of public finance – AWG scenario (% of GDP)

	2004	2005	2010	2020	2030	2050
Total expenditure	**38.9**	**41.5**	**37.0**	**36.5**	**37.8**	**44.3**
Of which: age-related expenditures	16.5	16.6	15.4	15.2	16.2	18.4
A. Pension expenditure*	7.2	7.2	6.7	7.0	7.7	9.0
1. Social security pension	7.2	7.2	6.7	7.0	7.7	9.0
a) Old-age and early pensions	5.4	5.4	4.8	4.6	5.0	6.3
b) Other pensions (disability, survivors)	1.8	1.8	1.9	2.3	2.7	2.7
2. Occupational pensions (if in general government)	-	-	-	-	-	-
B. Health care	4.7	4.8	4.7	5.1	5.5	6.1
C. Long-term care	-	-	-	-	-	-
D. Education expenditure	3.7	3.9	3.3	2.6	2.6	2.7
E. Other age-related expenditures	0.9	0.8	0.7	0.5	0.4	0.6
Interest expenditure	2.2	1.8	1.8	1.5	1.8	6.1
Total revenue	35.7	37.3	36.4	36.4	36.4	36.4
of which: property income (D.4)	1.6	1.7	1.3	1.3	1.3	1.3
of which: from pensions	12.8	12.3	11.2	11.0	10.9	10.8
Pension reserve fund assets	0.0	0.8	7.0	18.9	31.5	58.0
of which: consolidated public pension fund assets	0.0	0.0	0.0	0.0	0.0	0.0
Assumptions						
Labour productivity growth**	5.2	3.1	4.2	3.3	2.7	1.7
Real GDP growth	5.5	5.1	5.3	3.3	2.0	0.3
Participation rate of males (aged 15 - 64)	77.3	77.6	79.6	82.1	82.3	78.7
Participation rate of females (aged 15 - 64)	64.1	64.7	67.1	73.5	73.8	69.1
Total participation rate (aged 15 - 64)	70.7	71.1	73.3	77.8	78.0	73.9
Unemployment rate	18.1	16.4	15.2	9.7	7.0	7.0
Population aged 65+ over total population	11.5	11.6	12.3	16.3	20.8	29.3

** excl. expenditure on pensions of armed forces of the SR*

Source: Ministry of Finance

Table 8: Basic assumptions

	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
Short-term interest rate in Eurozone (annual average)	2.1	2.1	2.4	2.9	3.6	4.0	4.2
Long-term interest rate in Eurozone (annual average)	4.1	3.3	3.4	3.8	4.8	5.3	5.5
USD/EUR exchange rate (annual average) (Eurozone and ERM II countries)	1.2	1.3	1.2	1.2	1.2	1.2	1.2
World excluding EU, GDP growth	5.9	5.2	5.0	4.7	4.5	4.5	4.5
EU GDP growth	2.4	1.5	2.1	2.4	2.3	2.1	2.1
Growth of relevant foreign markets	2.4	2.1	2.6	3.1	2.8	2.6	2.6
World import volumes, excluding EU	14.0	8.8	8.8	8.4	8.2	8.1	8.1
Oil prices, (Brent, USD/barrel)	37.8	57.3	65.0	62.5	60.0	60.0	60.0

Source: Ministry of Finance