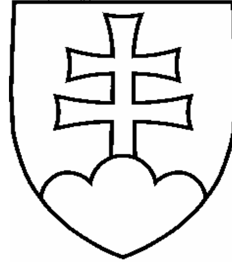

Ministry of Finance of the Slovak Republic

CONVERGENCE PROGRAMME OF THE SLOVAK REPUBLIC FOR 2007 - 2010

2007 Update

November 2007

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Policy Statement of the Slovak Government

The economic policy of the current Slovak government continues to follow the main lines of the process of Slovakia's integration into the Economic and Monetary Union; at the same time, the government is putting a greater emphasis in its agenda on striking a proper balance between individual responsibility and solidarity of the society as a whole. The government implements its economic policy in the spirit of its Manifesto, under which the economic system should be fine-tuned in order to make it more solidaristic and socially just without, however, impeding sound economic growth.

The main fiscal objective of the government is to reduce the general government deficit, including the cost of the pension system reform, below 3% of GDP in 2007 and thus meet the criterion for accession to the Eurozone. The second main objective is to reduce the cyclically-adjusted general government deficit, net of the one-off measures, to 0.8% of GDP by 2010. On meeting this medium-term objective and taking additional measures at appropriate points in time, mainly in the pension system, the sustainability of public finance will be ensured for the first time in Slovakia's history. The government therefore does not consider the fiscal deficit reduction important only in terms of meeting the convergence criteria and the rules of the revised Stability and Growth Pact, but primarily in terms of ensuring macroeconomic stability and long-term sustainability of public finance.

Being aware of the significance and, perhaps, exceptional nature of the current favourable economic development in Slovakia, coupled with the relatively good external economic conditions, the government remains committed to using these favourable conditions to the benefit of the continued consolidation of public finance in line with the objectives presented herein. The objectives presented in this programme are, at the same time, the objectives for the 2008-2010 general government budget.

The government will have to take fundamental measures in the pension system in order to secure the long-term sustainability of public finance. Any responsible government would have to open a public discussion and prepare corrective measures no later than now, which is exactly what the government is currently doing. The government strives to stabilise the system in two stages. The first stage comprises measures focusing on the medium-term system stabilisation – these measures will apply from 2008. The second stage will focus on the long-term financial and, equally importantly, also social sustainability of the system. The discussion on these aspects will unfold in the course of 2008 and will also include the measures to be taken to make the necessary parametric modifications in the pay-as-you-go pillar of the pension system. However, in its quest for solutions the government will not contemplate reductions in the rate of contributions to the fully-funded pillar of the pension system.

The Slovak economy as a whole is currently growing at a fast pace. The government, however, needs to make sure that the economic growth and its benefits to the living standard are spread more evenly across all regions of the country. It is impossible to make the development of certain backward regions more dynamic, mainly in the east of Slovakia, without putting in place a well-developed infrastructure, particularly the highway network. For this reason, the government intends to step up the pace of highway construction. The government is committed to ensuring that highway network development remains fully in line with the consolidation objectives presented in this programme. For this purpose, the government intends to utilise, to the maximum extent possible, EU funds, as well as public-private partnership (PPP) projects. The government shall enter only into PPPs that warrant better efficiency in meeting its objectives compared to the level of efficiency attainable purely on the basis of public funding, projects that will not sway the general government balance in both medium- and long-run through the accruement of implicit liabilities on the government's part. The government intends to make the best possible use of the PPP experience available in other countries and solicit advice from internationally renowned and experienced institutions.

The government is aware that the successful completion of the consolidation process will make the profile of another challenge in the fiscal policy area – the quality of public finance – more prominent than ever before. In this connection, the efficiency and effectiveness of public spending, as well as a more radical reallocation of funds in furtherance of the Lisbon Strategy objectives, will be a dominant theme for the years to come. In the case of Slovakia, this means more investment in the development of human resources and the knowledge-based society, entailing education and training, life-long learning, active labour-market policies, science, research and innovation.

The government realizes the importance of structural policies to the sound economic development, particularly after accession to the Eurozone when the room for the ability of macroeconomic policies to react to economic imbalances will narrow. The government does not intend to significantly alter those structural policy aspects that improve the quality of the business environment and the pro-growth potential of the economy. However, in line with its Manifesto, the government is implementing and will continue to implement such policies that increase the level of solidarity and social inclusion across the country so that the effects of dynamic economic growth shall be to the benefit of larger groups of population than has been the case so far.

The government is aware of the fact that Slovakia's integration in the Eurozone will be accompanied with additional inflationary pressures which represent a challenge for a prudent fiscal policy and structural policies aiming towards higher flexibility of the economy. On that account, the government is preparing a package of stabilisation measures. The key objectives in this area are already presented in this programme; the government intends to further develop these objectives in an extensive package of stabilisation measures.

INTRODUCTION

This Update of the Convergence Programme of the Slovak Republic until 2010 is consistent with the objectives and measures specified in the first Convergence Programme of May 2004 and its subsequent updates. As regards the fiscal policy area, the main fiscal objectives presented in the historically first convergence programme remain unchanged; more importantly, the objectives for fiscal consolidation by 2010 set out in this Convergence Programme are even more ambitious than those contained in the previous programmes. The higher degree of ambition in the medium-term objective for 2010 represents a reaction of the government to the recommendations issued by the European Council in February 2007 and also a tool reflecting commitments in the process of the SKK/EUR central rate revaluation within the ERM II system from March 2007. The government does not consider the fiscal deficit reduction important only in terms of meeting the convergence criteria and the rules of the revised Stability and Growth Pact, but primarily in terms of ensuring macroeconomic stability and long-term sustainability of public finance.

This updated Convergence Programme sets out two main objectives for the fiscal and monetary policy.

The main fiscal objective is to reduce the general government deficit, including the cost of the pension system reform, below 3% of GDP in 2007 and thus meet the criterion for accession to the Eurozone. The second main objective is to reduce the cyclically-adjusted general government deficit, adjusted for one-off measures, to 0.8% of GDP by 2010. This parameter falls within the range suggested by the European Commission to Slovakia for setting the medium-term objective under the revised Stability and Growth Pact. Provided that the necessary measures are adopted at appropriate points in time, the analyses of the Ministry of Finance show that all conditions will be in place to attain long-term sustainability of public finance.

The key objective of the monetary policy is to fulfil the inflation targets under the ERM II with the intention of entry to the Eurozone. It requires, first and foremost, that the rate of inflation be brought to the necessary level on a sustainable basis and the exchange-rate stability maintained in accordance with the convergence criteria. Slovakia is currently one of the countries which are members of the Economic and Monetary Union subject to a temporary derogation for the use of the euro, with full-fledged membership expected from 2009 onward. The Slovak *koruna* is a part of the ERM II as of 28 November 2005.

The Convergence Programme of the Slovak Republic is based on the *2008-2010 General Government Budget* which the Cabinet approved on 11 October 2007. The budget has subsequently been submitted to the Slovak parliament for approval, with the vote in plenary slated for the first week of December. One of the important aspects in the process of the budget approval is that the parliament may not open discussion on the underlying fiscal objectives, namely on the general government deficits proposed under the ESA 95 methodology until 2010. Thus any initiative by members of the parliament or government that could lead to an increase in deficit would have to be offset by a reduction in another expenditure chapter or by a corresponding increase in taxation. The Cabinet approved the binding deficit levels on 9 May 2007 within the *2008-2010 General Government Budget Framework*. From that point on, the budget discussion focuses solely on the spending priorities.

In institutional terms, the Convergence Programme of the Slovak Republic is a binding document approved by the Cabinet and submitted for a debate to the Parliament. The programme is due for submission to the European Commission by 1 December 2007. In terms its format and content, the document is structured fully in line with the guidelines issued by the Commission. These guidelines are based on the "*Specifications on the Implementation of the Stability and Growth Pact*" and "*Guidelines on the format and content of Stability and Convergence Programmes*" adopted in 2005 with a view to improving the implementation of the Stability and Growth Pact, which constitutes a basis for the macroeconomic framework of the Economic and Monetary Union. The Convergence Programme of Slovakia also reflects the discussions and recommendations of the Economic and Financial Committee (ECOFIN) of the Council of Ministers.

I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The objectives of the economic policy pursued by the Government of the Slovak Republic have remained unchanged compared to the previous convergence programmes. The priority is still to maintain high economic growth, sustainable in the long run, which is a prerequisite for enhancing the standard of living and catching up with the advanced EU Member States. Economic objectives can be achieved through the right choice, coordination and consistent implementation of macroeconomic and structural policies. Macroeconomic policies ensure the stability of the economic environment, whereas structural policies help strengthen economic potential and, ultimately, improve people's living standard.

I.1. Fiscal policy

Slovakia is well on the way to meet its medium-term consolidation objectives. The current convergence programme update indicates that the first objective – i.e. to reduce the general government deficit below 3% of GDP – will be met in 2007. Reduction of the general government deficit, including the pension reform costs, to a level below 3% of GDP complies with the Maastricht criterion for the general government deficit, which is one of the fundamental requirements for the adoption of the single European currency. While the fulfilment of the nominal convergence criteria is one of the government's priorities, the positive effect of consolidation on macroeconomic stability is more important in terms of economic policy.

The need for fiscal consolidation will not disappear in the near future, but will take on a new dimension. Anticipated adverse demographic developments oblige responsible governments to plan their fiscal policies well ahead. A positive development in public finance today does not necessarily imply positive developments in 30-50 years' time when the costs of the ageing population will peak. The Slovak government is well-aware of these potential costs, and therefore the long-term sustainability of public finance has been the key objective of its fiscal policy since the very first convergence programme. Transposing this long-term objective into a concrete medium-term interim objective means that the cyclically adjusted general government deficit, adjusted for one-off measures, should be reduced below 1% of GDP by 2010. The general government budget for the years 2008-2010, already approved by the government, projects a cyclically adjusted deficit of 0.8% of GDP in 2010.

This objective falls within the 0.5-1.0% GDP range set as a medium-term objective for Slovakia under the revised Stability and Growth Pact[1]. Even though the medium-term objective under the Stability and Growth Pact results from a transitive methodology[2] which only takes into account the expected growth of the potential output and the initial level of the general government debt, the analyses carried out by the Slovak Ministry of Finance suggest that a cyclically adjusted deficit in 2010 of 0.8% of GDP is sufficient even in terms of ensuring long-term sustainability of public finance, provided that necessary measures are adopted at the appropriate time. Such measures include, in particular, parametric changes in the pension system and certain policy adjustments designed to ensure that the future public expenditures increase in proportion to economic growth.

Compared to the previous update to the Convergence Programme the medium-term objective has been revised from 0.9% to 0.8% of GDP. The more ambitious medium-term objective for 2010 is the government's answer to the European Council recommendation of February 2007 and reflects the government's commitments under the revaluation of the SKK/EUR central rate in the ERM II system of March 2007. Slovakia thus demonstrates its effort to fulfil the commitments under the revised Stability and Growth Pact.

The consolidation of public finance is a key medium-term objective of the government. Successful consolidation is essential for automatic stabilisers to function effectively in the future. At the moment, the government's

[1] „The definition of country-specific medium-term objectives in the revised Stability and Growth Pact", EFC, 14 September 2005

[2] In 2007 the EFC Committee continued to discuss a methodology which should make it possible in the future to set country-specific medium-term fiscal objectives in such a way as to better reflect aspects of the sustainability of public finance.

stabilisation priority is to ensure that the consolidation objectives do not pose a threat to sound economic growth and that they underpin the effective implementation of monetary policy.

The consolidation objectives are important in terms of financial stability and, at the same time, these objectives are not in contradiction with the process of catching up with the advanced Member States. Continued success in the attainment of medium-term objectives allows a greater attention to be paid to the quality of public finance. Increasing the efficiency and effectiveness of public spending priorities and their orientation towards supporting potential growth will therefore become a policy priority in the upcoming period.

An important aspect in the quality of public finance is the appropriate linkage between fiscal objectives and the goals of the Lisbon Strategy. From the budgetary perspective it is essential for the structural policies and reforms to respect the government's fiscal objectives, which determine the financial framework for such policies. Transposed into the government's policy objectives and commitments, this entails coordination and linking of the Convergence Programme with the implementation report of the National Reform Programme. This Convergence Programme addresses the issue in a separate chapter in the section on the quality of public finance.

Fiscal policy will therefore aim at ensuring long-term sustainability, macroeconomic stability, support for economic growth and effective allocation of public funds.

I.2. Monetary and exchange rate policy

The key objective of the monetary policy is to fulfil the inflation targets under the ERM II with the intention of entry to the Eurozone. It requires, above all, that inflation be reduced to the necessary level in a sustainable manner and that exchange rate stability is maintained in compliance with the convergence criteria. Slovakia is one of the member countries of the Economic and Monetary Union that have been granted a derogation for the use of the single European currency; full membership in the Eurozone is expected in 2009.

Slovakia's exchange rate policy is currently implemented under the ERM II system, in line with the anticipated adoption of the euro on 1 January 2009. When Slovakia joined ERM II, the central rate was set at 38.455 SKK/EUR. The country's economy have since undergone significant structural changes. Sound macroeconomic policies and a significant inflow of foreign direct investments have gradually accelerated economic growth. The growth of the labour productivity differential vis-à-vis the Eurozone has led to a significant appreciation of the equilibrium real exchange rate. Against the backdrop of a relatively low inflation, this has also been reflected in the nominal exchange rate. As a result, the central rate no longer corresponded to the actual state of the country's economy. Upon Slovakia's request, the members of the ERM II Committee therefore agreed to revalue the central rate of the Slovak koruna, with effect from 19 March 2007. The new central rate was set at 35.4424 SKK/EUR. The lower limit for obligatory interventions was reduced to 30.1260 SKK/EUR and the upper limit to 40.7588 SKK/EUR.

I.3. Structural policies

Macroeconomic policies ensure the stability of the economic environment, while structural policies help strengthen economic potential and, ultimately, improve people's living standard. Structural policies are relevant in terms of healthy economic development. This will hold particularly true after Slovakia's entry to the Eurozone, when there will be less room for macroeconomic policies to respond to economic swings.

The Slovak Republic respects the conclusions adopted at the Spring European Council in March 2007. The Council appreciated the progress achieved, especially with regard to improvements in the business environment and the development of information society, on the other hand, it identified the most pressing challenges lying ahead, mainly in the field of microeconomic policies and employment.

Once the consolidation process is successfully completed, the quality of public finance will become an increasingly pressing challenge for fiscal policy. In this context, the efficiency and effectiveness of expenditure policies and a more radical reallocation of funds to promote the goals of the Lisbon Strategy will dominate the economic debate in the years to come. As far as Slovakia is concerned, this particularly means investments in human capital and the development of a knowledge society, which encompasses aspects of the education system, life-long learning, active labour market policies and issues of science, research and innovation.

I.4. Meeting the commitments of Slovakia's ERM II membership

When joining the ERM II system on 28 November 2005, Slovakia made commitments which, once fulfilled, should create appropriate conditions for the adoption of the single European currency as of 1 January 2009, as planned.

Implementation of economic policies aimed at preserving macroeconomic stability and the sustainable convergence of the Slovak economy is essential for the fulfilment of these commitments. The key commitments are, in particular, to create conditions for wage growth corresponding to growth of labour productivity, budgetary discipline in order to fulfil the medium-term consolidation strategy, and structural reforms and a cautious approach to the risks related to credit growth.

On 19 March 2007, the central rate of the Slovak koruna against the euro was revalued. This step confirmed the previously mentioned commitments, mainly highlighting the issues of price stability, competitiveness and improvements in the resistance of the Slovak economy to external shocks. At the same time, it underlined the necessity to intensify consolidation efforts, in compliance with the conclusions drawn by the European Council when assessing the previous update to the Convergence Programme of the Slovak Republic on 27 February 2007[3]. These commitments were also incorporated into Slovakia's economic policy measures.

Wage growth connected to labour productivity

Labour productivity in Slovakia has long been growing at a higher pace than wages. This trend is expected to continue in the next few years; in 2007, real wages are expected to grow by 4.5%, while real labour productivity is expected to increase by 6.6%. However, in the long-term, this differential is expected to gradually lessen, and both productivity and wages should grow at roughly the same pace. This development will be a natural consequence of structural changes in the economy. The Ministry of Finance expects gradual economy convergence, both real and nominal, without any serious risks for macroeconomic stability.

BOX 1 –What is the specificity of wage development in Slovakia?

From the outset of its transformation process the Slovak economy has been characterised by an unusually low inflation rate and by moderate wage growth when compared to other countries in a similar situation. According to the Ministry of Finance, the Slovak economy is distinguished, in addition to responsible macroeconomic policies, by three structural advantages which may also serve as examples of good practice for other countries facing problems with price stability and excessive wage growth.

The first advantage is a long-term culture of price stability and prudent wage growth. Throughout the history of price development in Slovakia there have been only a few periods when inflation was in two digits. These episodes, without exception, were either caused by price liberalisation aimed at eliminating the remnants of the centrally planned economy, or by price deregulation undertaken in order to gradually remove socially motivated instruments designed to mitigate the effects of economic transformation on vulnerable population groups. While a massive price liberalisation occurred at the very beginning of the transformation process, the deregulation of some prices was carried out at a rather more moderate pace but definitely finished in 2004-

[3] When assessing the previous update to the Convergence Programme of the Slovak Republic, the European Council invited Slovakia to increase its efforts for consolidation of public finance in the context of the country's high economic growth, in order to meet the medium-term budgetary objective; and to make the medium-term expenditure ceilings more binding at the central government level.

2005. From 2006 onwards, development in regulated prices of energy fully reflects only the situation on global commodity markets or gradual changes in relative prices.

The second advantage of the Slovak economy is a long-term extremely responsible approach to wage negotiations by all social partners. Wage development in the public sector plays an especially positive role in this, as it not only considerably facilitates the consolidation of public finance but sends a signal of prudence to the private sector as well. Nevertheless, Slovakia has objectively been successful in increasing the quality of the public sector, as evidenced by structural reforms and the gradual improvement of public services despite massive fiscal consolidation and even a sharper decrease in public expenditure as a percentage of GDP. (In 2006, among the 27 EU countries, Slovakia had the second lowest share of taxes and social contributions as a proportion of GDP - 29.5%[4]; only Romania was lower. Between 1995 and 2006, Slovakia managed to reduce this indicator by 10.3% of GDP, which is definitely the largest reduction among all EU Member States.) The quality of human capital in public institutions has been improved by means of intensive personnel policy measures; higher wages in reformed sectors are offset by reductions in the levels of staffing.

The last structural feature is the extreme openness of the economy, as Slovakia is one of the countries with the highest ratio of imports and exports compared to GDP (the figure for 2006 was 186.5%). Even in the 1990's, when there were several periods of less responsible fiscal policy, the macroeconomic imbalance had a tendency to show through a deficit in the trade balance, and consequent pressure on the exchange rate, rather than through pressure on the price level. Although transmission channels of economic shocks are very likely to change over time, the extreme openness of the Slovak economy will always be a factor significantly reducing price turbulences.

Acceleration of consolidation

Fiscal objectives set in the form of a general government balance stem from the approved 2008-2010 General Government Budget. When compared to the previous budget for the years 2007 to 2009, the objectives for the period 2008 to 2009 are more stringent, by 0.1% of GDP. The target deficit for 2010 was set at 0.8% of GDP, which is an improvement by 0.1% of GDP compared to the goal presented in the previous update to the Convergence Programme. At the first sight, the speeding up of consolidation does not look too ambitious against the backdrop of the significant economic growth. It should be noted, however, that tax revenues in Slovakia have for a long period been growing at a considerably slower pace than the country's economy. This is caused by the structure of economic growth, which is driven mainly by investments and export on the expenditure side and by an operating surplus on the income side of GDP. At the same time, the 2010 target is set within the range recommended by the European Commission as a medium-term budgetary objective for Slovakia.

Structural reforms

Changes in this area are based on the National Lisbon Strategy[5] approved by the government in 2005. Particular reform measures are described in the National Reform Programme for 2006 to 2008 and in subsequent implementation progress reports. The measures concentrate on two basic areas: employment and education policy and microeconomic policies including, for example, the informatisation of society, innovation policy and improvements in the business environment. The implementation of structural policies is also fully compatible with the medium-term fiscal framework.

A prudent approach to risks related to lending increase

A relatively low baseline position compared to other EU Member States was the key driving force behind the surge of lending in Slovakia. However, since approximately the second half of 2006 the pace of increase in the volume loans has slackened. This development is a natural phenomenon, and one of the accompanying effects of the convergence of the Slovak economy with the advanced EU economies.

[4] Eurostat, debt and deficit notification, April 2007
[5] "Competitiveness Strategy of Slovakia until 2010: the National Lisbon Strategy", 2005

As regards the preservation of financial stability, the National Bank of Slovakia (NBS) is the key institution responsible for overseeing financial market entities. In the light of NBS-conducted analyses we may say that development in this area does not endanger the financial, nor the macroeconomic stability. The NBS regularly publishes a Financial Stability Report and carries out stress tests.

I.5. Price stability package after the entry to the Eurozone

The Eurozone entry is not just another step in Slovakia's integration into the European economic and monetary area. It will also change the importance and effectiveness of the various economic policies. The loss of sovereign monetary policy must no doubt be replaced with a more active fiscal policy, and by structural policies aimed at increasing the flexibility of the economy. Slovakia is fully aware that inappropriately configured economic policies along with low real interest rates may give rise to additional inflation pressures. Bearing that in mind, the Slovak government intends to adopt the following measures:

Short-term measures to prevent the misuse of the euro adoption for unjustified price increases:

- engagement of non-governmental organisations and civic associations in the monitoring of price development after the introduction of the single European currency, possible use of so-called "black lists";
- adoption of a Code of Conduct by significant sections of the business sector;
- more frequent publication of price changes in December 2008 and January 2009 for selected items of the consumer basket;
- displaying dual prices.

Medium term measures to ensure price stability:

- the signing of an agreement between employer associations and trade unions concerning wage bargaining; wages should grow in line with labour productivity in the first years after the adoption of the euro; labour productivity growth and growth of average wage in economy should also be the main indicator used for the indexation of minimum wages, which has a considerable influence on the lower end of wage distribution;
- wage growth in the public sector should be kept strictly in compliance with labour productivity growth, since wages in the public sector have a signalling effect for the private sector;
- the government will carry on with its open labour market philosophy that can eliminate tensions mainly in the segment of low-skilled labour;
- the government intends to considerably support, within the limits of public finances, housing development and access to housing in order to increase labour force mobility in the medium term;
- the government will continue with coherent implementation into the national budget process of the main instruments under the revised Stability and Growth Pact. The Convergence, or the Stability Programme will always be kept fully consistent with the approved three-year general government budget, and budget targets will always respect the EU fiscal rules, especially during consolidation efforts in "good times," and where medium-term objectives are concerned;
- the government will consider increasing the flexibility of the budgetary process so that it is possible to modify budget target in the course of the year in emergency situations such as, for example, when a sharp increase in demand-pull inflation occurs;
- the strengthening of the competitive environment by means of more stringent sanctions for the misuse of dominant market position and more effective regulatory rules for natural monopolies;
- consistent monitoring of financial stability risks by the National Bank of Slovakia with special attention to preventing the relaxation of credit standards and the credit risk.

II. ECONOMIC OUTLOOK AND PROJECTIONS

The analyses and forecasts of the Slovak economy further prove that the economy is still following the path of high, yet sustainable growth. Employment is growing at a robust pace, particularly in the private sector, and the unemployment rate is falling significantly. Wages are growing in line with labour productivity, inflation is low and sustainable, and the current account deficit of the balance of payments is expected to gradually decrease due to an increasingly larger deployment of export capacities. The Ministry of Finance has based its projections on the assumptions of an external economic environment development corresponding to the European Commission "Common external assumptions" of 1 October 2007[6].

II.1. External environment

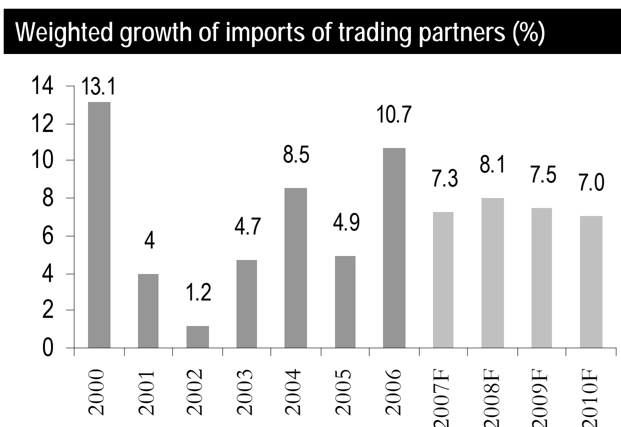
The global economy is expected to slow down a bit in 2007, particularly due to uncertain prospects for the US economy. Nevertheless, the global economy should sustain its growth trend, growing by 4.9% (compared to 5.5% in 2006). The highest growth rates and contributions to global economic performance are still to be found in China and India. In the United States, which was most affected by a mortgage crisis, real growth should fall from 3.3% in 2006 to 2.0% in 2007, and 1.7% in 2008. Decline in US economy performance should have a lesser impact on the global economy than in recent years, due to the dynamism of China and India. Rapidly developing countries are playing an ever more important role in global trading. In the first half of 2007, consumption growth in India and China accounted for a larger share of global GDP growth than the growth in US consumption. China's GDP this year is expected to overtake that of Germany, making China the third largest economy in the world.

Basic indicators of external environment (%)

	2007	2008	2009
Economic growth			
EU	2.8	2.4	2.4
USA	2.0	1.7	3.0
Japan	1.9	1.9	2.2
Long-term interest rates			
Euro area	4.2	4.2	4.3
USA	4.7	4.5	4.7
Exchange rate (USD/Euro)	1.35	1.39	1.39
Oil Price (Brent, USD/barel)	69.5	74.9	72.7

Source: Common external assumptions

Weighted growth of imports of trading partners (%)



Source: OECD, Ministry of Finance

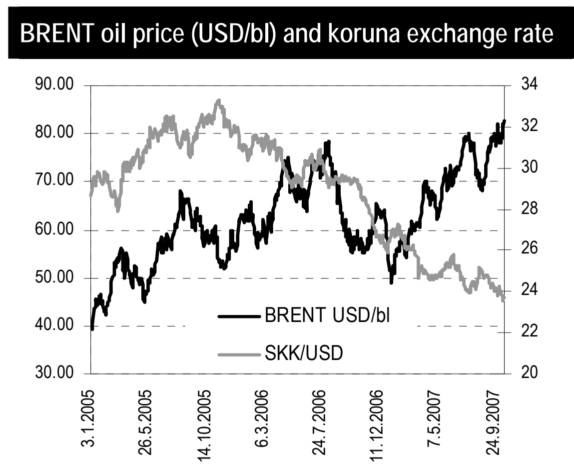
In 2006, the European economy rose by 3.0% in real terms; with economic growth of 2.7% in the Eurozone. The EU economy is expected to grow by 2.8% in 2007, or 2.6% in the Eurozone. This projection is based on a background of global economic growth as well as favourable domestic conditions influenced mainly by accelerating domestic demand. Germany remains the key driving force behind this development, and is expected to show a 2.2% increase in real GDP in 2007. This growth, driven by domestic demand, has its counter-pole on the supply side, especially as the productivity grows and labour market becomes more and more flexible thanks to recent reforms. Higher short-term interest rates, more stringent fiscal policies (especially in Germany and Italy), combined with the anticipated decline in US foreign trade, will tend to dampen economic growth throughout the Eurozone.

[6] These were the latest available assumptions at the time of preparation of this Convergence Programme.

The openness of the Slovak economy determines the degree of its dependence on global economic developments. The global economic pick-up of 2006 had a positive impact on Slovakia's major trading partners. However, this rapid acceleration is likely to be followed by a slow-down in 2007 on the part of our major trading partners. The export-weighted real GDP growth of Slovakia's major trading partners should contract from 3.7% in 2006 to 3.4% in 2007.[7]

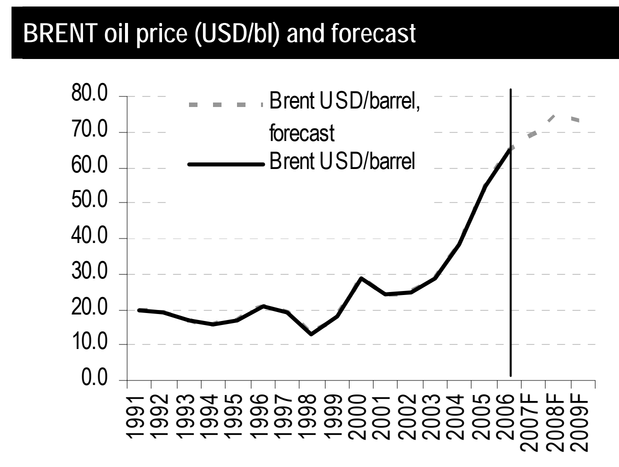
The development of oil prices and the impact of the credit crisis caused by the US mortgage market slump still represent risks for the global economy. As regards the US mortgage crisis, the main concern remains as to whether the difficulties on financial markets will have a distinctly negative impact on the development of the real economy. The 2007 oil prices were affected by growing consumption on emerging Asian markets and uncertain political developments in the Middle East. The price of Brent crude oil has been growing since the beginning of the year, reaching 89.4 USD per barrel at the end of October 2007. The average price for 2007 is expected to be 69.5 USD per barrel. Despite the likely slow-down in US consumer expenditure, the global demand for energy is expected to continue also through 2008, with the average oil price likely to approach 75 USD per barrel. The impact of rising oil prices on the Slovak economy and price levels is, to a large degree, limited by the relatively significant appreciation of the Slovak koruna against the US dollar.

BRENT oil price (USD/bl) and koruna exchange rate



Source: REUTERS

BRENT oil price (USD/bl) and forecast



Source: Common external assumption, REUTERS

History shows that crucial to the global economic development is whether the growth in oil prices comes as a consequence of developments of the demand or the supply side. Over the past three years, higher oil prices have mainly been driven by higher demand. The surging consumption of oil products by industrialised countries and fast growing economies, such as China and India, have kept oil prices at high levels. In other words, higher prices are the result of high global economic growth. Albeit the global growth is expected to slow by 0.6 percentage points compared to the previous year, the growth rates will remain fairly high. Rapidly developing economies do not just play an increasingly important role in terms of global trading; they also have a growing effect on prices of commodities and labour. China's labour productivity continues to grow faster than the wages of Chinese workers. This may partly explain why high oil prices did not result in as large an increase in global inflation as had been the case in the past. Low labour costs in countries like China function as a counter-balance.

The US Federal Reserve (the 'Fed') cut its key interest rate by 0.5 percentage points to 4.75% in September 2007.Through cuts in the interest rates the Fed is attempting to counteract the emerging decline in consumer expenditures and higher unemployment. Since the end of 2005 the European Central Bank (ECB) has been increasing its key refinancing interest rate in order to avoid potential inflationary pressures which could occur mainly as a consequence of wage growth. Although the ECB had been expected to increase its interest rate before the end of 2007, data on a weaker demand for loans in 3Q07 increased concern about the impact of the

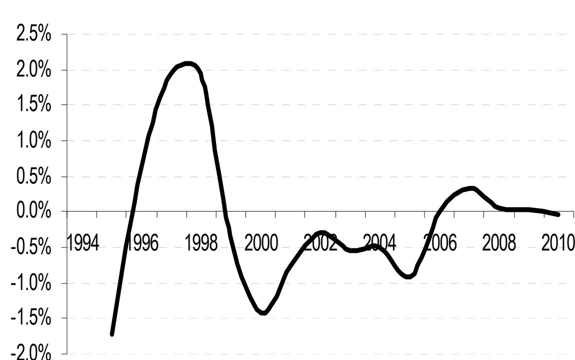
[7] The exports to major trade partners as a percentage of Slovakia's total exports were used as weights (which in total accounted for nearly 80% of overall turnover: Germany, Czech Republic, Italy, Austria, Poland, Hungary, France, the Netherlands, USA, Great Britain and Spain). For the years 2007-2010, the 2006 weights were used.

credit crisis on the Eurozone economy. Despite this heightened uncertainty, ECB President Jean-Claude Trichet did not rule out an increase in interest rates if necessary to curb inflation.

II.2. Cyclical development and current prospects

Economic predictions prepared by the Ministry of Finance, as well as forecasts by other Slovak institutions, such as the National Bank of Slovakia (NBS) and the commercial banks still suggest that, unlike in recent years, the Slovak economy is likely to perform slightly above its potential output in 2007 and 2008. The Ministry of Finance estimates this year's output gap at 0.3% of Slovakia's potential output. The country's potential should increase by 8.5%, i.e. 0.3 percentage points less than the real economic growth predicted for 2007. The strong growth of both the potential and actual GDP should be backed mainly by the positive development of total factor productivity (TFP) and by growth in capital stocks.

Output gap development (% of potential GDP)

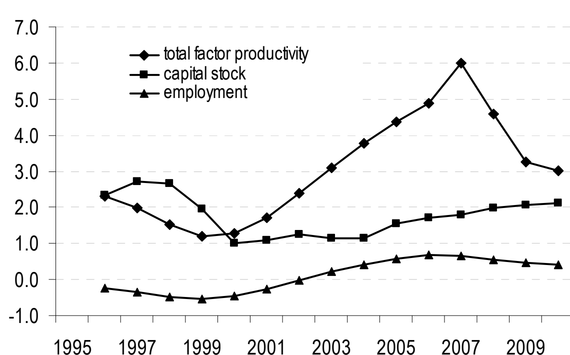


	GDP (real growth, %)	Potential GDP (growth, %)	Output Gap (% pot. GDP)
2002	4.1	3.6	-0.3
2003	4.2	4.4	-0.6
2004	5.4	5.4	-0.5
2005	6.0	6.5	-0.9
2006	8.3	7.3	0.0
2007F	8.8	8.5	0.3
2008F	6.8	7.1	0.1
2009F	5.8	5.8	0.0
2010F	5.0	5.1	0.0

Source: Ministry of Finance

The constantly accelerating growth of Slovakia's potential is expected to peak in 2007 in line with the growth-curve of total factor productivity, while the impact of capital stocks will gradually increase. The largest TFP contribution to the potential output in many years is expected to come in 2007, and to be as high as 6.0 percentage points. In the coming years an inflow of foreign direct investment and resources from EU funds should have a positive effect on growth in TFP and employment equilibrium, while economic potential should further benefit from structural reforms carried out, in particular in the labour market. The output gap is expected to close at the end of the projected period.

Contributions of the main factors to the potential GDP growth (p.p.)



	Pot. GDP (growth, %)	TFP*	Capital stock	Equilibrium employment
2002	3.6	2.4	1.3	0.0
2003	4.4	3.1	1.1	0.2
2004	5.4	3.8	1.2	0.4
2005	6.5	4.4	1.5	0.6
2006	7.3	4.9	1.7	0.7
2007F	8.5	6.0	1.8	0.7
2008F	7.1	4.6	2.0	0.6
2009F	5.8	3.3	2.1	0.5
2010F	5.1	2.6	2.1	0.4

* total factor productivity

Source: Ministry of Finance

Output gap estimates by the Ministry of Finance (and other domestic and foreign institutions) have differed, for quite some time, from those prepared by the European Commission. The Ministry of Finance respects the EC estimates, which are the result of a commonly agreed methodology and, at the same time, accepts the way in which they are applied in order to assess the government's consolidation effort. The Ministry of Finance agrees that if any common methodology is to be used in a transparent and fair way, it must be to a large degree uniform for all countries. Nevertheless, the Ministry of Finance is of the opinion that the currently applied methodology is unfit in terms of assessment of cyclical development in fast-growing economies, especially among new Member States, including Slovakia. The reason is that this methodology is basically unable to encompass significant structural turning points in the economy which lead to high productivity growth without putting macroeconomic stability at risk. The consequence is that output gaps estimated using the current EC methodology contradict other economic stability indicators, such as measures of inflation and the current account deficit.

The box below outlines the differences between the Ministry's and Commission's approach to output gap estimation.

BOX 2 – Methodology differences in output gap estimation between the Ministry of Finance and the European Commission

Both the European Commission and the Slovak Ministry of Finance use the production function method for the estimation of potential output. However a difference occurs in estimating the parameters serving as inputs for the production function, in particular in the estimation of the size of equilibrium employment, capital stock, total factor productivity and factor shares. When estimating potential output (an immeasurable quantity) the Commission, unlike the Slovak Ministry of Finance, does not take into account the development of actual (measurable) indicators which are commonly used to assess the cyclical development of economy.

Factor shares

The Commission uses uniform values for factor shares for all 10 "new" Member States: 0.65 for the labour share and 0.35 for the capital share. The Ministry of Finance estimates the labour share in Slovakia as a ratio between total labour costs and added value, based on officially reported and valid national accounts for the Slovak Republic, at a level of 0.52. The capital share estimate has then a residual value: 0.48. The Slovak Ministry of Finance believes that country-specific estimates based on the data pertaining to each economy represent a more reasonable approach than that available through the practice of absolute unification, used until now.

Capital stock

The Commission applies the "perpetual inventory" approach, where a baseline estimate is made of the capital/GDP ratio. For the baseline year 1995 capital stock was estimated as double the real GDP for all new Member States except for the Czech Republic, for which the figure was set at three times real GDP. In addition, the Commission includes under the capital item values reported both for the private and public sector. A uniform projection of 5% per year is also used for the depreciation rate. In contrast, the Slovak Ministry of Finance includes only the private sector under the capital item. The baseline capital stock estimate is based on Slovakia's official data from the end of 1998. Also, the Ministry sets a specific depreciation rate for Slovakia, calculated using national accounts. In this case too, the Ministry of Finance deems the use of country-specific data a more accurate method for the calculation of potential output.

Equilibrium employment

Both the Commission and the Slovak Ministry of Finance use national accounts as a source of labour force data. The Commission estimates the potential labour force indirectly: based on the size of the population fit for work, the participation rate, NAIRU and the trend of average hours worked. The Ministry of Finance applies a direct approach – HP-filtered employment that provides stable, reliable and transparent outputs. In contrast to the several immeasurable quantities required in the indirect approach, the direct approach requires only one, which decreases the degree of uncertainty. In future, the Ministry of Finance plans to adopt the uniform Commission procedure for the measurement of labour force using the number of hours worked instead of the currently used number of employed persons, but preserving the direct approach in determining the equilibrium employment.

Total factor productivity (TFP)

The Commission and the Ministry of Finance estimate TFP as an HP-filtered residual after deducting the labour and capital shares from real GDP. This simple statistical technique however cannot identify qualitative shifts in the economy (both past and future) which enhance the growth of potential. A GDP deviation from the trend component would therefore be explained as a signal that the economy is overheating even though indicators like inflation or the current account do not indicate overheating. The Ministry of Finance therefore makes adjustments to the TFP trend based on analytical estimates of the effects of imported know-how related to the large amount of FDI in Slovakia. These analytical estimates are based on a time series of labour productivity growth. According to the Ministry of Finance, the sharp growth of factor productivity in Slovakia driven by a massive FDI inflow cannot be fully grasped using purely statistical approaches applied to historical time series, therefore the use of analytical estimates and their additional correction is justified in this case.

Taking into account the development of other ´hard´ indicators

The estimation of potential output and output gap is a critical point in the process of assessment of the appropriateness of fiscal policy. However, the potential output and the input parameters of the production function are immeasurable quantities, estimations of the course of economic cycles change retroactively with every update to the forecast and, moreover, there are often diametrical differences between estimates prepared by different experts. In the light of the above it is clear that estimations of potential output and output gap may only be considered acceptable if they do not contradict the development (both actual and expected) of common macroeconomic stability indicators, in particular inflation, current account and employment.

II.3. Medium-term outlook

Economic growth has achieved record-breaking parameters[8] this year, not only from the perspective of Slovak history, but also with regard to the development across the entire European Union, since this uniquely high growth rate is coupled with a high degree of macroeconomic stability. The Ministry of Finance is rather conservative in its medium-term forecasting, therefore it is predicting a robust, yet moderately declining rate of economic growth in the coming years. The following section describes in detail the current development and medium-term estimate of inflation.

II.3.1. Developments in 2007

Following robust growth in the last two quarters of 2006 (9.6% and 9.0% respectively), GDP growth was again strong in 1H07 at 9.2%. These figures indicate that the acceleration of the Slovak economic growth is continuing, and is beginning to reflect the benefits of fiscal consolidation. Real economic development is dynamic, yet sustainable, without signs of overheating. Strong and healthy economic growth represents a sound basis for the further consolidation of public finance.

A look at the structure of demand shows that the economy is driven equally by domestic and foreign demand. Final household consumption grew at a faster pace in 1H07 than the year before. Consumption was backed by growth in real wages and employment, driven not only by the creation of new jobs in the domestic economy but also by a higher number of people working abroad. In addition, household consumption is positively affected by the increasing volume of loans. On the other hand, a very positive development of the labour market is creating room for increasing the degree of household savings. Gross fixed capital formation (growing at 6.9%) still shows good prospects for further economic growth. Though the dynamic of capital formation has declined moderately in the last quarter, it is nearly double the rate reported for the same period of the previous year.

[8] Data on the past and current development of Slovakia's economy as well as estimates by the Ministry of Finance are consistent with the data from before the revision of annual national accounts published by the Slovak Statistical Office on 24 October 2007. The key fiscal indicators, such as deficit to GDP and debt to GDP ratios, already use the revised GDP data, but planned general government deficits for 2008-2010 are throughout the entire document consistent with the Finance Ministry forecasts based on non-revised time series.

The strong economic growth helps to sustain positive trends on the labour market, which have been apparent since 2004. Investments create new jobs, increasing the number of employed people and reducing the *still relatively high* yet declining number of the unemployed. In 1H07 the number of employees rose by 2.5%, calculated according to the Labour Force Survey methodology[9] (LFS), while employment, calculated according to ESA 95, increased by 2.1%. Overall employment growth was driven mainly by the private sector, the number of entrepreneurs without employees (self-employed) increased, while the number of public sector employees continued to decline. The increasing number of jobs caused a massive decline in the number of the unemployed (down by 21.1%), bringing the unemployment rate down by 2.9 percentage points to 11.3%, one of the lowest values ever. Real wage growth (at 4.2%) was more than adequately covered by the labour productivity growth of 7.0%.

On the other hand, a positive development has also occurred in net foreign demand. This very good result is based on rapid growth of exports (20.9%) accompanied by a lower import dynamic (15.8%) tempered, among other things, by lower imports of goods to build up inventories. The growth in exports is linked to the launch of production in new car plants and positive development of production in the electrical and electronics industries. A considerable year-on-year improvement in the balance of goods in the first 6 months of 2007 has been reflected in the current account, with its deficit of SKK 40.4 billion shrinking by more than SKK 20 billion compared to a year earlier.

In March and April 2007 the NBS cut the key interest rate, both times by 0.25 percentage points, to the current value of 4.25%. The ECB rates are also expected to increase to 4.25%, which will bring the basic rates of the NBS and ECB on par. Long-term interest rates are currently hovering around values which reflect the commitment to adopt the euro by 1 January 2009 as scheduled. Changes in the Eurozone long-term interests rates will be crucial for the future development of Slovak rates; no considerable swings are expected to occur in the remaining months of 2007. The average interest rate on government bonds with a 10-year maturity should remain around 4.7%.

II.3.2. Forecast of economic development

The Ministry of Finance is rather conservative in its medium-term forecast therefore it expects robust, yet moderately declining rates of economic growth in the upcoming years.

Forecast of the selected economic indicators (June 2007)

No.	Indicator	unit.	Actual 2006	Forecast 2007	2008	2009	2010
1	GDP; current prices	SKK bn.	1636.3	1822.5	1988.5	2142.2	2289.7
2	GDP; constant prices	%	8.3	8.8	6.8	5.8	5.0
3	Final consumption of households	%	6.1	6.7	6.0	4.7	4.1
4	Final consumption of government	%	4.1	2.0	3.0	2.8	2.8
5	Gross fixed capital formation	%	7.3	8.8	8.0	6.0	5.5
6	Export of goods and services	%	20.7	21.1	12.8	8.9	6.8
7	Import of goods and services	%	17.8	17.2	11.5	8.1	6.1
8	Growth of average monthly wages (real)	%	3.3	4.5	4.5	4.0	4.0
9	Average employment growth (ESA95)	%	2.3	2.1	1.6	1.0	0.8
10	Average unemployment rate (LFS)	%	13.3	10.9	10.0	9.6	9.2
11	Harmonised index of consumer prices (HICP) growth	%	4.3	1.7	2.3	2.6	2.7
12	Current account balance (share of HDP)	%	-8.3	-4.0	-2.6	-1.9	-1.4

Source: Ministry of Finance

[9] Methodology of the Labour Force Survey is fully harmonized with the respective directives of the European Communities (EC).

Economic growth

The rate of economic growth is expected to peak in 2007 at the level of 8.8% and should be evenly driven by the combination of domestic and foreign demand. Foreign trade should account for a 3.4% increase in GDP growth. Household consumption will grow at a rate of 6.7% in 2007. The rate of growth of private consumption is expected to slow down in the upcoming years partly as a result of a baseline effect and partly due to gradual stabilisation of demand by baby-boomers. Real wage should grow at a rate of 4.5% in 2007, slowing down to 4.0% by 2010. The rate of real wage growth should remain below the rate of real labour productivity throughout the entire period, i.e. it should not create inflation risks. Driven by wage growth backed by increasing employment, private consumption is expected to grow by annual rates of 4.1-6.0% during the projected period.

In compliance with the objectives of consolidation of public finance, government consumption remains the slowest growing component of GDP, and is expected to stay below the 3% level in the coming years. The rate of growth in investment is likely to climax in 2007, with the rate of gross fixed capital formation approaching 9%; annual rates of investment growth are then expected to decelerate moderately until 2010.

Foreign demand for goods and services will be, to a large extent, driven by the investment inflow to Slovakia, increase in existing export capacities and the economic development of Slovakia's trading partners. Current estimates of growth in exports (21.1%) and imports (17.2%) for 2007 mirror the high dynamics in foreign trade. The contribution of net export to GDP growth should remain positive until 2010.

Labour market

Strong economic growth in 2007 will boost employment by a robust 2.1% (according to the ESA 95 methodology). The number of public sector employees continues to decline on a year-on-year basis, but this development is offset by the growing number of employees in the private sector. In the period from 2008 to 2010, the rate of growth in employment is expected to ease gradually, in a band between 0.8% and 1.5%. This is a conservative estimate, which takes into account the gradual moderation in investment activities as well as the ongoing, though gradually less intensive, movement of Slovak workers to foreign countries. If the government's plans concerning improvements in the business environment and the construction of the motorway network are successfully implemented, and provided that the active labour market policy is well set so as to make effective use of EU funds, the rate of growth in employment may be kept within an annual range of 1% to 2% even after 2008. The future employment growth rate will, of course, depend primarily on the economy's ability to create new jobs.

New job creation and employment growth are having a positive effect on the unemployment rate, which is expected to drop to 10.9% (according to the LFS) in 2007. The size of the population of productive age should not shrink during the forecast period; the participation rate is unlikely to decrease further and should approach 70%. According to the national methodology, based on the number of registered unemployed who are available for the market, unemployment is expected to fall to 7.5% by 2010 while according to the LFS the unemployment rate is expected to decline to 9,2% in the same period.

Developments so far suggest that the average nominal monthly wage might increase by 7.0% in 2007. With the growth in consumer prices anticipated at 2.4%, real wages would increase by 4.5%. With relatively low inflation in the upcoming years and a prudent mechanism of wage bargaining, nominal wages are expected to grow at an annual rate of 6.6% until the end of the forecast period. Real wage development should reflect growth in labour productivity throughout the entire forecast period and should not increase the risk of demand-pull inflation.

External balance

The updated macroeconomic forecast confirms the original projected improvement in the current account of the balance of payments. As expected, the 1H07 deficit on the current account of the balance of payments fell by SKK 21.50 billion, compared to a year earlier. This was mainly caused by a better-than-expected balance of trade, which showed even surplus in January, and, to a lesser degree, also by the income balance. On the other hand, further reduction of the current account deficit was hindered by poorer year-on-year development in the

income balance and a lower surplus in the balance of services. The deficit on the current account of the balance of payments is expected to fall to 4% of GDP in 2007 (from 8.3% in 2006) and continue to decrease to a level close to 1% of GDP by 2010.

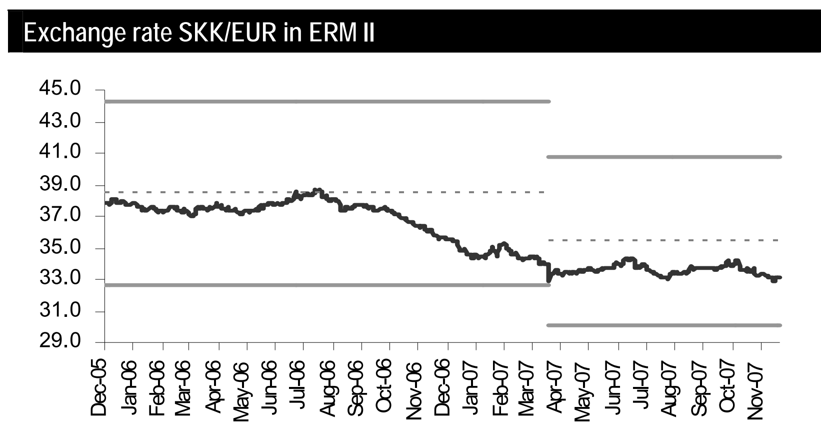
The high growth of the Slovak economy accompanied by a favourable development of external balance is predominantly driven by foreign investments. Even though the net inflow of foreign direct investments (equity capital and reinvested earnings) to Slovakia fell by SKK 36 billion in 1H07 compared to the same period of the previous year, this was due to significant privatisation revenues earned in 1H06. A stable inflow of "greenfield" FDI is expected in the next few years, mainly in connection with the car industry, and the entry of foreign investors to other sectors, such as the electrical and electronics, metal, wood-processing and paper industries.

The balance of trade deficit is expected to fall to 0.4% of GDP by 2008, and a surplus of 0.4% of GDP is projected for 2010. This anticipated positive development should reflect higher exports not only by the automotive industry but by the electrical and electronics and metallurgical industries as well. Total NBS foreign exchange reserves amounted to USD 17.8 billion at the end of August, which is 3.5-times the average value of monthly import of goods and services during the first seven months of 2007.

Exchange rate

Since Slovakia joined the ERM II mechanism in November 2005, and following the March 2007 revaluation of the central rate, the exchange rate of the Slovak koruna has mostly evolved within the appreciation half of the fluctuation band. Since April 2007, the development of the exchange rate has stabilized.

Exchange rate SKK/EUR in ERM II



Source: National Bank of Slovakia

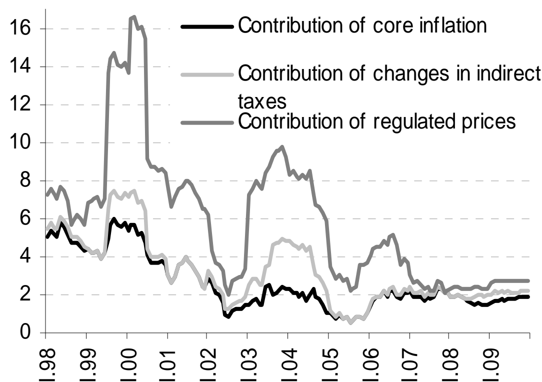
Further development on the foreign exchange market will be influenced by all aspects of the outlook of the Slovak economy, in particular its preparedness to adopt the euro in 2009. At this moment, financial markets largely expect Slovakia to join the Eurozone on 1 January 2009. The factors which will influence the koruna's exchange rate include: developments on the neighbouring foreign exchange markets, response of financial markets to the mortgage crisis, inflow of foreign direct investments, and the evolution of the interest rate differential between Slovakia and the Eurozone.

II.3.3. Inflation

Inflation[10] in Slovakia has eased in 2007 compared to the previous year. One of the consequences of the positive price development is that Slovakia began fulfilling the nominal Maastricht inflation criterion in August 2007 and has remained complying since.

[10] Estimates of all indicators in the present Convergence Programme of the Slovak Republic are identical with the data in the general government budget for 2008-2010, approved by the government on 11 October 2007. The only exception is the inflation estimate which

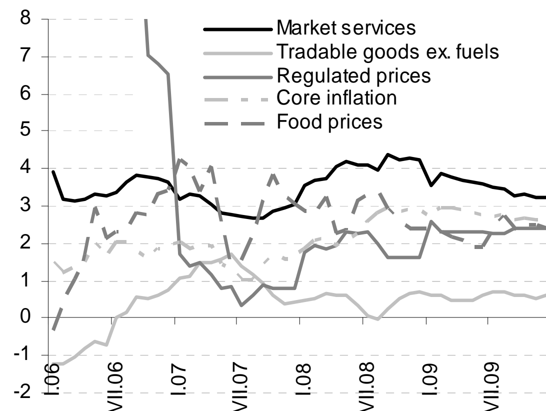
Contributions to the year-on-year inflation in the national methodology - CPI (p.p.)



Note: Contributions are shown cumulatively; the upper curve represents the year-on-year inflation rate measured as CPI

Source: Statistical Office, Ministry of Finance

HICP development from the point of view of CPI structure (%)



Note: year-on-year % changes of items of HICP classified according to the CPI structure

Source: Ministry of Finance

Inflation has been falling in 2007 mainly due to non-inflationary economic growth, credibility of monetary policy and anchoring inflation expectations at a low level. Declining inflation is also attributed to a lower growth in regulated prices which, in the previous year, responded to rising oil prices. Another reason for lower inflation is the appreciation of the koruna. On the other hand, market services show the highest rate of inflation, which undoubtedly confirms the presence of the Balassa-Samuelson effect. Since September it has been increasingly apparent that food prices represent a negative risk factor for inflation. Their adverse development is probably caused, above all, by this year's poorer harvests at the global level.

Anatomy of inflation in 2007-2009

The positive impact on inflation of the appreciation of the Slovak koruna is being felt gradually. The Ministry of Finance estimates the medium-term impact of the koruna's exchange rate on inflation at 0.1 (elasticity). In other words, a 1% appreciation of the koruna reduces the inflation rate by 0.1 percentage point. The stronger exchange rate was to a large degree already reflected in the prices of imported products but its effects still linger and, will have a positive impact on inflation in 2007 and 2008. On the other hand, it should be noted that the influence of the koruna's appreciation has significantly lessened in the course of 2007, as evident from the development in prices of tradable goods and import prices. In spite of a rather considerable appreciation of the koruna, the aforementioned indicators have not showed a more significant downturn. This may be caused by a general downward price rigidity and retail market saturation. The market is saturated, with margins and market shares stabilised, which means there is no impetus for further price wars. Also, it cannot be ruled out that importers and retailers believe that the considerable appreciation of the Slovak koruna was only a one-off business and that its exchange rate will remain stable until the time of the euro adoption. The exchange rate has been very stable over the past seven months, hovering, save for a few minor exceptions, within the 33-34 SKK/EUR range.

Current oil prices are higher than the average yearly forecasts for the period 2007 to 2010. In addition, current prices are already fully included in the prices of petrol and diesel. No significant hikes in fuel prices are expected in the coming years, particularly given the continuing appreciation of the Slovak koruna against the US dollar. Developments in 2007 have shown that, in the context of the appreciation of the SKK against the USD, rising oil prices and related fuel prices have had no accelerating effect on the inflation rate.

was updated for the purposes of the Convergence Programme on the basis of the inflation figures in September (faster growth in the prices of foodstuffs) and on the basis of technical discussion with the EC within the framework of the autumn round of projections.

Contributions of average total HICP inflation according to COICOP classification (p.p.)			
	2007	2008	2009
HICP	1.68	2.26	2.63
Food and non-alcoholic beverages	0.50	0.53	0.43
Alcoholic beverages and tobacco	0.25	0.21	0.37
Clothing and footwear	0.02	-0.01	0.00
Housing, water, electricity, gas and fuels	0.57	0.53	0.60
Furnishings, household equipment and routine	-0.01	-0.06	-0.05
Health	0.00	0.16	0.15
Transport	-0.22	0.18	0.20
Post and telecommunication	0.02	0.00	-0.01
Recreation and culture	0.08	0.07	0.10
Education	0.07	0.08	0.09
Hotels, cafes and restaurants	0.23	0.42	0.64
Miscellaneous goods and services	0.16	0.14	0.12

Source: Ministry of Finance

Food prices have an annual cyclical character. The highest price rises come in January, yet food prices tend to decline during the summer months. The cyclical character of food prices was confirmed this year as well; in July they fell by 1.3% and in August by 1%. However, the September inflation figures showed a higher-than-expected increase in food prices, most likely caused by poorer harvests worldwide. Food prices are expected to account for a 0.50 percentage points increase in overall inflation in 2007. This figure is expected to grow slightly in 2008, but its contribution will fall in 2009.

The healthcare sector has a regular influence on inflation, through changes in drug categorization; in 2007 a change in the VAT rate applicable for this sector also had a price impact. As a result of the reduction in VAT from 19% to 10%, prices in the healthcare sector declined by 2.4% in January 2007, with a further drop of 3.1% in June 2007 due to a change in the items of the consumer basket (more expensive standard drug substituted by a cheaper one). The contribution of the healthcare sector to inflation was -0.1 percentage point in August 2007, but its annual contribution will be near zero by the year-end. A similar effect is, however, not supposed in the next few years when the healthcare sector's contribution to inflation is expected to increase again.

The excise tax on cigarettes will increase by an average of SKK 0.49 per cigarette in 2008 due to the gradual harmonisation of Slovak excise tax rates with the minimum rates applicable in the EU Cigarettes account for 2.62% of the consumer basket, where three popular brands are represented (Marlboro, Petra, and Golden Gate). The rise in excise tax, and in the applicable VAT, will push the prices of cigarettes up 19.2% by the end of the year. The higher excise tax rate will be effective from 1 January 2008, but prices will increase gradually. It is expected that retailers will stockpile in advance, as was the case with the excise tax increase in 2006. At that time, older stocks of cigarettes with a lower rate of excise tax were in sale until about July 2006, six months after the introduction of the new tax rate. A similar stockpiling is expected for 2008. The increase in tobacco taxes will contribute 0.5 percentage points to the 2008 Harmonised Index of Consumer Prices (HICP) and 0.2 percentage points to average 2008 inflation using the HICP methodology. The lower contribution to inflation is due to the expected stockpiling; the 12-month average inflation rate will only reflect price increases in the second half of the year.

The next and the last planned increase in the excise tax on cigarettes required as part of the excise tax harmonisation, will be implemented 2009, with a similar impact in absolute figures as in 2008, i.e. SKK 0.37 per cigarette. However, when expressed as a percentage, the increase in prices will be lower than in 2008, due to a higher initial price. The price of cigarettes would rise by 12.0% in 2009 if the higher prices were reflected immediately. Advance stockpiling is however expected to be similar as in previous years. Its impact on the total year-on-year HICP inflation will be 0.3 percentage points at the end of 2009. Account should however also be taken of the 2008 price increase which will be reflected in the 2009 average inflation, through its impact on the monthly year-on-year inflation figures. The 2009 average year-on-year HICP inflation will rise by 0.4 percentage

points due to the aggregate increase in cigarette prices in both years. The impact of the 2008 and 2009 excise tax increase will be apparent, to a lesser degree, in 2010 as well. However, by August 2010 the impact of the 2008 and 2009 excise tax changes on year-on-year HICP inflation will be zero. Its contribution to average year-on-year HICP inflation will decrease at a slower pace, representing 0.1 percentage point in 2010.

An increase in water and electricity prices for households is expected in January 2008. Prices of natural gas and heating should remain unchanged, according to the projections of the Ministry of Finance. The price of water is expected to go up by 3% in January, increasing the HICP inflation by 0.1 percentage point (its weight in the consumer basket is 1.86%). The electricity price will increase by 5%, raising inflation by 0.2 percentage points. Together, water, electricity, gas and heat will increase average inflation by 0.3 percentage points. The Ministry of Finance expects a similar growth in electricity and water prices in the next few years too, accompanied by a moderate increase in gas and heating prices. This will result in a larger contribution to average inflation after 2008.

In compliance with EU legislation, Slovakia will introduce excise taxes on electricity, coal and natural gas in July 2008 (energy taxes); the rates applicable to natural gas and electricity will be increased again in January 2010. As a result, the price of electricity for industrial customers will go up 0.63% in July 2008 and 0.64% in January 2010. A one-off 6.7% increase in coal prices will come in July 2008, the natural gas prices will increase by 1.21% in July 2008 and by 1.17% in January 2010. The increase expressed in percentage is net of tax-exempt consumption. These taxes directly burden producers only and have only a secondary effect on consumer prices. They will have virtually a zero impact in 2008 since they are to be effectively applied only in the second half of the year, and will affect consumer prices with a delay. The contribution of energy taxes to average HICP inflation will be less than 0.1 percentage point in 2009 and 2010.

Influence of one-off factors to average total HICP inflation (p.p.)

	2007	2008	2009	2010
EMU accesion	-	-	0.30	-
Excise taxes on electricity, coal and natural gas	-	0.00	0.07	0.06
Increase of the assessment bases	-	0.03	-	-

Source: Ministry of Finance

Legislation currently under preparation is expected to increase the social insurance assessment base and the assessment base of contributions to the 2nd pillar as of January 2008 from three times to four-times the average wage. This change will result in higher employers' costs as it increases the amount of social contributions they have to pay for their employees, and will have an inflationary effect. On the other hand, employees whose gross wage exceeds three times the average wage will also pay higher social contributions (though to a lesser degree) which means that their real wage will drop. This will have a deflationary effect on the economy. Taking into account both of these effects, the overall contribution of the higher maximum assessment base to average inflation will represent a negligible 0.03 percentage points.

Major price changes in the hotels and restaurants sector usually occur in January; the month-on-month change in prices is expected to be 1.2% in January 2008. Before obligatory introduction of displaying dual prices, a moderate change may be expected in prices charged in restaurants. Restaurant owners will take this last chance to change prices before the introduction of strict monitoring during the period of displaying dual prices. Its contribution to average inflation in 2008 is estimated at 0.4 percentage points. Another traditional effect is the September increase in prices of student accommodation and school catering. These prices are expected to rise in September 2009 too. The average year-on-year change in prices for the sector will be 6.9%, and its contribution to the overall average inflation rate 0.64 percentage points.

The forecasts prepared by the Ministry of Finance have already taken into account the anticipated one-off increase in the price level caused by Slovakia's entry to the Eurozone. In the light of Slovenia's experience, in particular, the contribution of this factor to average HICP inflation is estimated at 0.3 percentage points, and has been fully factored into the current forecasts. This impact will be most felt in the hotels and restaurants sector and in transportation services.

The Balassa-Samuelson (BS) effect has a higher weight in the new EU Member States. The BS effect is the result of a faster increase in unit labour costs (ULC) in non-tradable sectors compared to tradable sectors. Since 1997, ULC in non-tradable sectors have grown on average by 9 percentage points more than in tradable sectors. In estimating the BS effect, the Ministry of Finance looks at growth in labour productivity, wages and ULC in tradable and non-tradable sectors, and on the transfer of ULC growth, using a mark-up model [11]. Assuming that the consumer market absorbs around 60% of the ULC impact, dual inflation could be around 2% which means that its impact on HICP will be 0.5-1.0 percentage points after weighting adjustments. The effect was stronger before 2004, considerably in excess of 1.0 percentage point. The impact of the BS effect has been factored into the inflation forecast for 2007-2010 and should not pose a threat to the sustainable respect of the inflation criterion.

Labour productivity in Slovakia has been growing at a higher pace than wages for a long time. In the long-term, this differential is expected to gradually lessen, and both wages and productivity should grow at roughly the same pace. Labour productivity growth is expected to be higher than wage growth in the next few years, and wage rises will therefore not constitute an inflation risk for Slovakia.

Contributions to the average total HICP inflation according to the CPI structure (p.p.)

	2007	2008	2009
HICP	1.68	2.26	2.63
Core inflation	1.40	1.71	1.95
Net inflation ex. fuels	0.90	1.16	1.50
Tradable goods ex. fuels	0.27	0.18	0.39
Market services	0.63	0.98	1.11
Fuels	0.03	0.12	0.06
Food	0.47	0.43	0.39
Regulated prices	0.28	0.55	0.68

Source: Ministry of Finance

Based on its analyses and estimates, the Ministry of Finance is confident that the current low inflation rate enjoyed by Slovakia is sustainable for the next few years. A number of factors affecting inflation are of a one-off, or temporary nature. They result from unique developments (Eurozone entry), legislative changes (increase in the maximum assessment bases), or approximation with EU legislation (higher excise taxes and introduction of energy taxes). Currently rising food prices may also be considered as a temporary global factor which, once it has abated, will have a stronger decelerating character in the future in Slovakia than in more advanced countries.

Heat, electricity, water and natural gas prices have a different character as they reflect real developments on global markets. These prices do not necessarily have to grow in the following years, nor can we rule out their reduction, since they depend mainly on the situation on global commodity markets. It is important to note that in recent years Slovak energy prices have already increased to match (and often even exceed) the EU average and that cross-subsidies have been eliminated. With the improving living standard of Slovakia's population, both the share of energy in the consumer basket and the energy intensity of the Slovak economy will weaken, which will reduce the impact of external shocks on inflation.

The only evident and longer lasting pro-inflationary factor will be nominal convergence following the adoption of the euro. Since the koruna will cease to exist, the entire weight of nominal convergence will be expressed through Slovakia's price level catching up with that of EU Member States. However, even in this case we should keep in mind that this will be a very gradual process, concurrent with the process of real convergence. All in all, even real convergence is a time-limited process in the long term.

[11] Net fuel inflation = 0.4*Slovak industrial producer price index + 0.6*seasonally adjusted ULC (ULC are broken down, by weight, to ULC in tradable and non-tradable sector).

III. PUBLIC FINANCE POSITION

III.1. Policy strategy and objectives

The strategy behind fiscal policy is built around two specific objectives of the government. **The first fundamental fiscal objective is to reduce the general government deficit including pension reform costs below 3% of GDP in 2007, in order to meet one of the criteria for joining the Eurozone.** **The second fundamental objective is to reduce the cyclically adjusted general government deficit, net of one-off measures, to 0.8% of GDP by 2010.** This figure is in line with the range recommended by the European Commission to Slovakia for setting its medium-term objective within the framework of the revised Stability and Growth Pact. Taking necessary measures at the right time, particularly the parametric changes to the pension system, will also prepare the ground for **achieving the long-term sustainability of public financ**e, according to the Ministry of Finance analyses.

Consolidation effort of the Government in 2006 and 2010 (ESA 95, % of GDP)						
	2006E	2007B	2007E	2008B	2009B	2010B
1. Net lending / net borrowing	-3.7	-2.9	-2.5	-2.3	-1.8	-0.8
2. One-off measures	0.4	0.0	0.0	-0.1	0.0	0.0
3. Cyclical component	0.0	0.1	0.1	0.0	0.0	0.0
4. Cyclically adjusted GG balance net of one-offs (MTO) (1+2-3)	-3.3	-3.0	-2.6	-2.5	-1.8	-0.8
5. Impact of the implementation of the 2nd pillar of pension scheme	1.2	1.1	1.3	1.3	1.3	1.4
6. Balance adjusted by the 2nd pillar (4+5)	-2.1	-1.9	-1.3	-1.2	-0.5	0.5
7. Interest expenditure	1.5	1.8	1.5	1.4	1.5	1.3
8. Adjusted primary balance (6+7)	-0.7	-0.1	0.2	0.3	1.0	1.8
9. Consolidation effort (y-o-y change in item 6)	-1.3	0.2	0.8	0.1	0.6	1.0

(+) restriction, (-) expansion *Source: Ministry of Finance*

The first objective is motivated by the joint effort of the government and the NBS to meet the Maastricht convergence criteria in 2007 and adopt single European currency in 2009. This objective was developed in more detail in the three-year general government budget for 2007-2009 as a deficit amounting to 2.9% of GDP.

The Ministry of Finance regularly (twice a year) prepares a document[12], the purpose of which is to monitor the development of the macroeconomic environment and analyze the trends in public finance, assessing how realistic it is to meet the budgetary objective of general government deficit. If a risk of exceeding the deficit is identified, this document should contain proposals for measures to eliminate the risk. After the end of the first half of 2007, this year's deficit was estimated at 2.7% of GDP, including pension reform costs. Further updates were made at the end of the third quarter. Compared to the half-year estimate, the deficit estimate was again adjusted downwards, to 2.5% of GDP, which is 0.4% of GDP lower than the value set in the approved budget.

The second fundamental objective is to reduce the cyclically adjusted general government deficit, net of one-off measures, to 0.8% of GDP by 2010. The objective of ensuring long-term sustainability of public finance was already formulated in Slovakia's first Convergence Programme in May 2004. The 2008-2010 General Government Budget is the first budget to explicitly confirm the commitment to reduce the general government deficit to the level of the medium-term objective. Compared to the previous update to the Convergence Programme the medium-term objective has been revised from 0.9% to 0.8% of GDP. This more ambitious medium-term objective set for 2010 is the government's answer to the European Council recommendation of February 2007, and reflects the government's commitments with respect to the March 2007 revaluation of the SKK/EUR central rate in the ERM II system. This demonstrates Slovakia's effort to fulfil its commitments under the revised Stability and Growth Pact.

[12] "Report on Macroeconomic Environment and Public Finance Development for the First Half/Three Quarters and Forecast until Year-End" is prepared after the end of the first half (July) and after the end of the three quarters of a calendar year (October).

Fiscal policy strategy will be determined by the government's consolidation objectives. Healthy economic growth will continue to represent an important source of consolidation. On the revenue side, measures have been taken which will slightly increase the state budget revenues from taxes and social contributions as of 2008. However, as in previous years, the main source of consolidation will consist in allocating funds for government spending policies strictly in line with economic growth and with the increase in tax revenues, while respecting the government's consolidation objectives, as reflected in the budgeted general government deficits according to the ESA 95 methodology. On the expenditures side, a staffing reduction in the state administration and efficiency improvements in the public procurement process will also bring noticeable savings.

General government budget consolidation in the medium term is an important measure, but is insufficient to ensure the long-term sustainability of public finance. In previous convergence programmes, concrete parametric changes in the pension system were specified. For example, a switch to the use of the inflation rate for the annual valorisation of the amount of benefits from old-age, disability and survivor pensions, and further increase in the retirement age. Even though these measures are not yet in place, they were explicitly mentioned during the preparation of the pension system reform, and their application in the future is generally expected. Another important fact regarding the long-term sustainability of the public finance is that Slovakia will, as of 2007, report a surplus of the cyclically-adjusted general government primary balance, adjusted for one-off effects and for the costs of the fully-funded pillar of the pension system.

Since 2003 Slovakia has been very successful in meeting its consolidation objectives. This is, in particular, evidenced by comparing the budgeted and actual general government deficits and the fact that significant fiscal consolidation is taking place in a situation where general government revenues expressed as a percentage of GDP are on a downward trajectory.

General government balance (ESA 95, % of GDP)					
	2003	2004	2005	2006	2007[3]
Budget	-5.0	-4.0	-3.8	-4.2	-2.9
Reality[1] (comparable methodology with the budget)	-3.3	-3.0	-2.1	-3.7	-2.5
Reality[1] (methodology change[2])	-2.3	-2.3	-1.8	-3.3	-2.5

Note: 1 – figure net of one-off effects
2 – as of April 2007, methodology of tax revenue reporting has changed which affected the reported GG balances. Reality in 2006 and estimate for 2007 are reported in this methodology
3 – latest estimate in 2007
Source: Ministry of Finance

Between 2003-2010, the tax-to-GDP ratio is expected to drop by almost 4.5% of GDP. Adjusted expenditures (net of interest payments and one-off effects) will drop in the same period by as much as 4.2% of GDP even though they include a higher amount of funds from the EU. Yet the most important finding is that the average increase, in real terms, of these expenditures remains well below the economic growth for the whole period.

General government revenues and expenditures in comparison with economic growth (ESA95, % of GDP)									
	2003	2004	2005	2006	2007E	2008B	2009B	2010B	2010B-2003
Adjusted total revenues***	36.7	35.9	36.6	34.0	33.8	33.7	33.2	33.8	-2.9
Taxes and social contributions	32.3	30.8	30.4	28.4	28.6	28.6	27.9	27.8	-4.5
Adjusted total expenditures**	38.8	38.1	38.3	37.2	36.3	36.1	35.0	34.6	-4.2
Adjusted total expenditures – real growth	-9.1	1.7	6.7	4.1	4.6	6.2	2.0	3.3	**2.4***
p.m. economic growth	*4.2*	*5.4*	*6.0*	*8.3*	*8.8*	*6.8*	*5.8*	*5.0*	**6.3***

**** adjusted total revenues are net of one-off effects*
Source: Ministry of Finance
*** adjusted total expenditures are net of one-off effects and interest expenditures*
** an average for 2003 - 2010*

The budget for 2008-2010 is exclusively based on the applicable legislative framework and future legislative changes already approved by the government. Where future legislative changes are taken into account, they are described in the budget along with an explicit quantification of their impact on budgetary revenues and expenditures.

The budget is based on realistic assumptions, and a balance is struck between the positive and negative risks. The macroeconomic scenario on which the budget is based, including the budgeted tax revenues, is subject to scrutiny by the professional public. Macroeconomic and tax projections are assessed by committees, the members of which include generally recognised national experts from both the public and private sector. The budget explicitly contains statements by the members of these committees concerning the projections of the Ministry of Finance, assessing whether these projections are optimistic, realistic, or conservative. Macroeconomic assumptions and tax projections in the 2008-2010 budget were described by the members of the committees as realistic in all cases.

III.2. Current developments and consequences for next year's budget

Assessment of the current situation in public finance is a key prerequisite for setting adequate and realistic fiscal objectives in the general government budget which is currently being prepared. Compared to the previous Convergence Programme, this chapter therefore offers – alongside basic data concerning the general government deficit estimate for this year – information on the result of the 2006 general government deficit revision and on the ongoing political discussion concerning the pension reform and the launch of public-private partnership (PPP) projects.

The approved 2007-2009 General Government Budget includes as a fiscal objective a 2007 general government deficit, including pension reform costs, of 2.9% of GDP. The current estimate of the 2007 deficit stands at 2.5% of GDP, which, compared to the budget, is an improvement of 0.4% of GDP. Improvement occurred even though the expected negative impact of the fully-funded pillar on the general government balance was 1.3% of GDP instead of the budgeted level of 1.1% of GDP.

Turning to the individual general government entities, it is assumed that the state budget will reduce the deficit by SKK 8.0 billion. In addition, the performance of state financial assets and extra-budgetary accounts are expected to improve (SKK 0.9 billion), as are the state funds (SKK 0.5 billion) and the National Property Fund (SKK 0.2 billion). The savings expected from these entities, together totalling SKK 9.6 billion, will be attenuated by worse economic performance of other general government entities, totalling SKK 2.3 billion. Worse performance is expected in the case of health insurance companies (by SKK 0.5 billion), the Social Insurance Agency (by SKK 0.4 billion) and, in particular, the higher territorial units (SKK 1.2 billion). Reclassifying Slovak Television and Slovak Radio as institutions coming under the general government is expected to translate into a negative impact of SKK 0.2 billion on the general government balance. Taking these various changes together, the general government deficit is likely to be SKK 7.1 billion lower than the approved budget.

The factors helping to improve the general government balance include the update of actual tax revenues of the general government. Compared to the approved budget, the tax revenues are now estimated to increase by SKK 3.8 billion. However, when quantifying the impact of the increase in tax revenues on the general government balance, it is necessary to consider other factors as well. The first of these is that 93.8% of personal income tax revenues go to local government authorities, which, assuming a balanced budget, will use all additional cash to cover their outlays. There has also been an update of the amount of funds earmarked from income taxes to the non-profit sector, which relate to an increase in expenditures. As a result, the net impact of tax revenues on the general government balance amounts to SKK 3.2 billion.

Impact of the tax revenues update on the GG balance when compared to the 2007 GG budget (ESA95, SKK mil.)	
(1) General government tax revenues	3 848
(2) Negative impact of municipalities and higher territorial units (cash)	638
(3) 2% of PIT and CIT revenues earmarked to the non-profit sector	-39
(4) Impact of tax revenues update on general government balance	3 249

(4)=(1)-(2)-(3) *Source: Ministry of Finance*

State budget expenditures are another important factor behind the reduction of the deficit estimate. These expenditures are now estimated to be SKK 4.5 billion lower than the approved budget. Savings on the expenditure side are due to lower state debt service costs, down by an estimated SKK 5.5 billion against the budget. On the contrary, other expenditures will exceed the approved budget by SKK 1 billion. This development is affected by the year-on-year change in the amount of carry-over funds previously budgeted for financing joint Slovakia and EU programmes and capital expenditures, with a negative impact of SKK 2.8 billion.

State financial assets and extra-budgetary accounts are also expected to report a better result than that planned in the budget – by some SKK 0.9 billion. Dividends from the National Property Fund should be SKK 2.7 billion higher than in the budget and this will have a positive role. This amount was, for the most part, the result of higher income in the form of dividends of the gas company SPP. Negative factors include unrealized revenues of the city of Žilina, in the amount of SKK 0.8 billion – because the government put off their return until mid-2008 – and higher expenditures for the purchase of reserves of crude oil and oil products which are SKK 0.6 billion higher than in the budget.

As regards other general government entities, the economic performance of higher territorial units is expected to be worse than planned in the budget – by SKK 1.2 billion – due to a higher number of loans taken out.

Current estimation of the general government blance in 2007 (ESA95, SKK mil., unconsolidated)	Latest update
General government deficit after approval of individual budgets in SKK mil.	52 763
General government deficit after approval of individual budgets in % of GDP	2.9
A. Update of the estimate of general government tax revenues	-3 249
B. Update of the estimate of other than tax revenues of the state budget	-230
C. Update of the estimate of the state budget expenditures	-4 500
D. Balance of the state financial assets and etra-budgetary accounts	-913
E. Balance of higher territorial units	1 175
F. Other general government entities	606
- of which: Slovak Television and Slovak Radio	181
Current estimation of general government deficit in SKK mil.	45 652
Current estimation of general government deficit in % of GDP	2.5
of which: improvement of deficit by means of the GDP estimation update (in % of GDP)	0.04

(+) indicates increase and (-) indicates decrease of the GG deficit in the ESA 95 methodology *Source: Ministry of Finance*

Within the framework of the deficit and debt notification as at 1 October 2007, Slovak Television and Slovak Radio were reclassified as entities falling under the general government, on the basis of a recommendation from Eurostat. This move only had a minimum impact on the 2007 deficit estimate, as the expected negative effect translates into only SKK 0.2 billion (0.01% of GDP).

BOX 3 – Eurostat EDP Dialogue Visit in September 2007

At the beginning of September this year, Eurostat representatives arrived for a regular mission to discuss the procedures applied in the reporting of the actual general government balance and debt in Slovakia. One major subject of discussion was the reclassification of several entities into the general government sector, namely the National Highway Company, Slovak Television, Slovak Radio and certain healthcare facilities. The above-mentioned estimate of the general government deficit at 2.5% of GDP is already adjusted for the impact of the reclassification of Slovak Television and Slovak Radio into the general government sector. On the other hand, the deficit estimate does not include the fiscal impact of the possible reclassification of the National Highway Company and the healthcare facilities, because Eurostat has not yet presented its standpoint on this issue. If the results of these entities were incorporated into the general government balance, the estimated 2007 general government deficit would increase by an additional 0.2% of GDP to 2.7% of GDP. This means that, regardless of Eurostat's final standpoint, the estimated deficit does not exceed the government's original objective for 2007. Whatever action is necessary in response to Eurostat's standpoint, the general government deficit should remain safely below 3% of GDP, meaning that respect for this Maastricht criterion is not in peril from the fiscal policy viewpoint.

The decisive aspect in terms of classifying the National Highway Company, Slovak Television and Slovak Radio into general government entities is the economic nature of these institutions' revenues from motorway toll stickers and from television and radio licence fees. The discussion revolved around the question of whether these revenues meet the definition of a tax, which would imply that they cannot be perceived as sales. In that case, when considering the 50% rule, these entities would come under the general government. As regards the classification of public healthcare facilities, the decisive question is the relative importance of the market mechanism in the operating environment of these entities. Assuming that the financial relations of these entities are not mostly determined by market forces, they should fall under the general government.

Within the framework of the deficit and debt notification as at 1 October 2007, Slovak Television and Slovak Radio were classified as entities falling under the general government sector based on Eurostat's recommendation. The actual general government balance for the years 2003 to 2006 has been revised accordingly. After this decision, the Ministry of Finance adjusted its 2007 estimates to incorporate the expected impact of these entities' economic performance into the general government balance. If all these entities are classified to the general government sector, the reported deficit in 2007 would increase by 0.2% of GDP.

Impact of reclassification of certain entities on the GG balance (in % of GDP)

	2006	2007E
National Highway Company	-0.37	-0.24
Public healthcare facilities	0.02	-
Slovak Television (already included in 2006 balance and estimate for 2007)	0.01	-0.01
Slovak Radio (already included in 2006 balance and estimate for 2007)	0.01	0.00
Total impact	-0.32	-0.25

Source: Ministry of Finance, Statistical Office

Apart from the possible impacts of a Eurostat's standpoint regarding the reclassification of several entities into the general government sector, current developments in 2007 suggest two potential risks for both this year and the next few years. The first risk comes in the form of the economic performance of municipalities and higher territorial units which, in 2006, was quite negatively affected by an increase in loans and the spending of any surplus that may have accumulated over the past years. With indebtedness of local government still low, the current configuration of the existing fiscal rules applicable to the debts of these entities provides room for some increase in indebtedness.

The second risk is that, since the capital expenditures and expenditures allocated for the co-financing of Slovakia and EU joint programmes were not fully spent, the unspent amounts may be carried over to the next budget year. In 2006 individual ministries had SKK 14.7 billion of such unspent financial resources, which were carried over to

2007. Based on current trends, the Ministry of Finance expects savings of SKK 12.0 billion in 2007, meaning that the amounts to be carried over to the following year will be lower than at the end of 2006. The negative effect on the general government balance for this year will be SKK 2.8 billion. Year-on-year amounts of carried over funds increased in recent years – in particular due to slower-than-expected spending of financial resources from the EU funds (and related co-financing), which had a positive effect on the general government balance. Faster spending of these financial resources may pose a negative risk in the next few years.

In 2007 there were two deficit and debt notifications, which were primarily focused on quantifying and refining the general government balance for 2006. Within the first deficit and debt notification, the general government deficit for 2006 was estimated at 3.4% of GDP. Based on data from Eurostat's second notification, the deficit increased by 0.3% of GDP to 3.7% of GDP. In spite of this, **the actual figure for 2006 is still down by 0.5% of GDP compared to the budget figure of 4.2% of GDP**.

The Ministry of Finance is aware of the fact that increased deficit estimate in the October notification may be perceived negatively, in particular in the context of meeting the Maastricht criterion for the general government deficit in 2007. In order to systematically improve the accounting and reporting system, a new accrual accounting system will be introduced at the general government level as of 1 January 2008, replacing the existing cash accounting system[13]. Within the new system, the quality of data provided will be improved by means of a revised monitoring system. All these changes are expected to bring positive results as soon as during the preparation of the April 2007 notification.

BOX 4 – General government balance in 2006

In April 2007, within the first deficit and debt notification, Eurostat was provided with data on the general government's economic result for 2006. The general government deficit reached SKK 55.4 billion, an amount equal to 3.4% of GDP. The gross general government debt stood at SKK 503 billion, which represented 30.7% of GDP. These data were flagged as preliminary, as is always the case with first notifications.

The main goal of the second deficit and debt notification in October is to present a more accurate value of the reported deficit, based on definitive financial statements and additional supporting documents not available at the time of preparing the preliminary notification in April. Within the October notification, the estimated general government deficit was refined to SKK 61.5 billion, which represents 3.7% of GDP. Compared to the April notification, the deficit rose by 0.3% of GDP. The absolute level of debt slightly increased to SKK 505.2 billion, but the relative value of the debt fell to 30.4% of GDP, due to a revised nominal GDP figure.

Revision of general government balance in 2006 (ESA95, SKK mil.)

	SKK mil.	% of GDP
General government balance - April 2007	**-55 415**	**3.40**
Revenue from foreign exchange swap	-1 218	-0.07
Accrualisation of interest expenditure	-5 416	-0.33
Receivable of National Nuclear Fund	557	0.03
Accrualisation of tax revenues and social contributions	-238	-0.01
Reclassification of STV and SRo into GG sector	314	0.02
Other	202	0.01
General government balance - October 2007	**-61 214**	**-3.69**
- of which: improvement due to GDP revision		**0.05**

Source: Ministry of Finance, Statistical Office, Eurostat

The revision of the general government balance in the October notification can be attributed to three categories of factors. The first category refers to the regular updates of data which had to be estimated within the first notification, because the actual data were not available during the preparation of that document. This covers, in particular, changes in accruals of tax revenues and social contributions. For instance, in the case of

[13] More on this issue can be found in Chapter VII.2 "Introduction of a uniform accounting system in the general government"

personal income tax from self-employment and the corporate income tax, the actual revenues under ESA 95 methodology is available as late as one year after the end of the given year, therefore the actual revenues are not known during the preparation of the second notification, although they can be estimated quite accurately. The effects of these changes on the resulting balance varied, and their overall impact on the deficit is slightly positive, although it amounts to less than 0.1% of GDP.

The second category of changes was made based on additional supporting documents, in particular those finalized financial statements not available during the preparation of the first notification. These changes included updated amount of a state fund's receivables, removal of foreign exchange swap income from the balance, and the revision of accruals and deferrals related to interest on the state debt. These changes worsened the balance by almost 0.4% of GDP. As regards the update of the impact of foreign exchange swap, it is worth noting that this transaction was performed in 2006 for the first time ever, without any previous experience with its recording in the national accounts.

The last category of changes is related to the above mentioned methodological reclassification of Slovak Television (STV) and Slovak Radio (SRo) into the general government sector. In 2006 their economic performance helped to improve the general government balance by 0.02% of GDP.

The boxes in the final part of this chapter offer an outline of the government's main intentions in the two key areas of public finance. As part of the preparation of the 2008-2010 General Government Budget, the government has presented its intention to adjust the pension system with a view to alleviating its financial impact on general government balance.

BOX 5 – Expected changes in the pension system

In Slovakia, a complex pension reform was undertaken between 2004 and 2005. The essence of the reform was to make parametrical changes to the pay-as-you-go (PAYG) pillar in 2004 and introduce a mandatory fully-funded pillar in 2005 (the so-called second pillar).

Reform of the pay-as-you-go pillar

1. *New definition of the replacement rate – the gross replacement rate was defined in the reform at approximately 50% of employment income. The most significant change concerned the definition of the replacement rate in relation to previous income, which shifted the character of the PAYG pillar from a solidarity-based to a merit-based principle.*
2. *Changes in the indexing of pension benefits – in the past, pension benefits were indexed only on the basis of a political decision; the reform introduced a rule for pension indexing. According to this rule, pension benefits are annually indexed using the arithmetic mean of the average wage growth in the economy and of inflation measured by CPI.*
3. *A gradual increase in the pension age to 62 for both men (original threshold was 60) and women (originally between 53 and 57 depending on the number of children cared for). The pension age for men rose to 62 in 2006, women will retire at 62 in 2015.*

Launch of the fully-funded pillar in 2005 – Within the transitory period (from January 2005 until June 2006) insurees participating in the PAYG scheme could make a decision as to whether to join the fully-funded pillar. The fully-funded pillar is mandatory for those entering the labour market in or after July 2006. Half of the pension contribution is sent to contributors' personal accounts maintained by one of the private pension fund management companies.

The main goal of the above changes in the pension system was to facilitate sustainability and bring about financial stability of the PAYG pillar in the medium term. All the reforms referred to in above were presented to the European Commission in previous Convergence Programme updates and are reflected in the long-term projections created within the framework of the Ageing Working Group (AWG).

It might seem that the elapsed 2-3 years is too soon tor evaluate changes in the pension system, which tend to

materialize mostly in the medium and long term. However, this is not quite the case with Slovakia. There are at least two reasons why the discussion about the pension system continues both on the political and the professional level at present. The first reason is that the actual financial situation in the PAYG system and the impact of the introduction of the fully funded pillar significantly differ from the assumptions valid at the time of adopting the reform legislation in 2003 and 2004.

Comparison of real-time financial impact with estimates preceding the implementation of reforms (SKK mil.)

	2004	2005	2006	2007	TOTAL
1st pillar balance (without the impact of the 2nd pillar)					
1. Estimate (Financial impact analysis of act no. 461/2003)	3 671	8 029	11 511	12 983	-
2. Real-time impact/Latest estimate	-2 891	-1 016	1 448	1 666(1)	-
Difference (2)-(1)	**-6 562**	**-9 045**	**-10 063**	**-11 317**	**-36 987**
% of GDP	**-0.5%**	**-0.6%**	**-0.6%**	**-0.6%**	**-2.3%**
Impact of the 2nd pillar					
1. Estimate (2005-2007 GG Budget)	-	5 596	15 056	17 950	-
2. Real-time impact/Latest estimate	-	11 266	20 167	24 688(1)	-
Difference (2)-(1)	-	**5 670**	**5 111**	**6 738**	**17 519**
% of GDP	-	**0.4%**	**0.3%**	**0.4%**	**1.1%**
TOTAL IMPACT ON GG BALANCE	**-6 562**	**-14 715**	**-15 174**	**-18 054**	**-54 506**
% of GDP	**-0.5%**	**-1.0%**	**-0.9%**	**-1.0%**	**-3.4%**

(1) - The 2008-2010 SIA Budget proposal dated on 11 July 2007

The above table indicates the difference between the expected and actual impacts of the pension system reform. It has become clear that the difference between the estimate and the actual data represents a shortfall of 1.0% of GDP a year – which has a direct negative impact on the general government balance. The actual balance of the Social Insurance Agency and the impact of the fully-funded pillar already take account of the actual macroeconomic development. In the first case, however, better macroeconomic indicators improved the PAYG pillar balance, in particular due to higher-than-expected revenues from social security contributions and lower expenditures on unemployment benefits. The situation was opposite with the fully-funded pillar: the better economic environment automatically boosted the negative impact, because contributions to the second pillar were necessarily higher than expected. It is obvious that the positive impact of better macroeconomic development on the PAYG scheme balance will outweigh the negative impact on this pillar stemming from the implementation of the fully-funded pillar. This is to say that, if the impact of the macroeconomic environment is taken into account, the system as a whole would generate even higher losses than that indicated in the table. Therefore the dominant portion of the current unfavourable trends in the pension system can be attributed to the PAYG pillar.

The degree of merit-based pension claims has a significant negative impact on the balance of the PAYG pillar. It is clear that the current configuration is not acceptable in the current conditions in Slovakia. Therefore it is necessary to emphasise that any responsible government would have to tackle the above problems and seek solutions. The government's strategy is divided into two stages.

As the first step, the government is trying to stabilise the PAYG pillar in the medium term. The government has presented measures which are intended to be effective as of 2008.

- *The maximum assessment base for several types of insurance (including pension insurance and contributions to the 2nd pillar) is to be increased from three to four times the average wage in the national economy. This higher assessment base will not affect the amount of benefits provided.*
- *The period after which pension scheme members become entitled for pension benefits from the PAYG and fully-funded pillars has been extended from 10 to 15 years.*
- *The eligibility criteria for early retirement will be stricter – it will be possible to authorise early retirement no earlier than two years prior to reaching retirement age.*
- *There will be a transitory period until mid-2008, during which pension scheme members may leave the fully-funded pillar and be fully covered in the PAYG pillar. At the same time, pension scheme members who are currently insured only in the PAYG pillar will be able to join the fully-funded pillar.*

- *The fully-funded pillar will be voluntary for new labour market entrants. They must make their decision within six months of the commencement date of their obligation to pay pension contributions.*

As a second step, the government will look at the long-term financial and social sustainability of the system. This discussion will commence in the course of 2008 and will also include necessary parametric changes in the PAYG pillar of the pension system. When looking for the solutions, however, the government will not consider a reduction of the contribution rates to the fully-funded pillar of the pension system.

As one of the measures to become effective as of 1 January 2008, entry to the fully-funded pillar of the pension system will be temporarily opened. Within the transitory period from 1 January 2008 to 30 June 2008, it will be possible for all contributors to leave the fully-funded pillar. At the same time, however, the individuals who did not yet participate in the fully-funded pillar will be able to join it. The key objective of this legislation is to allow those contributors who find the fully-funded pillar disadvantageous – either based on their previous experience or because they are now better informed – to revert to full coverage within the PAYG pillar.

Since legislation changes have extended the number of years necessary to become entitled for a pension benefit from both the PAYG pillar and the fully-funded pillar, it is expected that mostly individuals aged 40 and above will return to the PAYG pillar.

Age structure of 2nd pillar contributors – as of 31 October 2007		
	number of persons	*% share*
under 20 years	*52 822*	*3%*
from 21 to 30 years	*547 701*	*36%*
from 31 to 40 years	*573 141*	*37%*
from 41 to 50 years	*357 691*	*23%*
over 51 years	*29 671*	*2%*
Total	***1 561 026***	***100%***

The overall estimate of the number of those who will leave the second pillar is 68,000 persons, which is 4.4% of all registered contributors to the second pillar, and 18% of the approximately 387,000 people or aged 40 and above. The financial impact of these contributors' departure will affect the general government budget in two ways. Firstly, the departure of contributors from the second pillar will increase the volume of social contributions flowing into the PAYG pillar. Secondly, the funds saved on the contributors' accounts will be transferred to the Social Insurance Agency. The summary of these impacts is indicated in the table.

Estimated impact of optional entry/exit to/from the 2nd pillar on GG (ESA 95, SKK mil.)				
	number of persons	2008	2009	2010
Impact of optional entry to the 2nd pillar	10 000	205	220	230
Impact of optional exit from the 2nd pillar	68 000	3 670	1 335	1 422
transfer of accumulated funds		*2 416*	*0*	*0*
impact in a current year		*1 253*	*1 335*	*1 422*

The second issue concerns faster construction of motorways and express ways with the involvement of private entities through PPP projects. The discussion continues in both areas, although the main intentions are clear. Several specific steps will be discussed in 2008.

BOX 6 – Motorways and public-private partnership (PPP) projects

One of the priorities of the current government's economic policy, based on the government Manifesto, is to speed up the building and modernisation of transport infrastructure in order to connect it to the trans-European network. In this context, the aim is to link Bratislava with Košice through the northern D1 motorway, and with Banská Bystrica though the R1 express way. Once this routes are completed, significant positive effects are expected to occur in terms of economic development in affected regions and mitigation of regional disparities.

The government decided to speed up construction of certain sections of these routes mainly through PPP projects whose main benefit is the high quality and effectiveness of construction, though accompanied by higher financial requirements. Engagement of private partners requires exhaustive technical preparation for the implementation of such projects and some legislative changes. The key principles for the use of PPP projects are to respect the consolidation objectives and clearly define the risks in order to transfer their larger portion to a private partner (in compliance with the Eurostat rules). At the same time, the Slovak government will seek to ensure maximum transparency in the assessment of PPP projects; the process is also supposed to involve international institutions which have experiences with similar projects in the field of transport infrastructure.

A total of 151 km of motorways and express ways should be built through PPP projects by 2012, as approved by the government. Total costs are estimated at approximately EUR 3.9 billion, i.e. some SKK 130 billion.

III.3. Structural Balance, Fiscal Position, Fiscal Impulse

The consolidation of public finance should create room for sustainable economic growth with low inflation, low interest rates, a stable exchange rate and positive expectations of stakeholders concerning future economic policy. This will positively influence the supply-side of the economy, and more than compensate for a lower contribution to aggregate demand.

The consolidation effort describes the path the government plans to take in order to meet its medium-term objectives. The consolidation effort as presented in this paper is calculated using the European Commission methodology which, in the case of Slovakia, takes into account the cyclical component of the budget, one-off effects, and the costs associated with the launch of the fully-funded (second) pillar of the pension system.

Consolidation effort in years 2007 and 2010 (ESA 95, % of GDP)

	2003-2006 average	2007E	2008B	2009B	2010B
1. Net lending / net borrowing		-2.5	-2.3	-1.8	-0.8
2. Cyclical component		0.1	0.0	0.0	0.0
3. One-off measures		0.0	-0.1	0.0	0.0
- optional exit from the 2nd pillar of pension scheme		-	-0.1	-	-
4. Impact of the implementation of the 2nd pillar of pension scheme		1.3	1.3	1.3	1.4
5. Cyclically adjusted balance net of one-offs and 2nd pillar (1-2+3+4)		-1.3	-1.2	-0.5	0.5
Consolidation effort	1.0	0.8	0.1	0.6	1.0

Source: Ministry of Finance

In order to quantify the government's consolidation effort it is first necessary to divide the actual (officially reported) general government balance into its cyclical and structural components. The structural component shows the state of general government budgets provided that the economy functions at its potential level. The structural general government balance is the current general government balance, net of changes in the cyclical component which reflects the response of general government revenues and expenditures to changes in the output gap. The size of the cyclical component depends on the size of the output gap and the elasticity of selected revenue and expenditure categories which respond to swings in economic activity. Throughout the entire period covered by the Convergence Programme the output gap has kept close to zero, with the exception of 2007. The Ministry of Finance's estimate of the degree of sensitivity of the general government balance to changes in the output gap has been taken in full from OECD estimates.

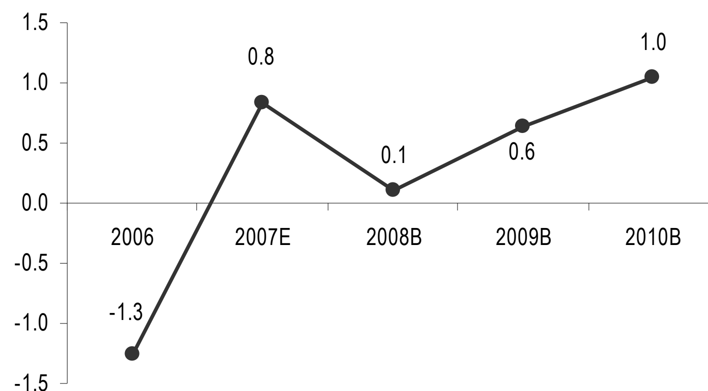
The second item comprises one-off and temporary measures taken by the government. Only one one-off effect has been identified for the years 2007 to 2010. The option to leave the fully-funded pillar of the pension system will be available throughout the first half of 2008[14]. If a contributor decides to leave the fully-funded pillar, his/her

[14] The measure is described in more detail in Box 6.

funds will be transferred from the fully-funded pillar to the PAYG pillar. All assets accrued since his/her entry to the fully-funded pillar, i.e. during the period form 2005 to 2007 at most, will be transferred. On that account, a one-off increase of 0.1% of GDP in general government revenues should occur in 2008.
The third item considered in quantifying the government's consolidation effort are the costs related to the implementation of the fully-funded pillar of the pension system. According to calculations made by the Ministry of Finance, the annual cost of pension reform should range from 1.2% of GDP in 2006 to 1.4% of GDP in 2010. A specific situation will occur in 2008 when the volume of funds transferred[15] from the Social Insurance Agency to the fully-funded pillar will amount to 1.3% of GDP. At the same time, however, the option to leave the fully-funded pillar will create a one-off 0.1% GDP inflow of funds to the Social Insurance Agency (specified in one-off measures), and simultaneously create a moderate reduction (below 0.1% GDP) in the costs of the 2nd pillar as of this year. This means that, considering all the above-mentioned changes, the net impact of the launch of the fully-funded pillar will represent 1.2% of GDP in 2008.

The following graph clearly indicates that the consolidation effort should considerably increase in 2007 compared to the previous year which will, however, result in a deceleration of the consolidation effort in 2008. The government's intention to carry on with the consolidation of public finance in order to meet its medium-term budgetary objective by 2010 has been transposed into concrete measures in the 2008-2010 General Government Budget. The current development as shown on the graph is mainly caused by the fact that the deficit estimated for 2007 is lower than the deficit projected in the budget, which also negatively affects the consolidation effort in 2008. The reason is that this estimated improvement could not be fully reflected in the budgetary objective for 2008.

Consolidation effort between 2006 and 2010 (% of GDP)



Source: Ministry of Finance

BOX 7 – Budgetary process and consolidation efforts amounting to 0.5% of GDP annually

Consolidation efforts and plans for their future development are significantly affected by the nature of the budgetary process. The budget for three years ahead is drawn up in a year, for which actual final data are not yet available. The first estimate of the general government's economic results is only prepared after the end of the first half of the year, i.e. in July; it is subsequently adjusted in October. The government approves its fiscal goals for the current year with finality in May; at that moment it is obviously not possible to take the actual figures into account. Therefore, the fiscal objectives for the new three-year budget are determined on the basis of the deficit budgeted for the current year.

As a result, if the current year's general government balance turns out better than budgeted, there will be a

[15] From the technical point of view, social contributions for old-pension insurance are paid in full to the Social Insurance Agency. Subsequently, the Social Insurance Agency forwards a relevant portion of these contributions on behalf of contributors who joined the 2nd pillar to their pension fund management companies.

negative impact on the consolidation effort in the following year. Therefore, the main tool for public budget consolidation remains the pursuit of medium-term objectives determined in preceding framework documents.

In the past three years, the general government's economic performance has been better than budgeted. The main reasons included tax revenues that were higher than budgeted and the state budget fiscal rule restricting expenditures in the event of a revenue surplus.

Certain tax revenues, namely corporate income tax and personal income tax from self-employment, are specific in that the resulting revenue from these taxes under the ESA95 methodology is only known one year after the end of the respective year. This means, for example, that revenues from 2006 will only be known at the beginning of January 2008. As an example, we may state that at the time when, based on a 2007 revenue estimate, the tax revenue forecasts were made for the 2008-2010 General Government Budget, the actual tax revenue figures for 2006 were not available yet. It therefore follows that, estimated revenues from the above taxes involve a high degree of uncertainty, for which the Ministry of Finance compensates by a particularly conservative approach in forecasting these taxes, compared to other types of taxes. Final tax revenues in the past three years has exceeded the prior expectations of the Ministry of Finance. In particular, corporate income tax revenues grew faster than the macroeconomic base.

Higher taxes do not necessarily lower the deficit, if general government expenditures are allowed to increase as well. However, the Slovak State Budget Act features a fiscal rule stating that in the event of a revenue surplus, state budget expenditures can be increased by a maximum of 1%.

The combination of the state budget fiscal rule and higher tax revenues in the past three years substantially contributed to a higher reduction of the general government deficit than was anticipated in the budget. However, this had an adverse impact on the consolidation effort in the next succeeding year.

The second part of this chapter is dedicated to the fiscal impulse, measuring the contribution of general government balance to the year-on-year change in aggregate demand. It indicates whether the government is pursuing an expansive or a restrictive fiscal policy. In conjunction with the output gap it serves to characterise the fiscal policy as either pro-cyclical or stabilising.

For the purposes of calculation of the fiscal impulse, the balance used in the calculation of the consolidation effort was adjusted to account for two more items, which describe more closely the impact of fiscal policy on aggregate demand. These are the financial links to the EU budget, and interest paid in servicing the general government debt. The link to the EU budget is included, because Slovak contributions to the EU budget lower aggregate demand; on the other hand, revenues from the EU, although they do not aggravate the deficit (since they are present both as revenues and expenditures), have an expansive effect.

Fiscal impulse (ESA 95, % of GDP)

	2006E	2007E	2008B	2009B	2010F
1. Net lending / net borrowing	-3.7	-2.5	-2.3	-1.8	-0.8
2. Cyclical component	0.0	0.1	0.0	0.0	0.0
3. One-off measures	0.4	0.0	-0.1	0.0	0.0
4. Impact of the implementation of the 2nd pillar of pension scheme	1.2	1.3	1.3	1.3	1.4
5. Cycl. adjusted balance net of one-off effects and 2nd pillar (1-2+3+4)	-2.1	-1.3	-1.2	-0.5	0.5
6. Financial links to the EU budget	0.5	0.8	0.9	1.8	2.7
7. Interest expenditure	1.5	1.5	1.4	1.5	1.3
8. Cyclically adjusted primary balance including the EU effect (5-6+7)	-1.1	-0.6	-0.6	-0.8	-0.9
9. Fiscal impulse	-1.7	0.6	0.0	-0.2	-0.1
p.m. Output gap	*0.0*	*0.3*	*0.1*	*0.0*	*0.0*

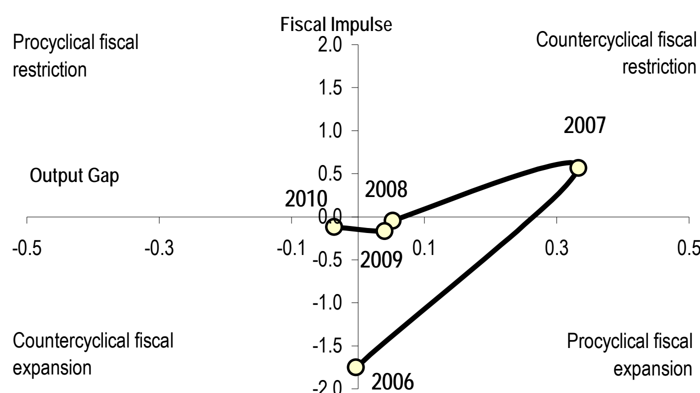
(+ restriction, - expansion) *Source: Ministry of Finance*

The above table shows that the nature of fiscal policy in the very short term will be affected by two competing trends. While the government continues to consolidate public finance, the considerable increase in resources

from the EU funds will have an opposite effect on aggregate demand. **As a result, this year's fiscal policy will be restrictive and stabilising, thus helping to smooth the economic cycle. However, the expansive character of the inflow of EU funds will be more pronounced in the next few years**, because of their substantial increase, and the fiscal impulse will reach values close to zero, with the output gap simultaneously approaching zero as well.

This expected development confirms the key role of fiscal consolidation in stable macroeconomic development; yet at the same time, it also raises the issue of efficient utilisation of resources from the EU funds in supporting the growth of the economy's potential output. This will highlight the Government's role in allocating resources to priority areas, placing emphasis on the qualitative aspects of public finance.

Fiscal impulse (ESA 95, % of GDP)



Source: Ministry of Finance

III.4. General government debt

Meeting the government's fiscal objectives and the continuing sound economic growth constitute the main factors stabilising the level of both gross and net general government debt in the medium term. **By the end of 2010, the gross general government debt will reach 29.5% of GDP, while the net general government debt will reach 25.7% of GDP**, which is well below the Maastricht criterion level.

General government debt indicators

		2006	2007F	2008F	2009F	2010F
Gross debt (mil. SKK)		505 178	558 070	612 195	653 808	676 499
of which: state guarantees		19 922	0	0	0	0
Net debt (% of GDP)	(2-1)	25.7	26.5	26.7	26.6	25.7
Liquid financial assets (% of GDP)	(1)	4.8	4.1	4.1	4.0	3.9
Gross debt (% of GDP)	(2)	30.4	30.6	30.8	30.5	29.5
Change in gross debt (p.p.)		-3.7	0.2	0.2	-0.3	-1.0
growth in nominal GDP		-3.6	-2.7	-2.6	-2.2	-2.0
primary balance		2.2	1.0	0.9	0.3	-0.5
interest payments		1.5	1.5	1.4	1.5	1.3
stock-flow adjustment		-3.8	0.4	0.4	0.1	0.2
p.m. Implicit interest rate (%)	**)*	*4.8*	*5.3*	*5.1*	*5.2*	*4.5*

*) The accelerated growth of the implicit interest rate in 2007 results not only from the expected growth of interest rates but also from state loans from the Treasury (refer to the text) that have reduced the reported gross debt but not interest payments to the same extent.

Source: Ministry of Finance

The level of the gross general government debt has been decreasing gradually since the year 2000, when it reached its historic peak at 50.4% of GDP. By the year 2006, the debt had gradually decreased by 19.9% of GDP – to the level of 30.4% of GDP; in the medium term, the debt is no longer expected to decrease significantly, but to stabilise at around 30% of GDP. The main factors allowing for this significant reduction and stabilisation of the general government debt primarily include the thorough implementation of the governments' consolidation objectives, the establishment of conditions for strong and sound economic growth, improved efficiency in the management of the debt and of state financial assets, as well as the use of revenues from privatisation primarily to reduce the debt.

In 2006, the general government's gross debt decreased in nominal terms for the second year in a row, although the reduction was not as great as in 2005. The gross debt decreased despite the fact that the total value of negative factors increasing the government's liabilities reached SKK 37.1 billion. For the most part, these are liabilities arising from the need to finance the cash deficit of the state budget (SKK 31.7 billion) and to include in the debt high-risk guarantees worth SKK 4.4 billion. The rest was attributable to deposits held by non-general government organisations in the State Treasury (SKK 0.9 billion) and financial leasing (SKK 0.1 billion). However, these negative impacts have been compensated by SKK 39.6 billion of positive factors lowering the gross debt. The main source of the general government's gross debt reduction in 2006 was the increase in borrowings from the State Treasury, of which SKK 19.1 billion were used by the Debt and Liquidity Management Agency (ARDAL) for financing of the current state budget deficit. The debt reduction was also substantially helped by the appreciation of the SKK exchange rate (SKK 12.4 billion) and the paying off of high-risk state guarantees (SKK 6.3 billion). The remaining part was attributable to the payment of liabilities of other general government entities (SKK 1.8 billion).

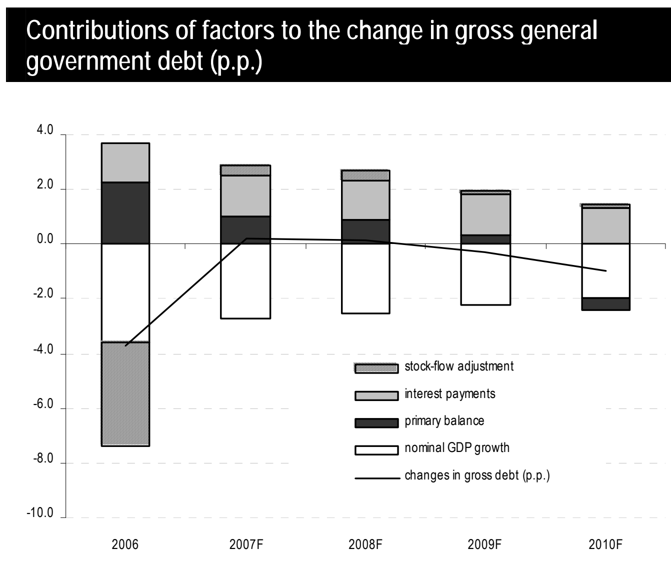
In the next few years, the debt will mainly be affected by the cash deficit of the state budget and by financing of pension reform costs using a system of borrowings from the State Treasury. Other general government entities will also contribute to an increase in the debt, mainly by way of credit facilities that municipalities and higher territorial units take out in order to implement their investment plans. As at 1st January 2007, the value of high-risk state guarantees had dropped to zero, since all state-guaranteed loans of the Railways of the Slovak Republic were incorporated in the state debt. This transaction has no effect upon the overall debt amount. In all the respective loan relationships, the State became the new debtor and these loans are to be repaid by ARDAL in the following years. Contrary to previous practice, when high-risk loans with a state guarantee were repaid from funds obtained in privatisation or from state financial assets, which had a positive impact on the debt amount, from now on ARDAL will obtain funds to repay these loans by issuing new debt.

As of 2007, the amount of resources drawn from the State Treasury to cover the state debt will gradually decrease by the amount of funds intended to finance the transformation costs of the pension reform. The lowered available liquidity in the State Treasury accounts highlights the need to refinance the state debt, more precisely the current state budget deficit, by issuing new bonds. In 2005 and 2006 increasing borrowings from the State Treasury contributed to the reduction of gross debt. But from 2007 onwards, borrowings will decrease, resulting in an increase in gross debt.

The decrease of the debt to GDP ratio is most primarily driven by the growth in GDP in nominal terms, since, in absolute terms, the GDP growth considerably outstrips the growth of debt. This means that even if gross debt was to increase in nominal terms, the debt to GDP ratio would still continue to decline at the current rate of growth in the economy. However, the debt is mainly driven by the general government balance. Even though a deficit is expected to occur during the entire forecast period, one must distinguish two deficit components – the primary balance and interest payments. Interest payments are a burden on the current budget due to the accumulation of past deficits (the current debt); therefore, they always have a negative impact on the gross debt. On the other hand, the primary balance indicates whether the current fiscal policy has a positive or negative impact on the amount of the general government's debt. A negative primary balance is expected during the entire forecast period with the exception of 2010, which means that the foreseen general government revenues will not suffice to finance the primary expenditures (exclusive of interest). The shortfall in funding must be obtained by way of borrowings, i.e. by way of taking on more debt. As the government's consolidation objectives are gradually

met, the impact of the negative primary balance will diminish. The approved budget foresees a primary surplus in 2010, which means that the budget will already be contributing to the reduction of gross debt at that time. The stock-flow adjustment will have a stable effect on the development of gross debt in 2007 – 2010, estimated at 0.1% – 0.4% of GDP.

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



Source: Ministry of Finance

In 2006, the stock-flow adjustment contributed to a decrease in debt, and achieved a high level when compared with the subsequent years. It was mainly affected by the already mentioned ARDAL borrowings from the State Treasury, by the positive development of the SKK exchange rate, decrease in liabilities towards foreign countries (either through forgiven debt or in the form of debt settlement) and the repayment of the debt from high-risk state guarantees. In the period of 2007 – 2010, this factor's level will be lower and stable, mainly as a consequence of the difference between the cash and accrual tax revenues and interest payments of the public sector, and the year-on-year change of EU receivables. Mainly the debts taken on by municipalities and higher territorial units will have a negative impact upon the debt.

Stock-flow adjustment (% of GDP)

	2006	2007F	2008F	2009F	2010F
ARDAL borrowings from the State treasury	-1.2	0.0	0.0	0.0	0.0
Difference between cash and accrual tax revenues	-0.5	0.2	0.1	0.0	-0.1
Difference between cash and accrual interest	-0.2	0.1	-0.2	-0.2	0.0
Foreign exchange differences	-0.8	0.0	0.0	0.0	0.0
Debt remission to foreign countries, deblocation of receivables	-0.7	0.0	0.0	0.0	0.0
Repayment of high-risk guarantees	-0.4	0.0	0.0	0.0	0.0
Other	-0.1	0.2	0.5	0.3	0.3
Stock-flow adjustment	-3.8	0.4	0.4	0.1	0.2

Source: Ministry of Finance

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

IV.1. Scenarios

Scenario 1. Weaker performance of the external economy

This scenario for the development of the economy simulates a negative risk in the form of a weaker-than-expected performance of the economies of Slovakia's trading partners, leading to a **slowdown in Slovakia's exports**. The simulation assumes a 3% reduction in real foreign demand in each year, 2007-2010, compared to the baseline scenario. This scenario therefore assumes that the shock has a permanent character, and that the National Bank is immediately able to identify the cause.

A simulated outage in production earmarked for export (in comparison with the baseline scenario) would increase the current account deficit. GDP, investment and consumption would all be reduced, compared to the baseline scenario, and the labour market situation would also worsen. Weaker domestic demand would subsequently be reflected in a lower rate of inflation. However, weaker economic performance would create pressure, pushing up the general government deficit (lower revenues and higher obligatory expenditures). If the pace of GDP growth fell faster than the pace of potential product growth, compared to the baseline scenario, it would be possible to reduce interest rates, which would mean that the negative effects of falling wages on private consumption (because of lower GDP and higher unemployment) would not be dramatically felt. However, compared to the baseline scenario, investments would fall much more dramatically, particularly because of a slower dynamic of FDI resulting from the generally lower foreign demand and the ensuing reduction in the need to build new production capacities. A fall in consumption and investments would slacken imports, which would gradually get on par with reduced exports, bringing the current account deficit as a percentage of GDP progressively back to the baseline scenario level. The negative effect of this permanent shock on GDP would probably culminate in the second year after the shock, when real GDP would be 0.9% lower than in the baseline scenario. The simulated risk would create negative pressures on public finances. As a result of the general slowdown in the economy until 2010, the general government deficit would be pushed up by the equivalent of 0.2 percentage points of GDP compared to the baseline scenario.

Drop in foreign demand by 3%

Relative/absolute change in values of the variables in comparison to the basic scenario
(relative change in %, absolute change in units indicated in the brackets)

	Consumer expend-iture	Gross fixed investment	GDP	Unem-ployment	CPI inflation	Short-term interest rate	Current account	Pressure on GG balance
				(`000s)	(% p.a.)	(% p.a.)	(% of GDP)	(% of GDP)
2008	-0.2	-1.4	-0.8	0.6	0.0	0.0	-0.1	-0.2
2009	-0.6	-1.9	-0.9	0.6	-0.3	-0.1	-0.0	-0.3
2010	-0.7	-1.9	-0.8	0.6	-0.3	-0.4	0.0	-0.2

Source: Ministry of Finance

Scenario 2. Higher oil prices

Since the second half of 2005, the rise in the world oil prices has been one of the most serious potential threats to the global economic growth. As the considerable increases in oil prices significantly affected the development of price indicators in Slovakia in the past, the effect of oil prices cannot be underestimated also in the current economic projections. It is important to stress that oil prices can affect the Slovak economy in two ways – directly through an increase in the price of imports, and indirectly, through a weakening of growth rates in the EU countries, thereby reducing the opportunities for Slovak exporters.

On the other hand, the effect of higher oil prices can be somewhat absorbed by the falling exchange rate of the US dollar against the Slovak koruna. Such a development is taking place in 2007, when the price of oil expressed in Slovak korunas has increased more slowly than the price in US dollars. We expect that the exchange rate will have a positive effect in the next few years too, based on the Ministry of Finance's predicted oil price of 74.9 USD/barrel in 2008 and 72.7 USD/barrel in 2009 (in accordance with the European Commission's *Common External Assumptions)*.

A model-based simulation of future trends suggests that, as a result of the expected future depreciation of the exchange rate of the US dollar against the Slovak koruna, a further moderate increase in the projected rate of growth in oil prices (compared to 2006 and 2007, and to the 2006 Convergence Programme) will not induce any significant deviation from how the major macroeconomic indicators are expected to develop under the baseline scenario. A more serious risk could lie in a significant increase in oil prices as a result of external factors connected with the stability or appreciation of the USD/SKK exchange rate. An increase in oil prices would directly push up the prices of fuel and gas and, subsequently, increase the household heating bills. According to our calculations, the effect of a 1% increase in oil prices would translate into a 0.3% increase in fuel prices. The effect on inflation would be most visible in the second year after the shock, when the secondary effects become fully apparent. Of course, should oil prices remain at the estimated level over time, their effect on inflation would be quickly exhausted; the dominant negative effect would then be a slowdown of EU and Slovak economic growth as a result of a weaker demand. Since the price of oil is a global problem, the results of our simulation take into account the general context of the economic development of the Slovak Republic within the global economy (using a multi-country model).

An increase in inflation caused by the rising prices of oil and petrochemical products would force the central bank into raise the interest rate. Higher inflation would cause a reduction in real income and, in combination with higher interest rates, would contribute to reduction in household consumption. Higher interest rates would also have a negative effect on inflation. The real economic growth would slacken and, consequently, the unemployment would rise. An economic slowdown as the result of a price shock would also have a negative effect on the current account deficit and the general government deficit, which would be negatively affected by the combination of lower revenues and higher expenditures.

Increase in oil price by 10$ (from USD 74.9 to UDS 84.9 pre barrel)

Relative/absolute change in values of the variables in comparison to the basic scenario
(relative change in %, absolute change in units indicated in the brackets)

	Consumer expend-iture	Gross fixed invest-ment	GDP	Unem-ployment	CPI inflation	Short-term interest rate	Current account	Pressure on GG balance
				(`000s)	(% p.a.)	(% p.a.)	(% of GDP)	(% of GDP)
2008	-0.6	-0.5	-0.3	0.2	0.5	0.8	-0.4	-0.4
2009	-1.7	-1.5	-0.6	0.4	0.7	1.2	-0.3	-0.6
2010	-1.9	-1.8	-0.6	0.4	0.3	0.6	-0.3	-0.5

Source: Ministry of Finance

Scenario 3 - General government interest payments

In terms of the interest cost of general government, the major risk factors comprise higher interest rates and a weaker exchange rate of the koruna compared to the baseline scenario. The following table shows the results of testing the partial sensitivities of debt to interest rates and the exchange rate (without modelling the entire Slovak economy). It should be pointed out that even the baseline scenario is based on conservative assumptions. As in previous Convergence Programmes, the Risk Scenario was defined as a technical simulation of a 5% devaluation of the exchange rate of the Slovak currency against the EUR, combined with an increase in interest rate of 1% compared to the baseline scenario, for each year of the forecast. Higher interest payments are not

expected to influence the general government deficit which is why the changes in interest payments had no impact on the plan for the issue of government bonds and government borrowings.

General government interest expenditures (ESA 95, % of GDP)				
	2007F	2008F	2009F	2010F
A. Baseline scenario	1.5	1.4	1.5	1.3
B. Risk scenario	1.5	1.6	1.7	1.5
C. Difference (B-A)	0.0	0.1	0.2	0.2

Source: Ministry of Finance

The overall risk for the general government balance oscillates around 0.2% of GDP and should be sufficiently covered by the conservative approach taken in quantifying the baseline scenario. The most felt effect on interest costs across various scenarios came from the increase in interest rates, to which 85% of the total difference can be attributed. The remaining 15% is attributable to the depreciation of the Slovak currency against EUR.

IV.2. Comparison with the previous update

The current update confirms the future development trends of the macroeconomic and fiscal parameters that were presented in last year's update of Slovakia's Convergence Programme. Corrections have been made mostly in the estimation of the magnitude of the dynamics, and for most indicators these corrections go in a positive direction, towards a more rapid and stable process of the country's convergence in both real and nominal terms. When predicting those indicators of macroeconomic developments that are important for the projection of fiscal parameters we continue to employ a very cautious approach so as not to create excessive risks in meeting the fiscal policy objectives due to overly optimistic estimates for macroeconomic development.

The 2007 update introduces higher estimates for economic growth, particularly under the influence of positive developments in foreign trade, but also because of domestic demand, supported by a positive labour-market development. Estimates for future years suggest that the growth of the Slovak economy will remain at relatively high, yet sustainable, levels. A stronger economic growth could support, to a moderate degree, the meeting of fiscal objectives, having a positive impact on the reduction of the general government deficit and, with some delay, also on the debt-to-GDP ratio.

Comparison between the previous forecast and the updated forecast						
	ESA code	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
Real growth of GDP (%)						
Previous update		6.6	7.1	5.5	5.1	-
Reality and current update		8.3	8.8	6.8	5.8	5.0
Difference		1.7	1.7	1.3	0.7	-
General government balance (% of GDP)	EDP B.9					
Previous update		-3.7	-2.9	-2.4	-1.9	-0.9
Reality and current update		-3.7	-2.5	-2.3	-1.8	-0.8
Difference		0.0	0.4	0.1	0.1	0.1
Gross general government debt (% of GDP)						
Previous update		33.1	31.8	31.0	29.7	-
Reality and current update		30.4	30.6	30.8	30.5	29.5
Difference		-2.7	-1.2	-0.2	0.8	-

Source: Ministry of Finance

V. QUALITY OF PUBLIC FINANCES

V.1. Policy strategy

The consolidation of public finances is the pivotal medium-term goal of the government underlying the government's measures in fiscal policy. The government, however, is aware of its key role in forming economic policy, the main goal of which is facilitating the increase in the standard of living, and catching up with the developed EU Member States. The priority of the government is therefore the harmonisation of policies, so that consolidation objectives do not threaten the high and sustainable growth rate of the economy. The question of quality of public finance is therefore gaining in importance.

The main goals of government policy, set out in its Manifesto, represent a continuity with the priorities identified in the previous update of the Convergence Programme. The key priorities are health care, education and agriculture. Alongside these sectors, attention is also concentrated on the pension system, and on promoting a better standard of living in the regions of Slovakia, with the goal of reducing regional disparities.

In addition to these measures, adjustments are being carried out which should result in better efficiency in the general government. The first concrete step is downsizing the number of civil servants in central government by 10%. Other plans for improving public administration concern the public procurement process, where it should be possible to make significant savings. However, as in previous years, the main source of consolidation will consist in allocating funds for government spending policies strictly in line with economic growth and with the resulting increase in tax revenues, while respecting the government's consolidation objectives, as reflected in the budgeted general government deficits according to the ESA 95 methodology.

This chapter outlines the main trends of medium-term development of general government revenues and expenditures. The starting point for this analysis are the data in the economic classification, since reliable data which would allow for a functional classification according to COFOG are not available at this time. Although progress has been made in eliminating shortcomings with the data, it is still not possible to present the data of sufficient quality.

V.2. Revenue developments

The Slovak government continues to address its priorities and goals, including through modifications to the tax and social contribution system. The following table summarises the projected impact of proposed measures, which have a positive effect on general government revenues in future years. Nevertheless, the overall level of the tax burden as a percentage of GDP should decline slightly.

Quantification of the impact of legislative changes on general government revenues (ESA95, SKK mil.)

	2007	2008	2009	2010
1. CIT - amendment of the Act on Income Tax	100	2 701	2 601	-625
2. VAT - lower rate (10%) on books and selected medical aid tools	-	-320	-338	-357
3. VAT - taxation of returnable bottles	-	-18	-10	-10
4. Excise taxes - electricity, coal and natural gas	-	429	883	1 711
5. SC - increase of max. assessment base - impact on the SIA revenues	-	1 816	1 742	1 555
- impact on tax revenues	-	-391	-374	-333
6. SC - optional entry/exit to/from the 2nd pillar - one-off impact on the SIA	-	2 416	-	-
- long-term impact on the SIA	-	1 048	1 115	1 192
TOTAL IMPACT ON GG BALANCE	100	7 681	5 619	3 133

Source: Ministry of Finance

Significant changes in the tax system concern mainly the corporate income tax. There has been a tightening of the regulations governing the tax deductibility of provisions for outstanding claims (in the case of banks and corporations) and reserves (in the case of insurance companies). Some of these changes will be applicable to the tax return filings for 2007, which in turn will produce more robust corporate income tax revenues for this year according to the ESA 95 methodology. In understanding the trend in tax revenues, it is important to recognize that the measures with the greatest impact have neutral consequences in the medium-term. The main aim of these modifications is to make systemic improvements to the regulations governing corporate income taxation and to prompt the taxable persons concerned to take a more pro-active approach to managing their outstanding receivables.

Another important change implementing Council Directive No. 2003/96/EC into the Slovak tax system widens the range of goods subject to excise tax to include electricity, coal and natural gas. The collection of excise tax on these commodities will begin on 1 July 2008, whereby the minimum rate of tax on coal, as set by the EU, should be reached in 2008, while for electricity and natural gas the EU minimum rate of tax should be reached in 2010.

As far as excise taxes are concerned, in addition to the changes mentioned above, a number of other adjustments will be implemented. To ensure harmonisation at the EU level: the long-planned gradual increase of excise tax on cigarettes. The excise tax on these commodities will be increased at the beginning of 2008 and 2009, so that in 2009 it reaches the minimum level of taxation required by the EU.

In the course of this year, the Slovak government has given rise to a society-wide debate on the pension system by way of proposing amendments to Social Insurance Act and Act on the Fully-funded Pension Scheme. The main goal is to stabilise the medium-term financial situation in the PAYG pillar. The proposed amendments to the aforementioned acts bring two significant changes which would have an influence on the revenue side of the general government. The first is an increase of the maximum assessment base for the calculation of social contributions from three to four times the average wage. This change is not accompanied by any increase in obligations on the expenditure side of the insurance system. This measure will increase the revenues of the Social Insurance Agency, which will however be partially offset by a reduction in tax revenues of the general government by reason of a lower personal tax base, higher labour costs incurred by employers, and a decline in the disposable income of households.

The second significant change is the proposal to allow the fully-funded pillar contributors to return solely to the PAYG pillar or to allow all persons to enter into the fully-funded pillar during the first six months of 2008. It is expected that overall some 5% of the contributors will use the opportunity to change pillars, whereby the number of contributors to leave the fully-funded pillar should markedly outstrip the number of persons to enter the fully-funded pillar. This change will have two effects on the Social Insurance Agency balance. The first is a one-off effect, since each fully-funded pillar contributor who decides to leave this pillar will bring all their savings accumulated from 2005 (or from their entry to the fully-funded pillar) to 2007 into the Social Insurance Agency. Secondly, and with a long term effect, as a result of each such individual decision, the amount of funds transferred to the fully-funded pillar from 2008 onwards will be reduced. The above table takes also account of the adverse impact (from the perspective of public finances) resulting from the decisions of those pension scheme members who opt to join the fully-funded pillar. Although the period of time is limited, the introduction of an element of free choice in the decision to participate in a specific system creates an adequate space for the individual to seriously weigh his judgement. This step will give each individual the possibility to reconsider their initial decision to participate in a specific system by way of being able to compare the current legislative development against the initial expectations.

There will also be changes in health insurance contributions in 2008, the contributions paid by state on behalf of the certain groups of persons defined by the law will increase to 4.5% of the assessment base[16]. Following the introduction of a lower rate of VAT for medicines and selected medical aid tools in 2007, the government will

[16] In the first four months of 2007 the state transferred 5% of the assessment base of these persons, in the remaining months of the year this fell back to 4%.

widen the range of medical aid tools eligible for the lower rate of VAT in 2008 to include medical aid tools for patients suffering from incontinence. These measures represent an increase in the resources at disposal for one of the government's priority sectors.

In evaluating the consolidation path, it is important to remember that, in the 2007-2010 period, revenues from taxes and social contributions, expressed as a percentage of GDP, will fall in aggregate terms by an amount equivalent to about 0.8% of GDP. Looking at the structure of tax revenues, we primarily expect a downturn in indirect taxation; in the case of excise taxes this is mainly due to the stockpiling effect recurring before each expected increase in the tax on cigarettes. But non-tax revenues will decline even further, by the equivalent of up to 1.0% of GDP. The main cause of this decline are lower expectations concerning dividend payment (in nominal terms) from state owned companies. The European Union funds will gradually play a larger role in general government balance, rising by an amount equivalent to 1.7% of GDP during the same period. However, this fact creates no additional room for the reduction of the deficit; quite the opposite is true. Mainly capital expenditures will rise equiproportionately, which, however, will result in higher requirements for co-financing from the state budget to accompany the EU funds.

V.3. Expenditure developments

Developments on the expenditure side in 2008 to 2010 will be influenced on the one hand by efforts to increase the quality of general government functioning, and on the other hand by the government's priorities: education, health care and agriculture Regional development issues will also receive attention.

Measures to improve the effectiveness and efficiency of general government expenditures focus on wages and public procurement. Analyses were carried out in the central government institutions in 2006 and 2007, reviewing labour efficiency in carrying out assigned tasks, with the goal of identifying the downsizing potential. The result is a reduction of approximately 10% in the number of central government employees, which, as well as increasing efficiency, should produce annual savings of SKK 2.5 billion in the years 2008 to 2010.

The second significant area involves expenditures related to public procurement. Initial steps have been taken here, in an attempt to increase pressure for a more effective use of general government expenditures. Preliminary estimates indicate that there is room for savings of up to 10%, which in 2008 would represent some SKK 7.3 billion.

Concerning its priorities, the government has continued in the education sector, raising the salary level of teaching staff in primary and secondary schools, with the intention of bringing these wages up to the average wage in the national economy. The general government budget for 2008-2010 provides for an 8.9% increase in teachers' salaries in 2008, whereby this target will have been reached. The school network is also being rationalised, to take account of the falling number of children of school age For the same reason, the number of teachers should decline by 2.8% in 2008. In the period until 2010, a significant increase in EU funds is expected in the education sector, rising from 0.1% of GDP in 2007 to 0.5% of GDP in 2010.

Agriculture is another of the government's priorities, and this is reflected in an increase in planned subsidies to the sector. In the 2008-2010 general government budget direct payments in 2008 (as in 2007) will be at the maximum level, which is 80% of the EU average. The level of subsidies in 2009 and 2010 will depend on the budgetary possibilities in the respective years. For the moment, the minimum level of subsidies determined by the EU is budgeted.

The creation of conditions for growth in living standards in the various regions of Slovakia, with the aim of reducing regional disparities is an area of concern for the government. Practical measures are aimed at improving the conditions to facilitate the entry of foreign investors. The government has undertaken to improve the administrative approval process for investment projects by way of adopting the Large-Scale Companies Regional Aid Scheme. There has also been an SKK 3 billion increase in the 2008 budget allocation for investment

incentives. Transport infrastructure is another important factor in regional development. The government's goal is to speed up the construction of the motorway and expressway system, so as to connect the various regions of the country, using Public-Private Partnership (PPP) projects. EU funds will also play an important part in the process of regional development, whereby a major part of the funds will be committed to this purpose, as laid down in the approved National Strategic Reference Framework.

The expected decline of labour costs by the equivalent of 0.8% of GDP between 2007 and 2010, as a result of the downsizing in central government, will be an important contribution to the consolidation of expenditures. But the major expenditure factor in consolidation will be an expected reduction in current transfers by 1.1% of GDP between 2007 and 2010. Here, the largest reductions will be achieved in old-age and disability benefit payments, the reasons being an expected lower valorisation of benefit payments (resulting from the development of the relevant macroeconomic indicators) as well as a gradually higher retirement age for women (increase to 62 years of age by the year of 2015). Another important source of consolidation will be the reduction in expenditure on social benefits, as the number of beneficiaries should drop as a result of the positive macroeconomic development.

The level of capital expenditures should increase significantly in the coming years, exceeding 4% of GDP by the year 2010. This is because of the expected increase in the use of the structural funds from the Cohesion Fund, of which a significant amount should be directed to regional development projects, particularly in the areas of infrastructure, education and the environment. However, the actual development of capital expenditures is conditional on the ability and the speed in using these resources.

General government revenue and expenditure in years 2002 and 2010 (ESA 95, % GDP)

	2002E	2006E	2007B	2007E	2008B	2009B	2010B	2010B-2007E
TOTAL REVENUES	37.4	33.9	33.5	33.8	33.7	33.2	33.8	0.0
Tax revenues	18.0	16.8	17.1	17.0	16.8	16.6	16.6	-0.4
Personal income tax	3.3	2.5	2.6	2.5	2.6	2.6	2.7	0.1
from dependent activity	2.9	2.2	2.2	2.2	2.3	2.3	2.3	0.1
from self-employment	0.4	0.3	0.4	0.3	0.3	0.3	0.3	0.0
Corporate income tax	2.5	2.8	2.7	2.9	3.0	3.1	3.0	0.1
Witholding income tax	0.8	0.3	0.2	0.3	0.3	0.3	0.3	0.0
Property taxes	0.5	0.4	0.4	0.4	0.4	0.3	0.3	-0.1
Value added tax	7.0	7.4	7.5	7.2	7.1	7.0	7.0	-0.2
Excise taxes	3.0	2.9	3.2	3.2	3.1	2.9	3.0	-0.2
Road tax	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.0
Taxes from international trade and transactions	0.4	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Taxes on specific services (municipalities)	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.0
Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	14.3	11.6	11.3	11.5	11.7	11.2	11.2	-0.4
Social Insurance Agency	8.4	6.9	6.7	6.7	6.8	6.6	6.5	-0.2
Health insurance companies	5.0	4.7	4.6	4.9	4.9	4.7	4.7	-0.2
National labour office	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-tax revenues	4.8	3.9	3.2	3.5	3.3	2.7	2.5	-1.0
of which Interest	0.7	0.3	0.2	0.2	0.3	0.2	0.2	0.0
Grants and transfers	0.2	1.5	1.9	1.8	1.8	2.6	3.5	1.7
of which from the European Union	0.0	1.3	1.8	1.7	1.8	2.6	3.5	1.9
TOTAL EXPENDITURES	45.5	37.6	36.4	36.3	36.1	35.0	34.6	-1.7
Current expenditure	38.0	33.6	33.3	32.7	32.6	31.3	30.6	-2.1
Compensation of employees	7.5	6.6	6.7	6.6	6.2	5.9	5.8	-0.8
- Wages and salaries	5.5	4.9	4.9	4.9	4.6	4.4	4.3	-0.6
- Employers´ social contributions	1.9	1.6	1.8	1.7	1.6	1.5	1.5	-0.2
Goods and other services	9.8	10.0	9.3	9.3	9.4	9.6	9.3	0.0
- Health insurance companies	4.9	4.4	4.5	4.6	4.6	4.5	4.5	-0.2
- Other	5.0	5.6	4.9	4.7	4.8	5.1	4.8	0.1
Subsidies and transfers	17.1	15.5	15.5	15.4	15.5	14.3	14.2	-1.1
- Agricultural subsidies	0.7	0.8	1.0	1.0	1.2	1.0	1.0	0.0
- Transport subsidies	0.4	0.8	0.7	0.7	0.7	0.6	0.6	-0.1
- Housing subsidies	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.0
- Active labour market policy	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.1
- Sickness benefits	0.8	0.3	0.3	0.3	0.3	0.3	0.3	0.0
- Old-age and disability pensions	7.2	6.9	6.9	7.0	6.7	6.5	6.5	-0.4
- Unemployment benefits	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.0
- State benefits and social assistance	3.0	2.0	1.8	1.8	1.8	1.6	1.5	-0.3
- Social contributions on behalf of certain groups	2.2	2.0	2.1	2.1	2.1	2.0	2.0	-0.1
- Transfers to the EU budget	0.0	0.8	0.9	0.9	0.9	0.8	0.8	-0.1
- Transfer of 2% of income tax to the third sector	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0
- Other subsidies and transfers	1.8	1.3	1.2	1.2	1.3	1.1	1.1	-0.2
Interest	3.6	1.5	1.8	1.5	1.4	1.5	1.3	-0.2
Capital expenditures	7.6	4.0	3.1	3.6	3.5	3.7	4.0	0.4
Capital assets	3.2	2.3	1.5	1.7	1.9	1.5	1.4	-0.3
Capital transfers	4.4	1.7	1.6	1.9	1.6	2.2	2.6	0.7
General Government balance	-8.2	-3.7	-2.9	-2.5	-2.3	-1.8	-0.8	1.7
Impact of the 2nd pillar	0.0	-1.2	-1.1	-1.3	-1.3	-1.3	-1.4	-0.1
GG balance excluding the impact of 2nd pillar	-8.2	-2.5	-1.8	-1.2	-1.0	-0.5	0.5	1.7

Note: In the 2008-2010 GG Budget, expenditures from the EU funds concerning the programme period 2007-2013 are almost fully allocated on item Goods and other services. For the sake of comparability, allocation of these funds among current and capital expenditures was estimated by the MoF taking into account the trends in previous years.

Source: Ministry of Finance

V.4. Linkage of the Convergence Programme with the National Reform Programme

With respect to the budget, it is important that structural policies and reforms are in line with the government's fiscal objectives, which define the financial framework for these policies. This section provides an overview of the way the fiscal objectives are aligned with the objectives set out in the Lisbon Strategy, which is an important aspect of the quality of public finances.

The goals and objectives of the National Lisbon Strategy are presented in the 2006 – 2008 National Reform Programme of the Slovak Republic (NRP) which was presented to the European Commission in October 2005. Since these objectives were not transposed into concrete measures covering the whole 2006-2008 programming period, the Slovak government prepared an Addendum to the NRP.

The NRP identifies priorities in two key areas. The goal is sustainable long-term growth in the economy and in the living standard of the population:

- employment and education policy,
- microeconomic policies – science, research and innovation, business environment, information society; in the Addendum to the NRP energy and environmental policies were added.

The current state of implementation of the NRP is presented in the Progress Report on the Implementation of the 2006-2008 National Reform Programme (hereafter the "Implementation Report") approved by the Slovak government and submitted to the European Commission in October 2007.

The financing of the aforementioned Lisbon objectives stems in large part from the public funds of the Slovak Republic and from the funds of the EU. The implementation of the NRP must comply with the medium-term plan for fiscal consolidation in order to safeguard the sustainability of public finance. For this reason, the effort to meet the individual priorities must always respects the given fiscal framework in the general government budgeting process. Although most of the proposed measures increase public expenditures, in the medium- and long-term they will contribute to economic growth, therefore they are considered as investments.

In the interest of ensuring consistency between fiscal and Lisbon objectives, the Coordination Committee on the Fiscal Aspects of the NRP was set up in August 2007, its members being the State Secretaries of the relevant ministries and institutions involved. The Committee focuses on coordinating NRP structural policies with macroeconomic and fiscal policies. A system for recording expenditure according to the general categories of the National Lisbon Strategy is under preparation, and will be incorporated into the 2009-2011 General Government Budget.

Thanks to a concerted effort, this year's Implementation Report presents measures which are financed from the 2008-2010 General Government Budget or are to be financed from EU funds. In the Implementation Report Assessment Grid, the main reform measures are identified and valued according to the new common methodology developed by the European Commission.

Expenditures on reform measures included in Progress Report's assessment grid (SKK mil.)

Key challenge	No.	SB 2007	SB 2008	ESF 2008	SF 2008	Total 2008
Education	10	60	66	303	-	369
Employment	8	-	0	7 121	-	7 121
Research, Development and Innovation	9	202	116	-	1 730	1 846
Business Environment	10	-	3 386	-	951	4 337
Information Society	13	221	212	-	2	213
Environmental Policy	5	8 102	2 968	-	-	2 968
Energy Policy	3	-	350	-	1	351
Total	58	8 585	7 097	7 424	2 684	17 204

Note: SB – State Budget, ESF – European Social Fund, SF – Structural Funds

Source: Progress Report NRP 2007

VI. SUSTAINABILITY OF PUBLIC FINANCES

The sustainability of Slovak public finances was first set out in the Convergence Programme of May 2004. Since that time the question of long-term sustainability has been covered in other major government documents, most significantly in the general government budgets. The 2005-2007 General Government Budget contained a separate addendum which defined long-term sustainability of the general government as the basic goal for fiscal policy. This brought the issues of sustainability of public finances, as well as the measures necessary to ensure sustainability, to the attention of the professional and general public; more importantly, they became a guiding framework for political decision-making.

VI.1. Policy strategy

The long-term sustainability of public finances has an economic and a moral dimension. From the economic point of view, sound public finances are an essential precondition for high and sustainable economic growth. The moral dimension lies in ensuring intergenerational justice. This is because public budgets do not just reallocate resources between different groups of the population (solidarity) but also between generations. Carrying out a policy of high deficits and debts automatically means requiring future generations to pay the cost – usually through higher taxes.

From this perspective Slovakia belongs among responsible countries. This is above all due to the realisation of ambitious goals in fiscal consolidation, which automatically contributes to reductions in general government debt. This has been confirmed by the European Commission, which lists Slovakia among the medium-risk countries in its assessment of the sustainability of public finances. Reforms in the retirement pension system had a positive effect on Slovakia's assessment, since they reduced pressure for increased expenditures linked to the future ageing of the population. However, the general government deficit is still high, indicating a need for further consolidation effort. A positive initial fiscal position is the basic precondition for the ability of public finances to absorb the future negative consequences of demographic developments. Reducing the general government deficit is therefore a central medium-term goal of fiscal policy.

The main fiscal-policy objective in the area of public finance is to reduce the cyclically-adjusted general government deficit, net of one-off effects, to 0.8% of GDP by 2010. This level is within the range which the European Commission recommended for Slovakia in setting the medium-term goal for the revised Stability and Growth Pact. The Slovak government has decided to amend its medium-term objective downwards by 0.1% of GDP, from 0.9% to 0.8% of GDP, setting a more ambitious objective than in the previous Convergence Programme. Providing that the necessary additional measures are taken, the Slovak Ministry of Finance believes that this will also create conditions for the long-term sustainability of public finances. These necessary measures include parametric changes in the pension system, additional consolidation effort in 2010 representing 1.0% of GDP, and introduction of policies which will ensure that increases in public expenditure in proportion to economic growth.

The Ministry of Finance defined the long-term sustainability of public finances in the first Convergence Programme in May 2004. **The general government deficit must not exceed 3% of GDP and general government debt 60% of GDP by 2080.** This definition takes into account the demographic conditions in Slovakia and the basic principles of the Stability and Growth Pact. It is also sufficiently concrete and measurable to enable the setting of political objectives.

The basic precondition for achieving sustainability of public finances is to attain the medium-term objective by 2010. This would establish a favourable starting position for public finances. Notwithstanding the realized reforms in pension system and additional consolidation measures, the negative implications of the ageing population must be dealt with by further structural reforms not only in the pension system, but also in the healthcare sector. Higher employment, productivity and economic growth are not just the only sustainable sources of growth in the standard of living of the population; they can also make a significant contribution to the sustainability of the pension

system, and the consolidation of public finances. Higher employment and productivity are only objectives; it is the measures taken towards achieving which are decisive from the political point of view. According to the Ministry of Finance, the fundamental policies in this area include the relatively low and effective tax burden, flexible labour market, and flexible markets for goods and services.

VI.2. Long-term budget projections with a view to population ageing

Population ageing is a global phenomenon, which currently affects mainly the industrially advanced economies. Slovakia is no exception. This question has received special attention within the European Union in recent years. An Ageing Working Group (AWG) has been established to cooperate with the European Commission in analysing those expenditures that are sensitive to demographic trends, and identifying implications for the overall development of public finances. The purpose is to obtain comparable information, as complete as possible, concerning the risks associated with the expected demographic change. In February 2006 new forecasts were approved and published for the public[17].

According to the Code of conduct, Member States are obliged to present the projections produced by AWG in their Convergence Programmes. Slovakia endorsed these projections at an expert level within the AWG and the Ministry of Finance therefore fully accepts them and uses them for its own analyses. The European Commission assesses the long-term sustainability of fiscal positions and fiscal objectives against these projections. Since the joint projections prepared by AWG will not be updated before 2009, Member States have a possibility to provide in their Convergence Programmes information about developments which may have a significant impact on the long-term sustainability of public finances. This particularly concerns projections for pension systems, which each country produces separately for the AWG. If a country embarks on pension system reform which has a significant impact on long-term sustainability, the country may ask for the revision of the projections also before 2009. This ensures that the projections are up-to-date and so are the ensuing recommendations for economic policy.

It is therefore important to state that **there have been no developments in Slovakia since the most recent publication of joint projections which could have a significant impact on the balance of the pension system, and thereby on the long-term sustainability of public finances.**

In Chapter III.2 – Current developments, the current state of the pension system is described. Despite the reforms carried out, the current pension system represents a major burden for public finances. The major political and policy debate focuses on the identification of reasons why the pension system is not developing in line with the assumptions postulated before the launch of the reform. These, on the one hand, include the negative consequences of the parameters set for the PAYG pillar and, on the other hand, a shortfall in the PAYG pillar revenues to the benefit of the fully-funded pillar. While, in the first case, the PAYG pillar impairs the long-term sustainability of public finances, the second factor will actually ease the burden on public finances in the future. When assessing the long term sustainability of public finances, it is important to bear in mind that **the long-term projections for the pension system, presented to the AWG at the end of 2005, already take into account the current situation in the pension system.**

The prepared changes in the pension system as of 1 January 2008 warrant a mention here. The stricter eligibility criteria for early retirement and an increase in the maximum assessment base for pension insurance and contributions to the fully-funded pillar are expected to have an immediately positive influence on the balance of the PAYG pillar. At the same time, individuals are not likely to show any significant preference for PAYG once contributions to the fully-funded pillar has become optional. **The overall impact of these legislative proposals should have a positive effect on the long-term sustainability of the pension system.**

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[17] Economic Policy Committee and European Commission-DG ECFIN (2006) 'The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Reports No 1, 2006, ("Ageing Report")

This section has two parts. The first part quantifies the problem with which public finance in Slovakia will have to deal in the future. The second part outlines a certain number of sustainability indicators. This entails quantified measures in the area of fiscal policy, which will have to be adopted now in order to resolve the problem of the sustainability of public finance. Both parts present the calculations of the European Commission made within the process of evaluating the 2006 Convergence Programme. The Ministry of Finance fully accepts this calculation method and only adds its comments to the results.

Long-term projections of revenue and expenditures sensitive to population ageing

The AWG has identified those expenditures of the general government that may be positively or negatively influenced by demographic changes. These include expenditures on pension payments, health care, long-term care, education and unemployment benefits. The first three types of expenditure will rise in the future, while expenditure on education and on the unemployed will fall – less children, falling unemployment, less people in the labour market

In addition, changes in the revenue of the pension systems have been taken into account for a number of countries, including Slovakia. In the Slovak case, this entails a shortfall in the general government revenue associated with the launch of the fully-funded pillar of the pension system.

Interest on the public debt represents the last item sensitive to the ageing of the population. The above factors influence the growth of the deficit, and thereby the general govrnment debt. A higher debt automatically requires higher interest payments to service it.

Changes in general government revenues and expenditures induced by demographic changes (% of GDP)

	2004	2010	2020	2030	2040	2050	Change 2004-2050
A. Revenue shortfall (loss due to 2nd pillar)	0.0	-1.3	-1.5	-1.7	-1.7	-1.9	-1.9
B. Expenditures sensitive to population ageing	16.2	15.4	15.3	16.5	17.7	19.1	2.9
- pension benefits	7.2	6.7	7.0	7.7	8.2	9.0	1.8
- health care	4.4	4.7	5.2	5.7	6.0	6.3	1.9
- long-term care	0.7	0.8	0.7	0.9	1.1	1.3	0.6
- education	3.7	3.0	2.2	2.2	2.3	2.4	-1.3
- unemployment benefits	0.3	0.2	0.1	0.1	0.1	0.1	-0.2
C. Interest expenditures	2.2	1.6	2.1	3.3	5.9	10.3	8.1
Impact on general government balance							-12.8
p.m. Gross debt	*41.6*	*32.4*	*41.3*	*65.2*	*117.1*	*205.4*	*163.8*

**Current legislation status*: retirement age 62 years, valorisation 50:50 (wages, inflation), 2nd pillar implemented

Source: Ageing report (February 2006), The sustainability of public finances: the 2006/07 updates of stability and convergence programmes (March 2007)

Unless corrective measures are taken, negative demographic trends will inflate the general government deficit by 12.8% of GDP by the year 2050, bringing general government debt to 163.8% of GDP. These calculations are based on an AWG projection using 2004 as a starting point. That year was taken because no more recent calculations are officially available as of yet. The above-mentioned projections for Slovakia take into account all major measures, including introduction of a fully-funded pillar, increase of the retirement age to 62, valorisation of pensions using the Swiss method, and the like. In that sense, the calculations are based on the current situation. However, since these projections should above all serve as an aid to political decisions regarding the medium-term and long-term goals of government, they must be updated every year to reflect the actual fiscal position (size of the deficit and general government debt) which the country has reported in the most recent Convergence Programme.

These results have two basic implications for fiscal policy. The first implication may come as a surprise in that the most negative element will ultimately be the interest payments on the general government debt. This shows how important it is to use every opportunity to reduce the general government debt. In the Slovak context these opportunities stem mostly from higher-than-expected tax revenues and receipts from privatisation. The second implication for fiscal policy relates to the fully-funded pillar of the pension system. The introduction of this pillar has indeed reduced the general government revenues (immediately and prospectively), yet it will also reduce public expenditure on old-age and survivor pensions in the future. In other words, if the fully-funded pillar had not been introduced, then by 2050 the general government deficit would have increased not by 12.8% of GDP but by 16.7% of GDP.

Assessment of long term sustainability

In assessing the long-term sustainability of public finances, it is essential to establish mutual consistency of the short- or medium-term fiscal objectives with the long-term ones. In the European Union, the assessment process is based on indicators of sustainability. The assessment does not merely end with a judgement of whether or not public finances are sustainable, but, through the use of concrete indicators, quantifies the magnitude of the fiscal measures to be taken in order to attain sustainability.

The European Commission uses the following quantitative indicators[18]:

1. *Indicator S1* – the value, by which the primary balance must change (through increased taxes or reductions in “non-interest” expenditures) so that the level of general government debt in the year 2050 is 60% of GDP.
2. *Indicator S2* – shows by how much the primary balance must change (as with S1) so that the current level of government liabilities (current debt) and the discounted value of future expenditures are covered by the discounted value of future revenues in an indefinite horizon. No specific year and no specific level of debt are thus defined. The key is that the debt must be sustainable, and is not likely to “explode” in the future. This is not covered by Indicator S1, which only ‘targets’ a certain level of debt.
3. *RPB – Required Primary Balance* – This indicator is based on S2, but presents the result in another way. It indicates what average primary balance should be maintained over the next five years in order to attain long-term sustainability, as defined with the help of Indicator S2.
4. *Costs of delay* – indicates the growth in S1 or S2 if the deficit reduction needed to attain long-term sustainability is delayed for five years.

The Ministry of Finance accepts the methodology used by the European Commission in calculating the sustainability indicators, and therefore fully incorporates these into the Convergence Programme. The calculations are based on the 2006 data contained in the 2006 Update of the Convergence Programme (apart from the cyclical budget position, for which the European Commission uses its own calculations). The important parameters of calculation include the current deficit level, current debt, and the level of future public expenditure sensitive to demographic changes, which are assumed to develop in accordance with the previously-mentioned AWG projection. An important assumption is that the Commission takes into account only the actual legislation (year 2006) and its effects on the future growth of these expenditures. The planned changes and reforms are thus not taken into account in the calculations. Demography-unrelated revenues and expenditures are constant as a percentage of GDP over the entire period. In other words, only those revenues and expenditures which are influenced by the ageing of the population are considered to have an impact on the deficit level.

[18] European Commission-DG ECFIN (2006) ‘Long-term sustainability of public finances in the European Union‘ European Economy, No 4, 2006, (“Sustainability Report”)

Quantitative indicators of long-term sustainability of public finance (2006 scenario)				
	Value	Initial fiscal position	Requirement for debt in 2050 (60% of GDP)	Change of the primary balance within a long-term horizon
S1 Indicator	2.4 (1.3)	1.9 (0.7)	-0.5 (-0.5)	1.0 (1.1)
S2 Indicator	4.1 (3.0)	2.2 (0.9)	-	2.0 (2.1)
RPB	2.8 (2.9)			

** values from the previous year´s CP update are displayed in parentheses (2005 scenario)*

Source: The sustainability of public finances: the 2006/07 updates of stability and convergence programmes (March 2007)

The indicators in the table are interpreted as follows. For Slovakia's general government debt in 2050 to be 60% of GDP, the government (in 2007) should increase taxation and/or reduce expenditures by an amount equal to 2.4% of GDP (Indicator S1). This necessary fiscal consolidation of 2.4% of GDP can be divided into three components. Consolidation equivalent to 1.9% of GDP is necessary because of the high current deficit[19]. However, because Slovakia's general government debt is relatively low, this would make it possible to loosen fiscal policy (reduce taxes and/or increase expenditures) by an amount equal to 0.5% of GDP. The third factor are the demographic trends themselves, which call for a consolidation equivalent to 1.0% of GDP in 2007.

The interpretation of Indicator S2 is similar. Unlike S1, the goal is not a specific level of debt in a given year, but the overall sustainability of that debt In the given conditions, it is hardly surprising that the necessary consolidation is significantly higher, and in 2006 was close to 4.1% of GDP.

Unlike long-term fiscal forecasts, these indicators are updated every year. Their main role is to remind us that the country will face a fundamental fiscal problem in the relatively distant future, in the Slovak case in some 40 to 50 years. However, the solution to that problem is in the hands of today's politicians. If the government reduces the general government deficit and general government debt today, the size of fiscal consolidation necessary in the future will be much smaller. On the other hand, the longer it is before corrective measures are adopted, the more serious (more fiscally severe) they will have to be. And the greater the necessity for fiscal consolidation, the greater the negative effect on living standards, since in such a situation consolidation always means above all paying off old debts, at the cost of future development.

[19] In comparison with the previous year, the value of the indicator for the initial fiscal position rose from 0.7 to 1.9. This is because the "starting point" for the calculation was the primary balance for 2006, and not 2005 as was used in the 2006 Convergence Programme. Since the fiscal position worsened from -2.9% of GDP in 2005 (EC: Economic Forecasts - Spring 2006) to -3.7% of GDP in 2006 (2006 Update of the Slovak Republic's Convergence Programme), this difference was adequately reflected in the sustainability indicators. In future years, according to the proposed budget for 2008-2010, the opposite trend is expected – a faster rate of consolidation will lead to an improvement in the sustainability indicators.

VII. INSTITUTIONAL ASPECTS OF PUBLIC FINANCE

Effective functioning of fiscal rules, institutions and procedures at the national level can substantially affect fiscal discipline, thus contributing to the long-term sustainability of public finance. The current changes in this area are aimed at improving the quality of the budgetary process by changing the rules for fiscal management of various general government entities, and by introducing a uniform system of general government accounting and reporting.

VII.1. Rules for fiscal management of general government entities

The fiscal management of general government entities throughout the fiscal year is governed by three fundamental laws: the State Budget Act for the respective budget year, the General Government Budgetary Rules Act, and the Local Government Budgetary Rules Act. The fundamental principles of these three laws were described in the November 2005 Convergence Programme of the Slovak Republic. Since that period, certain changes have taken place, of which the most significant are described in the following section.

General Government Budgetary Rules Act

The General Government Budgetary Rules Act is a fundamental piece of legislation establishing the framework for the fiscal management of all general government bodies. It stipulates the rules for the preparation and implementation of the general government budget.

An amendment to this Act has introduced a regulatory mechanism for PPP projects (concessions on construction works) - applicable to all general government entities, except for municipalities and higher territorial units. The projects entailing the cost of construction above SKK 100 million are subject to approval by the government of the Slovak Republic. In all such cases, the Ministry of Finance shall prepare for the government an analysis of the potential impact of the project on the general government debt, calculated according to the uniform methodology applicable across the EU.

Another amendment to the Act gives public universities a higher degree of flexibility in taking loans subject to compliance with the rules set forth in the law. Public universities may take on loans if the total amount of their debt does not exceed 60% of their actual revenues in the preceding fiscal year, excluding subsidies from the state budget, and if the total of their annual instalments for loans does not exceed 25% of their actual revenues in the preceding fiscal year, excluding subsidies from the state budget. Public universities may not use state subsidies to service their debt.

Local Government Budgetary Rules Act

Although the basic provisions of the General Government Budgetary Rules Act apply to local government entities, also a separate regulatory mechanism exists in their case.

This Act specifically addresses the implementation of PPP projects (concessions on construction works) by municipalities and higher territorial units, as well as by the legal persons founded by municipalities and higher territorial units. Local government entities are obliged to notify the Ministry of Finance of the Slovak Republic of their intention to implement such a project; the Ministry will then prepare an analysis assessing the impact of the project on the general government debt, calculated according to the uniform methodology applicable across the EU. Where such a project has an impact on how the general government debt is reported (in other words, if the project needs to be classified in accounting terms in the general government sector), the decision on its

implementation must duly consider compliance with both fiscal rules[20] covering the entity's total debt and its annual instalments. Provided that the implementation of the project has no effect on general government debt, the decision will take into account only the rule regarding the maximum amount of the entity's annual debt service. The minimum project value to which these rules apply depends, for municipalities, on the number of their citizens. In the case of higher territorial units, the threshold is set to SKK 100 million.

An additional room has also been created for local governments to increase their revenues from the EU funds. The new legislation specifically addresses the question of the funds necessary to pre-finance joint programmes of the Slovak Republic and the EU; these funds will no longer be included in the total debt amount of the municipality/ higher territorial unit for the purpose of assessing compliance with the fiscal criteria.

VII.2. Introduction of a uniform accounting system in the general government

The accounting entries based on the accrual principle allow for international comparability and provide a higher quality of information. The Slovak general government's current accounting system is based on the cash principle; the book entries are converted in line with methodologies based on the accrual principle (ESA 95, GFS 2001) only in the subsequent reporting of the general government balance. In order to remove these deficiencies, a decision has been taken to implement a project that will introduce the necessary changes in Slovakia's accounting and reporting systems.

Improved quality and unification of the general government accounting and reporting systems will significantly improve the budgetary process – mainly in terms of improving the quality of information available in the period of budget implementation, as well as in the subsequent reporting of the actual general government balance. From this viewpoint, the introduction of an accounting methodology based on the accrual principle will be a key step forward.

The introduction of a uniform accounting and reporting system will be achieved by incorporation into the national legislation of the principles enshrined in the International Public Sector Accounting Standards (IPSAS). The IPSAS accounting standards, based on the accrual principle, are being internationally harmonised with the ESA95 methodology, and are based on international accounting standards applied in the business sector.

The timetable and the main stages of the project are laid down in the documents[21] that have been discussed by the government of the Slovak Republic. The Ministry of Finance acts as the project's professional coordinator responsible for its implementation in organisational, technical, financial and legislative terms, and submit annual progress reports in these areas to the Government.

The first steps were taken in 2005 when the project was divided into several stages. During the initial phase, the main objective was to draft the necessary legislative changes and to adjust IT systems. Simultaneously, a methodology was developed for the consolidation of final accounts and transposition of data into the reports prepared for international institutions pursuant to the ESA 95 and GFS 2001 methodologies.

The necessary legislative changes are currently in the process of approval, one of them being an amendment to the Accounting Act that transposes IPSAS principles into national legislation. The Ministry of Finance has issued

[20] According to the fiscal rules for municipalities and higher territorial units, the total amount of these entities' debt may not exceed 60% of their actual current income in the previous fiscal year and the sum of annual instalments for loans, including the payment of proceeds, may not exceed 25% of the actual current income in the previous fiscal year. The total amount of PPP projects and projects in the phase of realisation with budgetary impacts is included into the total debt for the purposes of debt criterion assessment and the sum of annual instalments from these projects is taken into account when assessing the criterion of annual instalments.

[21] This entails the following documents: "Information concerning the Project for the Introduction of a Uniform System of Central Government Accounting and Reporting" acknowledged by the Slovak government on 13 July 2005 and the "Report on the Implementation of the Project for the Introduction of a Uniform System of Central Government Accounting and Reporting" approved by the government on 25 October 2006.

generally binding guidelines containing a detailed specification of the rules in the key areas of the proposed changes (such as accounting procedures, rules for the presentation of accounting information, etc.). In parallel with these steps, the training of central government and local government accountants is underway in order to facilitate project implementation through enhanced professional capacity.

An important milestone in realisation of the project will come on 1 January 2008, as of which practical implementation of the new accounting standards will begin; for the year 2008 the bodies of central and local governments will prepare individual financial statements. The next stage contemplates a gradual preparation of consolidated final accounts, as well as the inclusion of other general government entities (health insurance companies, the Social Insurance Agency, state funds, etc.). For this purpose it is necessary to develop a further legislative framework and harmonise the charts of accounts and accounting procedures of all general government entities. According to the timetable, the first consolidated financial statements covering central government will be compiled for the year 2009 and the entire general government will be, for the first time, covered for the year 2010.

ANNEXES

Annex 1 – Required Tables

Table 1a. Macroeconomic prospects

	ESA code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g	1 275.3	8.3	8.8	6.8	5.8	5.0
2. Nominal GDP	B1*g	1 636.3	11.2	11.4	9.1	7.7	6.9
Components of real GDP							
3. Final consumption of households	P.3	698.9	6.1	6.7	6.0	4.7	4.1
4. Final consumption of government	P.3	227.8	4.1	2.0	3.0	2.8	2.8
5. Gross fixed capital formation	P.51	355.0	7.3	8.8	8.0	6.0	5.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	33.1	2.6	1.6	0.6	0.6	0.5
7. Exports of goods and services	P.6	1 270.5	20.7	21.1	12.8	8.9	6.8
8. Imports of goods and services	P.7	1 308.2	17.8	17.2	11.5	8.1	6.1
Contributions to real GDP growth							
9. Final domestic demand		-	6.2	6.5	5.9	4.7	4.1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.4	-0.9	-0.9	0.0	-0.1
11. Balance of goods and services	B.11	-	1.7	3.4	1.5	1.1	1.0

Source: Statistical Office, Ministry of Finance

Table 1b. Price developments

	ESA code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. GDP deflator		1.283	2.7	2.4	2.2	1.8	1.8
2. Private consumption deflator		1.348	5.1	2.2	2.1	2.4	2.4
3. HICP		-	4.3	1.7	2.3	2.6	2.7
4. Public consumption deflator		1.306	5.0	2.6	1.8	2.2	2.3
5. Investment deflator		1.217	2.0	2.0	1.7	1.6	1.7
6. Export price deflator (goods and services)		1.104	2.2	-0.5	-0.1	0.0	1.1
7. Import price deflator (goods and services)		1.130	3.6	-1.3	-0.4	0.3	1.4

Source: Ministry of Finance

Table 1c. Labour market developments

	ESA code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Employment, persons (thousands) [1]		2 132	2.3	2.1	1.6	1.0	0.8
2. Employment, hours worked (thousands) [2]		3 728 616	2.7	4.2	2.2	1.6	1.9
3. Unemployment rate (%) [3]		13.4	-2.9	-2.4	-0.9	-0.4	-0.3
4. Labour productivity, persons [4]		-	5.8	6.6	5.1	4.7	4.2
5. Labour productivity, hours worked [5]		-	5.4	4.5	4.5	4.1	3.1
6. Compensation of employees	D.1	601 883	10.2	11.5	8.3	7.6	7.4
7. Compensation per employee		251.3	7.7	9.2	6.6	6.5	6.5

1 Occupied population. domestic concept national accounts definition.

2 National accounts definition.

3 Harmonised definition, Eurostat levels.

4 Real GDP per person employed.

5 Real GDP per hour worked.

Source: Statistical Office, Ministry of Finance

Table 1d. Sectoral balances

	ESA code	2006	2007	2008	2009	2010
1. Net lending / borrowing vis-à-vis the rest of the world	B.9	-8.4	-3.4	-1.9	-1.1	-0.4
of which:						
- Balance of goods and services		-4.4	-1.2	0.3	0.7	1.3
- Balance of primary incomes and transfers		-3.9	-2.8	-2.8	-2.6	-2.5
- Capital account		-0.1	0.6	0.6	0.8	0.8
2. Net lending / borrowing of the private sector	B.9	-4.7	-0.9	0.4	0.7	0.4
3. Net lending / borrowing of general government	EDP B.9	-3.7	-2.5	-2.3	-1.8	-0.8
4. Statistical discrepancy						

Source: Ministry of Finance

Table 2. General government budgetary prospects							
	ESA code	2006 SKK mil.	2006 % GDP	2007 % GDP	2008 % GDP	2009 % GDP	2010 % GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-61 214	-3.7	-2.5	-2.3	-1.8	-0.8
2. Central government	S.1311	-57 541	-3.5	-2.3	-2.3	-1.9	-0.9
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-4 894	-0.3	-0.1	-0.1	0.0	0.0
5. Social security funds	S.1314	1 221	0.1	-0.1	0.1	0.1	0.1
General government (S.13)							
6. Total revenue	TR	555 334	33.5	33.2	33.0	31.8	31.8
7. Total expenditure	TE [1]	616 548	37.2	35.7	35.3	33.7	32.6
8. Net lending/borrowing	EDP B.9	-61 214	-3.7	-2.5	-2.3	-1.8	-0.8
9. Interest expenditure	EDP D.41	24 225	1.5	1.5	1.4	1.5	1.3
10. Primary balance	[2]	-36 989	-2.2	-1.0	-0.9	-0.3	0.5
11. One-off and other temporary measures	[3]	-6 253	-0.4	0.0	0.1	0.0	0.0
Selected components of revenue							
12. Total taxes (11=11a+11b+11c)		287 099	17.3	17.5	17.3	17.1	17,1
12a. Taxes on production and imports	D.2	187 731	11.3	11.4	11.0	10.8	10,8
12b. Current taxes on income, wealth, etc.	D.5	99 360	6.0	6.1	6.2	6.3	6,2
12c. Capital taxes	D.91	8	0.0	0.0	0.0	0.0	0,0
13. Social contributions	D.61	197 406	11.9	11.8	12.0	11.5	11,5
14. Property income	D.4	25 778	1.6	1.6	1.7	1.2	1,1
15. Other	[4]	45 051	2.7	2.3	2.0	2.0	2,2
16=6. Total revenue	TR	555 334	33.5	33.2	33.0	31.8	31,8
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)	[5]	489 467	29,5	29.6	29.6	28.9	28.8
Selected components of expenditure							
17. Compensation of employees + Intermediate consumption	D.1+P.2	217 611	13.1	12.1	11.9	11.9	11.5
17a. Compensation of employees	D.1	122 817	7.4	7.4	7.0	6.7	6.6
17b. Intermediate consumption	P.2	94 794	5.7	4.7	4.9	5.2	4.9
18. Social payments		270 250	16.3	16.4	16.2	15.5	15.4
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	73 094	4.4	4.6	4.6	4.5	4.5
18b. Social transfers other than in kind	D.62	197 156	11.9	11.8	11.6	11.0	10.9
19.=9. Interest expenditure	EDP D.41	24 225	1.5	1.5	1.4	1.5	1.3
20. Subsidies	D.3	22 134	1.3	1.3	1.2	1.0	0.9
21. Gross fixed capital formation	P.51	36 310	2.2	1.6	1.8	1.4	1.3
22. Other	[6]	46 018	2.8	2.7	2.8	2.4	2.2
23=7. Total expenditure	TE [1]	616 548	37.2	35.7	35.3	33.7	32.6
p.m.: Government consumption (nominal)	P.3	318 497	19.2	18.4	18.2	18.0	17.6

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[2] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).
[3] A plus sign means deficit-reducing one-off measures.
[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).
[5] Including those collected by the EU
[6] D.29+D4 (other than D.41)+D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Source: Ministry of Finance

Table 3. General government expenditure by function (% of GDP)			
	COFOG code	2005*	2010
1. General public services	1	6.4	
2. Defence	2	1.6	
3. Public order and safety	3	2.0	
4. Economic affairs	4	3.8	
5. Environmental protection	5	0.7	
6. Housing and community amenities	6	0.8	
7. Health	7	5.0	
8. Recreation, culture and religion	8	0.9	
9. Education	9	4.0	
10. Social protection	10	11.6	
11. Total expenditure	TE	36.7	

*With regard to the fact that data are updated with a delay of T+1, revised data for the year 2005 and the reality for the year 2006 are not available at present.

Source: Eurostat, Ministry of Finance

Table 4. General government debt developments (% of GDP)						
	ESA code	2006	2007	2008	2009	2010
1. Gross debt		30.4	30.6	30.8	30.5	29.5
2. Change in gross debt ratio		-3.7	0.2	0.2	-0.3	-1.0
Contributions to change in gross debt						
3. Primary balance		2.2	1.0	0.9	0.3	-0.5
4. Interest expenditure	EDP D.41	1.5	1.5	1.4	1.5	1.3
5. Stock-flow adjustment		-3.8	0.4	0.4	0.1	0.2
Of which:						
- Differences between cash and acrruals		-0.6	0.2	-0.1	-0.2	-0.1
- Net accumulation of financial assets		-2.3	0.0	0.0	0.0	0.0
- Valuation effects and others		-0.9	0.2	0.5	0.3	0.3
p.m. Implicit interest rate on debt		4.8	5.3	5.1	5.2	4.5
Other relevant variables						
6. Liquid financial assets		4.8	4.1	4.1	4.0	3.9
7. Net financial debt (7=1-6)		25.7	26.5	26.7	26.6	25.7

Source: Ministry of Finance

Table 5. Cyclical developments (% of GDP)						
	ESA code	2006	2007	2008	2009	2010
1. Real GDP growth (%)		8.3	8.8	6.8	5.8	5.0
2. Net lending of general government	EDP B.9	-3.7	-2.5	-2.3	-1.8	-0.8
3. Interest expenditure	EDP D.41	1.5	1.5	1.4	1.5	1.3
4. One-off and other temporary measures	[1]	-0.4	0.0	0.1	0.0	0.0
5. Potential GDP growth (%)		7.3	8.5	7.1	5.8	5.1
contributions:						
- labour		0.7	0.7	0.6	0.5	0.4
- capital		1.7	1.8	2.0	2.1	2.1
- total factor productivity		4.9	6.0	4.6	3.3	2.6
6. Output gap		0.0	0.3	0.1	0.0	0.0
7. Cyclical budgetary component		0.0	0.1	0.0	0.0	0.0
8. Cyclically-adjusted balance (2 - 7)		-3.7	-2.6	-2.4	-1.8	-0.8
9. Cyclically-adjusted primary balance (8 + 3)		-2.2	-1.1	-0.9	-0.4	0.5
10. Structural balance (8 - 4)		-3.3	-2.6	-2.5	-1.8	-0.8

[1] A plus sign means deficit-reducing one-off measure

Source: Ministry of Finance

Table 6. Divergence from previous update	ESA code	2006	2007	2008	2009	2010
Real GDP growth (%)						
Previous update		106.6	107.1	105.5	105.1	105.0
Current update		108.3	108.8	106.8	105.8	105.0
Difference		1.7	1.7	1.3	0.7	0.1
General government net lending (% of GDP)	EDP B.9					
Previous update		-3.7	-2.9	-2.4	-1.9	-0.9
Current update		-3.7	-2.5	-2.3	-1.8	-0.8
Difference		0.0	0.4	0.1	0.1	0.1
General government gross debt (% of GDP)						
Previous update		33.1	31.8	31.0	29.7	
Current update		30.4	30.6	30.8	30.5	29.5
Difference		-2.7	-1.2	-0.2	0.8	

Source: Ministry of Finance

Table 7. Long-term sustainability of public finances - AWG scenario (% of GDP)	2004	2010	2020	2030	2040	2050
Total expenditure	38.0	36.4	36.2	38.0	40.9	45.3
Of which: age-related expenditure	16.2	15.4	15.3	16.5	17.7	19.1
A. Pension expenditure	7.2	6.7	7.0	7.7	8.2	9.0
1. Social security pension	7.2	6.7	7.0	7.7	8.2	9.0
a) Old-age and early pensions	5.4	4.8	4.6	5.0	5.5	6.3
b) Other pensions (disability, survivors)	1.8	1.9	2.3	2.7	2.7	2.7
2. Occupational pensions (if in general government)	-	-	-	-	-	-
B. Health care	4.4	4.7	5.2	5.7	6.0	6.3
C. Long-term care	0.7	0.8	0.7	0.9	1.1	1.3
D. Education expenditure	3.7	3.0	2.2	2.2	2.3	2.4
E. Other age-related expenditures	0.3	0.2	0.1	0.1	0.1	0.1
Interest expenditure	2.2	1.5	1.4	2.0	3.7	6.7
Total revenue	35.0	31.8	31.6	31.5	31.4	31.2
Of which: property income (D.4)	1.7	1.1	1.1	1.1	1.1	1.1
Of which: from pensions contributions	12.8	11.5	11.3	11.2	11.1	10.9
Pension reserve fund assets	0.0	7.0	18.9	31.5	45.7	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	4.2	3.3	2.7	1.9	1.7
Real GDP growth	5.5	5.3	3.3	2.0	0.4	0.3
Participation rate males (aged 15-64)	77.3	79.6	82.1	82.3	79.4	78.7
Participation rate females (aged 15-64)	64.1	67.1	73.5	73.8	70.0	69.1
Total participation rates (aged 15-64)	70.7	73.3	77.8	78.0	74.7	73.9
Unemployment rate	18.1	15.2	9.7	7.0	7.0	7.0
Population aged 65+ over total population (in %)	11.5	12.3	16.3	20.8	24.1	29.3

Source: Ministry of Finance

Table 8. Basic assumptions	2006	2007	2008	2009	2010
Short-term interest rate (annual average)	3.1	4.3	4.2	4.1	3.9
Long-term interest rate (annual average)	3.8	4.2	4.2	4.3	4.4
USD/€ exchange rate (annual average)	1.26	1.35	1.39	1.39	1.39
World excluding EU, GDP growth	5.8	5.6	5.3	5.5	5.5
EU GDP growth	3.0	2.8	2.4	2.4	1.9
Growth of relevant foreign markets	3.7	3.4	3.1	2.6	2.5
World import volumes. excluding EU	8.4	7.5	6.8	7.5	7.5
Oil prices (Brent, USD/barrel)	66.2	69.5	74.9	72.7	73.2

Source: Common external assumptions, Ministry of Finance

Annex 2 - Indicative Estimate up to 2010

Forecast	unit	2006	2007F	2008F	2009F	2010F
GDP, constant prices 2000	%	8.3	8.8	6.8	5.8	5.0
Final consumption of households	%	6.1	6.7	6.0	4.7	4.1
Final consumption of government	%	4.1	2.0	3.0	2.8	2.8
Gross fixed capital formation	%	7.3	8.8	8.0	6.0	5.5
Exports of goods and services	%	20.7	21.1	12.8	8.9	6.8
Imports of goods and services	%	17.8	17.2	11.5	8.1	6.1
HICP (annual average)	%	4.3	1.7	2.3	2.6	2.7
Current account balance	% GDP	-8.3	-4.0	-2.6	-1.9	-1.4
Total employment LFS	%	3.8	2.6	1.6	1.0	0.8
Unemployment rate LFS	%	13.3	10.9	10.0	9.6	9.2
Real wages per employee	%	3.3	4.5	4.5	4.0	4.0
GG revenues (ESA 95)	% GDP	33.5	33.2	33.0	31.8	31.8
GG expenditures (ESA 95)	% GDP	37.2	35.7	35.3	33.7	32.6
GG balance (ESA 95)	% GDP	-3.7	-2.5	-2.3	-1.8	-0.8

Source: Ministry of Finance

Annex 3 - Macroeconomic Forecasts Committee

The Ministry of Finance regularly approaches the members of the Macroeconomic Forecasts Committee in pursuit of higher transparency and objectivity of the macroeconomic forecasts. The update of the forecasts of the individual member institutions and the assessment of the MoF forecast took place in September 2007. The medium-term macroeconomic forecast of the MoF was perceived by the members of the committee as realistic:

Assessment of the MoF forecast in the Macroeconomic Forecasts Committee

Member of the MFC	Forecast assessment
NBS	realistic
VÚB	realistic
Infostat	realistic
ING Bank	realistic
Tatrabanka	realistic
SLSP	realistic
ČSOB	slightly conservative
SAV	realistic 73%, conservative 6%, optimistic 21%

Source: Macroeconomic Forecasts Committee

Average forecasts of the selected indicators of the economic development of the Slovak republic by the members of the Macroeconomic Forecasts Committee (excluding MoF) and MoF forecasts

No.	Indicator	unit	Current year		Forecast					
			2007		2008		2009		2010	
			MFC	MoF	MFC	MoF	MFC	MoF	MFC	MoF
1	GDP; current prices	bn. SKK	1823.3	1822.5	1991.5	1988.5	2162.0	2142.2	2333.9	2289.7
2	GDP; real growth	%	9.0	8.8	7.1	6.8	6.0	5.8	5.5	5.0
3	Final consumption of households; real growth	%	6.7	6.7	5.9	6.0	5.4	4.7	5.0	4.1
4	Final consumption of households; nominal growth	%	9.6	9.1	8.4	8.2	8.1	7.3	8.2	6.6
5	Average monthly wages (nominal growth)	%	7.3	7.0	7.1	6.6	7.2	6.5	7.4	6.5
6	Average monthly wages (real growth)	%	4.5	4.5	4.8	4.5	4.5	4.0	4.2	4.0
7	Average employment growth, LFS	%	2.5	2.6	1.6	1.6	1.0	1.0	0.9	0.8
8	Average employment growth, registered	%	2.2	2.3	1.3	1.6	1.0	1.0	0.9	0.8
9	Average employment growth, ESA95	%	1.9	2.1	1.2	1.6	1.0	1.0	0.9	0.8
10	Average unemployment rate, LFS	%	10.9	10.9	10.2	10.0	9.8	9.6	9.6	9.2
11	Consumer price index, (average growth)	%	2.5	2.4	2.3	2.0	2.8	2.5	3.2	2.4
12	Harmonised index of consumer prices (average growth)	%	1.8	1.6	2.1	1.8	2.7	2.4	2.9	2.4
13	Producer price index (average growth)	%	2.3	2.0	2.2	3.0	2.0	2.3	2.1	2.2
14	Current account balance (share of GDP)	%	-4.0	-4.0	-2.4	-2.6	-1.8	-1.9	-1.3	-1.4
15	Final consumption of government (real growth)	%	2.6	2.0	2.7	3.0	2.8	2.8	3.5	2.8
16	Gross fixed capital formation (real growth)	%	6.7	8.8	6.6	8.0	7.3	6.0	7.3	5.5
17	Export of goods and services (real growth)	%	19.1	21.1	12.5	12.8	8.2	8.9	7.9	6.8
18	Import of goods and services (real growth)	%	14.9	17.2	11.0	11.5	7.7	8.1	7.8	6.1

** year 2010 – Committee excluding NBS*
Source: Macroeconomic Forecasts Committee

Annex 4 - Tax Revenue Forecasts Committee

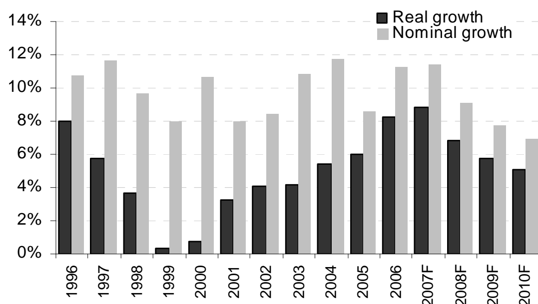
On 21 September 2007, after the meeting of the Macroeconomic Forecasts Committee, the session of the Tax Revenue Forecasts Committee took place. The Ministry of Finance submitted its updated medium-term forecasts of tax revenues covering the period of 2007 - 2010. These forecasts were evaluated as realistic by each member of the Committee.

Assessment of the tax revenues forecasts by the Committee	
Member of the Committee	**Assessment**
NBS	realistic
Infostat	realistic
ING Bank	realistic
Tatra banka	realistic
ČSOB	realistic
SLSP	realistic

Source: Tax Revenue Forecasts Committee

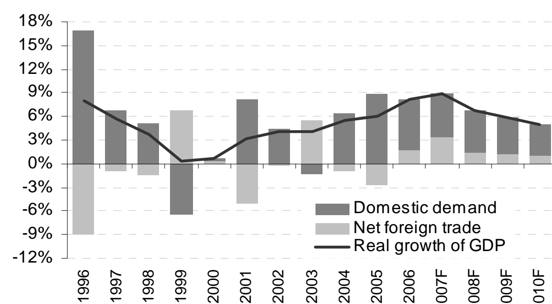
Annex 5 – Graphs

Growth of gross domestic product in %



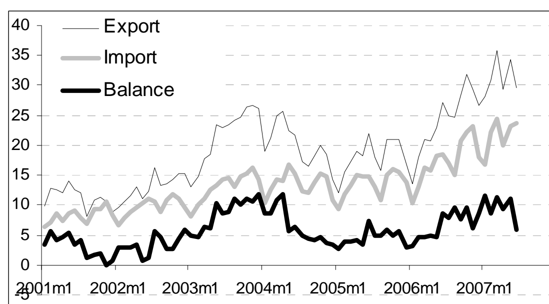
Source: Statistical Office, Ministry of Finance

Contributions to growth of GDP in p.p.



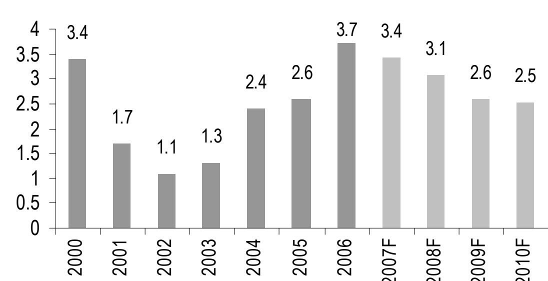
Source: Statistical Office, Ministry of Finance

Export. import and balance of motor vehicles and their parts and accessories (billion SKK)



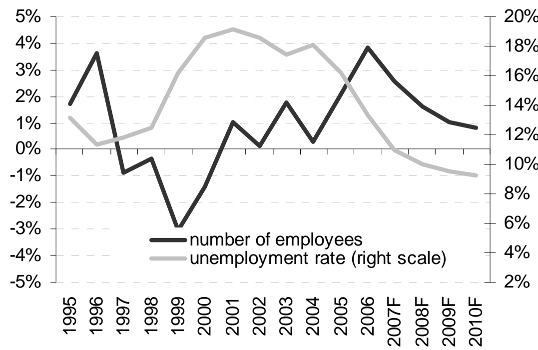
Source: Statistical Office, Ministry of Finance

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



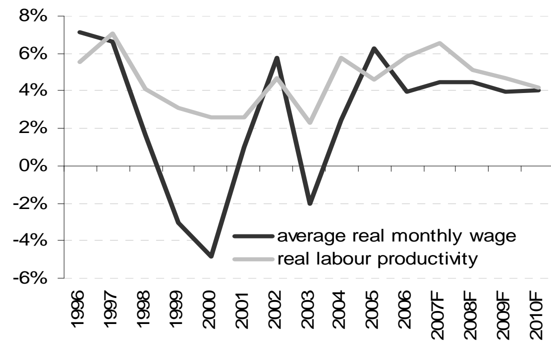
Source: OECD, Ministry of Finance

Economic activity according to LFS



Source: Statistical Office, Ministry of Finance

Real wage and labour productivity



Source: Statistical Office, Ministry of Finance