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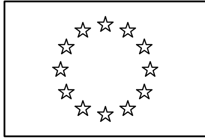

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2009
SEC(2009) 856 final

Recommendation for a

COUNCIL RECOMMENDATION TO HUNGARY

with a view to bringing an end to the situation of an excessive government deficit

EXPLANATORY MEMORANDUM

1. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

In July 2004, based on a general government deficit of 5.9% of GDP in 2003, the Council adopted a decision that Hungary had an excessive deficit and issued recommendations to correct it[1]. In particular, Hungary was recommended to take action to bring the deficit below 3% of GDP by 2008, which was in line with the Council Opinion on the May 2004 convergence programme and took into account the "ongoing structural shift in the economy" and the fact that the "general government deficit upon EU accession was significantly above the reference value". The Council decided in January 2005 that action taken by the deadline of 5 November 2004 by the Hungarian authorities was inadequate and it issued new recommendations in March 2005. In November 2005, the Council decided once again that action taken by the Hungarian authorities by the 8 July 2005 deadline was inadequate and in October 2006, it issued for the third time recommendations to correct the excessive deficit. These recommendations reflected the Council opinion on the September 2006 adjusted update of the convergence programme which had put forward a front-loaded fiscal adjustment path, from the high starting position of 10.1% of GDP in 2006 to 6.8% of GDP in 2007, 4.3% of GDP in 2008, and 3.2% of GDP in 2009[2]. In view of the high deficit level in 2006, the Council extended the deadline for the correction of the excessive deficit to 2009. The Hungarian authorities were recommended to limit the deterioration of the fiscal position in 2006, ensure a frontloaded and sustained substantial correction of the structural deficit, and swiftly implement the planned structural reforms. They were also recommended to bring the government gross debt ratio on a firm downward trajectory and to improve budgetary control by enhancing fiscal rules and strengthening the institutional framework. The Council recommendation welcomed the commitment of the Hungarian authorities in the September 2006 adjusted programme update to present semi-annual progress reports to the Commission and the Council until the abrogation of the excessive deficit procedure.

In April 2007, the Hungarian Government submitted the first progress report on the implementation of its consolidation and reform programmes. Taking into account this report, the Commission adopted a Communication in June 2007 concluding that Hungary had taken effective action by the deadline of 10 April 2007 regarding the recommendations of October 2006 but underlining that the planned adjustment crucially hinged upon further specifying and implementing the structural reform plans in the field of public administration, health care, pension and education as well as on reinforcing the budgetary framework. In its meeting of July 2007, the Council concurred with this assessment. Afterwards, in September 2007, in April 2008 and in November 2008 the authorities submitted successive progress reports, informing on the implementation of the fiscal consolidation measures and on the progress made with the structural reform agenda. The Commission services analysed these reports and on all occasions it was considered – and communicated to the Economic and Financial Committee – that in view of the progress achieved and continued successful implementation,

[1] The deficit figure for 2003 was revised in subsequent steps to 7.2% of GDP.

[2] Albeit the deficit target of 3.2% of GDP in 2009 would still exceed the 3% of GDP threshold specified in the Treaty, the authorities assumed that the Council and the Commission, when considering the case for an abrogation of the excessive deficit procedure for Hungary, could take into account a part of the net cost of the pension reform, in line with the revised Stability and Growth Pact. For Hungary, this would correspond in 2009 to 20% of the net cost of the pension reform or an estimated 0.3% of GDP.

no further steps in the excessive deficit procedure were necessary. The fifth report, submitted on 29 May 2009, updated the Government's macroeconomic scenario in view of the depth of the global economic downturn as well as the continued stress in domestic financial markets. The report presents a revised multi-annual fiscal consolidation and reform strategy with the aim of correcting the excessive deficit by 2011, i.e. two years later than planned and foreseen in the Council recommendation of 2006.

2. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States, with more room for manoeuvre for those Member States that have achieved sustainable public finance positions and improved their competitive positions. The EERP also called for structural reforms that support demand and promote resilience in the short term, while paying special attention to actions in the four priority areas of the Lisbon strategy. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

3. RECENT MACROECONOMIC AND BUDGETARY DEVELOPMENTS

Regarding the economic outlook for 2009 and 2010, the progress report submitted by the authorities on 29 May presents their newly revised macroeconomic projections, which were discussed with the Commission services and the IMF staff in the context of the second review mission associated with the international financial assistance in May 2009. Even though slightly more pessimistic than the Commission Services' spring 2009 forecast, the expected GDP deterioration of 6.7% in 2009 and a further decline of 0.9% in 2010 appear to be plausible. Such a large contraction in economic activity this year seems to be confirmed by the preliminary 2009 first quarter data, which showed a 5.8% (calendar-effects-adjusted) decline compared to the same quarter in 2008. The downturn is mainly driven by the collapse of exports due to contracting world trade. Furthermore, a sharp drop in household consumption can be expected as a result of a sudden reversal in credit growth, the substantial fiscal tightening and the negative labour market impact of the recession. Concerning 2011, a strong rebound in growth to 3.6% is foreseen in the progress report, which appears to be

slightly favourable in light of the generally expected L-shaped recovery in the world economy, although the assessment is made rather difficult by the unusually large uncertainty surrounding the projections. In 2011, if the downturn proves to be prolonged and, as a result, consumer confidence remains low, exports may perform worse than foreseen, precautionary saving may remain high and thus growth could be somewhat more muted than anticipated. As regards inflation, the report foresees a continuous decline in the CPI from 6.1% in 2008 to 2.8% in 2011. This trajectory reflects a rapid disinflationary process induced by the large negative output gap interrupted by the hike in the VAT rate and excise duties as of July 2009 and a gradual increase in oil prices in the outer years. Finally, the progress report also expects the current account to improve by more than 4 percentage points in 2009 and stay rather stable at around 4% of GDP thereafter. Overall, the updated macroeconomic scenario appears to be plausible for 2009 and 2010 and somewhat favourable in 2011.

Following a deficit of 9.2% of GDP and 4.9% of GDP in 2007 and 2008 (compared to the targets endorsed in the EDP recommendation, i.e. 10.1% and 6.8% of GDP, respectively), the 2008 deficit outcome was 3.4% of GDP. It is significantly lower than the target contained in the EDP recommendation (4.3% of GDP) and the budgeted deficit target of 4.0% of GDP. The 2009 budget adopted by Parliament on 15 December 2008 sets a general government deficit target of 2.6% of GDP, in conformity with the conditionality agreed in the context of the balance of payments assistance provided by the EU in conjunction with loans from the IMF and the World Bank. This was to be achieved through deficit-reducing expenditure measures of 1% of GDP incorporated in the budget. However, in February 2009, in the light of the deteriorated 2009 growth outlook (with GDP expected to contract by 3- 3.5% rather than by 1% as expected in the scenario underpinning the budget) and despite additional expenditure-based corrective measures of 0.7% of GDP, the Government revised upwards its deficit target slightly, to 2.9% of GDP.

The further substantial deterioration of growth prospects, with GDP in the Commission services' Spring 2009 forecast expected to contract by 6.3% this year, is having a significant adverse impact on public finance projections (around 1¼% of GDP). The somewhat higher contraction of 6¾% in 2009 in the most recent progress report of the Hungarian authorities can be considered plausible in view of the fact that after the cut off date of the Spring forecast some downside risks materialised and further corrective measures were implemented. In this very weak economic context, keeping the revised deficit target of 2.9% of GDP in 2009 would risk triggering a serious downward spiral of the economy. With the intention to find an appropriate balance between letting the automatic stabilisers work to an important extent and containing the revision of the 2009 deficit target by 1% of GDP (from 2.9% of GDP to 3.9% of GDP, while maintaining the full amount of the stability reserves of 0.3% of GDP[3]), the authorities decided to take additional corrective measures of 0.8% of GDP. The revised deficit target includes a one-off deficit-increasing impact of ¼% of GDP for 2009 following the recent decision of the European Court of Justice (ECJ), which found the Hungarian regulation on VAT deduction in 2004-2005 to be against the EU law. The announced and already largely adopted additional expenditure measures notably include substantial cuts in the 13th month pension and the housing subsidy systems as well as a further reduction in the public sector wage bill, which will all deliver important and increasing savings beyond 2009. In order to improve the long-term sustainability of public finances and the growth potential of the economy, the structural reform plans in the areas of pension (further parametric changes) and

[3] The stability reserves could be considered as genuine budgetary buffers, as these amounts could be used to compensate for unforeseen budgetary slippages.

social support systems announced in February were strengthened and augmented. Moreover, further consolidation measures were announced for 2010 on the expenditure side, which, among others, include the areas of public sector wage bill and the energy and public transport subsidy schemes. On the revenue side, the first phase of the tax reform is expected to be deficit-reducing by around 0.2% of GDP in 2009. In 2010, the Government plans to continue the tax reform in a broadly revenue-neutral way to reduce the tax wedge on labour, which is, inter alia, to be financed from an increase of consumption and wealth-related taxes.

On the basis of the above described fiscal consolidation measures and structural steps, the new strategy of the Government contained in the May 2009 EDP progress report aims to correct the excessive deficit by 2011. This would be achieved through a deficit reduction from 3.9% of GDP in 2009 to 2.8% of GDP in 2011, which would be back-loaded in view of the current recession. The Commission services' spring 2009 forecast shows a deficit of 3.4% of GDP for 2009. It could not take into account the above-described decision of the ECJ of 23 April (i.e. one day after the cut-off date of the forecast of 22 April). Moreover, it was based on a slightly more optimistic macro scenario, both in terms of overall growth performance but also in terms of composition as regards tax-rich elements (e.g. private consumption). For 2010, the Commission services' forecast, on the basis of a no-policy-change assumption, projected a deficit of 3.9% of GDP. This forecast included the positive budgetary impact of the adopted corrective measures (carried over impacts of the short-term expenditure cuts and the revenue-increasing phase of the tax reform). However, it did not take into account any expenditure cuts linked to the announced additional structural reform steps in the pension, social support and public administration systems in view of the lack of sufficient detail. At the same time, it was based on a somewhat more favourable growth outlook compared to the new official macro scenario.

Following the stabilisation of the gross debt-to-GDP ratio at around 65¾% in 2007, it increased steeply in 2008 to 73% of GDP as the international loans were drawn on, chiefly to increase reserves. According to the progress report, the debt ratio is expected to increase further to around 80% in 2009 and to over 82% in 2010. These dynamics are mainly explained by the combination of the revaluation of foreign-exchange-denominated debt due to the weaker exchange rate assumption in the light of the depreciation at the beginning of 2009 and the lacklustre nominal GDP outlook. The official projections are broadly in line with that of the Commission services' spring 2009 forecast. For 2011, the report projects a decline in the debt ratio by around 4% of GDP, which should be supported by the full repayment of first disbursement of the EU loan (implying a debt-reducing stock-flow adjustment of around 2% of GDP).

4. ASSESSMENT OF EFFECTIVE ACTION WITH A VIEW TO REPEATING EDP STEPS

According to Regulation 1467/97[4] and the revised Code of Conduct[5] a Member State should be considered to have taken effective action if it has acted in compliance with the 104(7) recommendation. If effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission

[4] OJ L 209, 2.8.1997, p. 6.

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

and before taking into account the relevant factors mentioned in Article 2(3) of Regulation 1467/97, to adopt a revised recommendation under Article 104(7).

The assessment of effective action should in particular take into account whether the Member State concerned has achieved the annual improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. For Hungary, the October 2006 recommendation under Art.104(7) asked for a cumulative structural adjustment of 6½ percentage points of GDP from 2006 to 2009, which translates into an annual structural improvement of close to 2¼ percentage points of GDP (see also Table 1 at the end of the document). Based on the revised 2009 deficit target of 3.9% of GDP contained in the progress report (which is considered to be realistic in the light of the Commission services' spring forecast and the most recent developments as presented in Section 3), the achieved structural adjustment is 8¾ percentage points of GDP over the same period or close to 3 percentage points of GDP on annual average (Commission services' calculations on the basis of the information in the report according to the commonly agreed methodology[6]). Moreover, the implementation record of the budgetary consolidation measures both on the revenue and the expenditure side, as well as the structural reform steps announced in the September 2006 adjusted convergence programme update appear to be appropriate. In particular, most of the planned tax increases were implemented, which together with a series of measures addressing tax evasion provided an important contribution in the deficit reduction, especially in the second half of 2006 and 2007. Moreover, significant spending cuts in universal price subsidies and the public sector wage bill were achieved. In addition, the institutional networks of the public administration and health care systems were considerably streamlined. Finally, in the context of the fiscal consolidation programme, the fiscal governance framework was also considerably revamped. Following some gradual improvement in transparency and budgetary planning starting from the second half of 2006, a new fiscal responsibility law was adopted in November 2008 containing multi-annual numerical rules and the establishment of a Fiscal Council. The new body will carry out independent macroeconomic and budgetary forecasts as well as fiscal impact assessments; thereby enhancing external scrutiny on fiscal policy design and implementation. Overall, given the results of the fiscal adjustment programme since 2006, and specifically the achieved higher-than-recommended structural adjustment, the Hungarian authorities can be considered to have taken effective action.

The occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the Council recommendation. At the time of the October 2006 104(7) recommendation, the official macroeconomic scenario projected an average economic growth of around 3% annually for the 2007-2009 period. More specifically, for 2009, the scenario was based on the assumption that growth would return to its potential, which was at the time estimated to be at around 4%. This growth scenario was considered to be broadly plausible until 2008 and somewhat optimistic for 2009 by the Council at that time. Based on the projections contained in the authorities' report, GDP is expected to contract by 1¾% on annual average over the period 2007-2009 and by 6.7% in 2009. The revenue loss associated to this major downward revision in the economic outlook and in particular of consumption is very significant, as for example,

[6] It should be noted that there are uncertainties linked to the calculations of cyclically-adjusted and structural balances, notably due to the difficulty of contemporaneous output gap estimates and budgetary elasticity volatility, and especially during turbulent economic times. Thus, any interpretation should be made with caution.

it is over 4% of GDP for 2009 compared to projections contained in the most recent convergence programme update. All in all, the repetition of the 104(7) recommendation and the extension of the deadline for the correction of the excessive deficit beyond 2009 appear to be justified.

5. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned. Article 3(4) of the Regulation also specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

Following the postponement of the target year for the correction of the excessive deficit to 2009, the Hungarian authorities made important progress towards ending the excessive deficit as planned in line with their medium-term policy framework. However, in view of the very strong economic deterioration expected both in the Commission spring forecast (a contraction of GDP by 6.3% in 2009, followed by further decline by 0.3%) and in the progress report of the Hungarian authorities, which draws on more recent data (GDP is projected to contract by 6.7% in 2009 and register a further decline of around 1% in 2010), this target date can no longer be achievable. Further corrective steps in 2009 on top of those decided in December 2008 in the context of the adoption of the 2009 budget, and in February and in April 2009 (totalling around 2.5% of GDP), would seriously risk triggering a downward spiral, with concerns for economic, financial and structural stability. Moreover, against the projected continuous downturn, the consolidation effort associated with a correction in 2010 could prolong the recession in the light of the adverse effects of additional budgetary measures on aggregate demand. The new medium-term framework for the correction of the excessive deficit, laid down in the May 2009 progress report of the authorities, puts forward 2011 as the target year for the correction. In view of the depth and length of the current crisis, this target appears appropriate as a new deadline. However, based on the government's projection of growth of 3.6%, the new headline 2011 deficit target of 2.8% of GDP does not appear sufficiently ambitious. A structural adjustment of a cumulative 0.5 percentage point of GDP over 2010 and 2011 should be ensured. Taking into account the planned substantial structural effort of 2½% of GDP in 2009, the proposed correction would represent an annual average fiscal effort of around 1% of GDP over the 2009-2011 period.

As regards the plausibility of the envisaged deficit reduction, while for 2010 the exclusive reliance on expenditure side adjustment is welcome, some important planned cuts, in particular in the transfers to local governments and in public sector subsidies, will need to be underpinned by concrete measures in the coming months as also acknowledged by the government. In addition, the foreseen sizeable expenditure reduction in 2011 will need to be backed up with further fiscal consolidation measures, which is all the more important in view of the somewhat favourable growth assumption of the authorities for that year.

Against this background and on the basis of the macroeconomic outlook of the Commission services' spring 2009 forecast, it would seem necessary for the Hungarian authorities to (i) limit the deterioration of the fiscal position in 2009 by ensuring a rigorous implementation of the adopted and announced corrective measures to respect the target of 3.9% of GDP, and by allocating possible windfall gains for improving the headline balance; (ii) starting from 2010

(when the deficit should not exceed 3.8% of GDP), rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures so as to warrant a lasting improvement of public finances; (iii) spell out and adopt in a timely manner additional expenditure cuts which will be necessary to achieve the correction of the excessive deficit by 2011 and ensure a cumulative 0.5 percentage point of GDP fiscal effort over 2010 and 2011; (iv) stand ready to seize every opportunity to accelerate the fiscal adjustment, especially as regards 2011; and (v) incorporate sufficient reserve provisions in the forthcoming budget laws to avoid slippages even in case of unforeseen events. At the same time, the government debt ratio will have to be brought on a firm downward trajectory, in line with the multi-annual path for deficit reduction laid down in the progress report and if possible before 2011.

The budgetary adjustment needs to be framed within a comprehensive structural reform strategy, including the announced reform of the local administration, pension and social support systems with a view to containing and reducing expenditure and to improve the efficiency of the public sector. In addition, to limit risks to the adjustment, Hungary should implement with vigour the recently adopted fiscal responsibility law, including the compliance with the new numerical rules, as well as improve budgetary planning procedures and monitoring of the budget execution with a view to enhancing the medium-term budgetary framework.

Enhanced surveillance under the EDP will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. The Commission and the Council shall monitor the implementation of action taken by Hungary in response to this recommendation, in accordance with Article 10 of Regulation (EC) No 1467/97, including on the basis of the continued submission of regular progress reports by the authorities and the information contained in a separate chapter of the Hungarian convergence programme updates.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**Report May 2009**	**n.a.**	**n.a.**	**0.6**	**-6.7**	**-0.9**	**3.6**
	COM May 2009	3.9	1.1	0.5	-6.3	-0.3	n.a.
	CP Dec 2008	***n.a.***	***1.1***	***1.3***	***-0.9***	***1.6***	***2.5***
	CP Sept 2006	*4.1*	*2.2*	*2.6*	*4.1*	*n.a.*	*n.a.*
HICP inflation (%)	**Report May 2009**	**n.a.**	**n.a.**	**6.0**	**4.5**	**3.8**	**2.8**
	COM May 2009	4.0	7.9	6.0	4.4	4.1	n.a.
	CP Dec 2008	***n.a.***	***7.9***	***6.2***	***4.5***	***3.2***	***3.0***
	CP Sept 2006	*3.5*	*6.2*	*3.3*	*3.0*	*n.a.*	*n.a.*
Output gap[1] (% of potential GDP)	**Report May 2009**	**3.8**	**3.4**	**3.2**	**-3.9**	**-4.9**	**-1.6**
	COM May 2009[2]	3.6	3.3	3.0	-3.7	-4.1	n.a.
	CP Dec 2008	***n.a.***	***1.9***	***1.1***	***-1.7***	***-1.9***	***-1.1***
	CP Sept 2006	*0.8*	*-0.3*	*-0.9*	*0.0*	*n.a.*	*n.a.*
General government balance (% of GDP)	**Report May 2009**	**n.a.**	**n.a.**	**-3.4**	**-3.9**	**-3.8**	**-2.8**
	COM May 2009	-9.2	-4.9	-3.4	-3.4	-3.9	n.a.
	CP Dec 2008	***n.a.***	***-5.0***	***-3.4***	***-2.6***	***-2.5***	***-2.2***
	CP Sept 2006	*-10.1*	*-6.8*	*-4.3*	*-3.2*	*n.a.*	*n.a.*
Primary balance (% of GDP)	**Report May 2009**	**n.a.**	**n.a.**	**0.8**	**0.6**	**1.1**	**1.7**
	COM May 2009	-5.3	-0.9	0.8	1.4	1.0	n.a.
	CP Dec 2008	***n.a.***	***-0.9***	***0.6***	***1.9***	***2.0***	***2.2***
	CP Sept 2006	*-6.3*	*-2.4*	*-0.2*	*0.8*	*n.a.*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**Report May 2009**	**n.a.**	**n.a.**	**-4.9**	**-2.1**	**-1.6**	**-2.1**
	COM May 2009	-10.8	-6.4	-4.8	-1.7	-2.0	n.a.
	CP Dec 2008	***n.a.***	***-5.8***	***-3.9***	***-1.8***	***-1.6***	***-1.7***
	CP Sept 2006	*-10.5*	*-6.7*	*-3.9*	*-3.2*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**Report May 2009**	**n.a.**	**n.a.**	**-4.5**	**-1.9**	**-1.6**	**-2.1**
	COM May 2009	-10.5	-5.5	-4.5	-1.7	-2.0	n.a.
	CP Dec 2008	***n.a.***	***-4.9***	***-3.5***	***-1.8***	***-1.6***	***-1.7***
	CP Sept 2006	*-9.7*	*-5.8*	*-3.6*	*-3.2*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**Report May 2009**	**n.a.**	**n.a.**	**73.0**	**80.2**	**82.2**	**78.3**
	COM May 2009	65.6	65.8	73	80.3	82.3	n.a.
	CP Dec 2008	***n.a.***	***65.8***	***71.1***	***72.5***	***72.2***	***69.0***
	CP Sept 2006	*68.5*	*71.3*	*72.3*	*70.4*	*n.a.*	*n.a.*

Notes:

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

[2] Based on estimated potential growth of 2.2%, 1.4%, 0.8%, 0.2%, 0.1%, and 0.3% respectively in the period 2006-2011.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.9% of GDP in 2007 and 0.3% of GDP in 2008; all deficit-increasing, according to the Commission services' Spring 2009 economic forecast and 0.9% of GDP in 2007, 0.4% in 2008 and 0.2% of GDP in 2009; all deficit-increasing, according to the May 2009 EDP progress report

Source:
Convergence programme (CP); May 2009 EDP Progress report (Report); Commission services' Spring 2009 economic forecast (COM); Commission services' calculations.

Recommendation for a

COUNCIL RECOMMENDATION TO HUNGARY

with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) According to Article 104 of the Treaty, Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(4) On 5 July 2004, the Council decided, in accordance with Article 104(6), that an excessive deficit exists in Hungary.

(5) Having decided on the existence of an excessive deficit in Hungary, the Council, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[7], recommended on 5 July 2004 that the Hungarian authorities take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2008 in accordance with the path for deficit reduction as specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004. On 18 January 2005, the Council acting pursuant to Article 104(8) of the Treaty on a recommendation by the Commission, decided that Hungary had not taken effective action by the target date 5 November 2004 in response to its

[7] OJ L 209, 2.8.1997, p. 6.

recommendation, particularly since the deficit target for 2005 was expected to be missed by a sizable margin.

(7) On 8 March 2005, upon a recommendation by the Commission, the Council adopted, in accordance with Article 104(7), a new recommendation to the Hungarian authorities to take action to bring the deficit below 3% of GDP by 2008.[8] On 8 November 2005, the Council decided for the second time, pursuant to Article 104(8) on a Commission recommendation, that Hungary's action was inadequate. Thereby it notably took into account the fact that the deficit targets of 3.6% of GDP in 2005 and of 2.9% of GDP in 2006 (without the burden arising from the 1998 pension reform)[9] would be missed by a sizable margin and that the implementation of tax cuts starting from 2006 was contrary to the Council recommendation.

(8) On 10 October 2006, upon a recommendation by the Commission, the Council adopted, in accordance with Article 104(7), a third recommendation to the Hungarian authorities to take action to correct the excessive deficit. This recommendation extended the deadline for the correction of the excessive deficit to 2009 in view of the marked increase in the 2006 government deficit and reflected the Council opinion on the September 2006 adjusted update of the convergence programme, notably endorsing the authorities' new adjustment path. It envisaged a front-loaded deficit reduction, from the high starting position of 10.1% of GDP in 2006 to 6.8% of GDP in 2007, 4.3% of GDP in 2008, and 3.2% of GDP in 2009. In particular, the Hungarian authorities were recommended to limit the deterioration of the fiscal position in 2006, ensure a front-loaded and sustained substantial correction of the structural deficit, and swiftly implement the planned structural reforms. They were also recommended to bring the government gross debt ratio on a firm downward trajectory and to improve budgetary control by enhancing fiscal rules and strengthening the institutional framework. The Council recommendation welcomed the commitment of the Hungarian authorities in the September 2006 adjusted programme update to present semi-annual progress reports to the Commission and the Council until the abrogation of the excessive deficit procedure.

(9) In April 2007, the Hungarian Government submitted the first progress report on the implementation of its consolidation and reform programme. Taking into account this report, the Commission adopted a Communication in June 2007[10] concluding that Hungary had taken effective action by the deadline of 10 April 2007 regarding the recommendations of October 2006. Meanwhile, it underlined that the planned adjustment crucially hinged upon further specifying and implementing the structural reform plans in the field of public administration, health care, pension and education as well as on reinforcing the budgetary framework. In its meeting of July 2007, the

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[8] Having joined the Community on 1 May 2004, Hungary is a Member State with a derogation within the meaning of Article 122(1) of the Treaty, which means that it is to avoid excessive deficits but that Articles 104(9) and Article 104(11) of the Treaty do not apply to it; further recommendations can only be addressed to Hungary on the basis of Article 104(7).

[9] These targets did not include the burden arising from the 1998 reform of the pension system since in December 2004 the Hungarian authorities decided to avail themselves of the decision by Eurostat on 23 September 2004 allowing the classification of second-pillar pension schemes inside the general government sector for a transitory period until the March 2007 notification. Using the most recent estimates of the pension reform contribution, these deficit targets including the pension reform burden would have been 5% of GDP and of 4.5% of GDP, respectively.

[10] SEC(2007) 775.

Council concurred with this assessment. In September 2007, April 2008 and November 2008 the authorities submitted successive progress reports to the Commission and the Council. These reports were analysed and it was considered on all occasions that in view of the progress achieved in terms of fiscal consolidation, structural reform, and improvements in fiscal governance, no further steps in the excessive deficit procedure were necessary. In particular, this took into account that the deficit targets in 2007 and 2008 were outperformed (4.9% of GDP and 3.4% of GDP instead of 6.8% of GDP and 4.3% of GDP, respectively). At the same time, the debt-to-GDP ratio stabilised at around 66% in 2007 until autumn 2008.

(10) In its opinion of 10 March 2009 on the December 2008 update of the convergence programme, the Council concluded that, in spite of distinct improvements in its high imbalances, including the reduction in the budget deficit from 9.2% of GDP in 2006 to below 3.5% of GDP in 2008, Hungary had been particularly exposed to the financial crisis and thus had to limit the financing need of the government rather than stimulate the economy during the economic downturn. The Council acknowledged that, in this context, the country adopted a policy of further fiscal adjustments and tighter deficit targets to restore investor confidence and noted that this strategy had been backed by international financial assistance from the EU, the IMF and the World Bank[11]. However, the Council also underlined that the planned deficit reduction path was subject to risks, especially since the macro-economic assumptions underlying the programme had in the meantime become markedly favourable.

(11) At the time of the October 2006 104(7) recommendation, the official macroeconomic scenario projected an average economic growth of around 3% annually for the 2007-2009 period. More specifically, for 2009, the scenario was based on the assumption that growth would return to its potential, which was at the time estimated to be at around 4%. This scenario was considered to be broadly plausible until 2008 and somewhat optimistic for 2009 by the Council at that time. In view of the continued strong economic deterioration associated with the financial crisis and the global economic downturn, the Commission services' spring 2009 economic forecast, released on 4 May 2009, projected GDP to contract by 6.3% and 0.3% in 2009 and 2010, respectively. Inevitably, this unexpected major adverse economic event, with average GDP growth close to 5 percentage points lower in the 2007-2009 period than expected at the time of the Council recommendation, will bring about large unfavourable budgetary effects. Specifically, taking into account the Commission services' spring 2009 forecast, the associated revenue loss might attain 3% of GDP in 2010, compared to projections contained in the most recent convergence programme update.

(12) On 29 May 2009, the Hungarian authorities submitted their fifth progress report in the framework of the Excessive Deficit Procedure, which updated the Government's macroeconomic scenario; GDP is now expected to contract by 6¾% in 2009, with an expected adverse impact on public finance projections of around 1½% of GDP

[11] Against the background of increased financial stress, on 4 November 2008, the Council adopted a decision to make available to Hungary a medium-term financial loan of up to EUR 6.5 billion under the balance of payments (BoP) facility for Member States. This assistance was provided in conjunction with loans from the IMF of around EUR 12.5 billion supported by a Stand-by arrangement and from the World Bank of EUR 1 billion. The Council Decision can be found at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:037:0005:0006:EN:PDF

compared to the February plans. Respecting the revised deficit target of 2.9% of GDP in 2009 would risk triggering a serious downward spiral of the economy. With the intention of finding an appropriate balance between letting the automatic stabilisers work and containing the revision of the 2009 deficit target to 1 percentage point of GDP (from 2.9% of GDP to 3.9% of GDP), the authorities decided to take additional corrective measures of 0.8% of GDP, while maintaining the full amount of the stability reserves of 0.3% of GDP. The new strategy of the Government aims to correct the excessive deficit by 2011 through a back-loaded deficit reduction from 3.9% of GDP in 2009 to 3.8% in 2010 (in view of the continued recession) and 2.8% of GDP in 2011. The debt ratio is expected to increase further to around 80% in 2009, and to over 82% in 2010, after having increased to 73% of GDP at the end of 2008 as the first instalments of the international financial assistance from the EU and the IMF (totalling close to EUR 7 billion) were drawn on chiefly to increase reserves. This further increase is mainly explained by the combination of the revaluation of foreign-exchange-denominated debt due to the weaker exchange rate assumption and the lacklustre nominal GDP outlook. For 2011, the report projects a decline in the debt ratio by around 4% of GDP, which should be supported by the full repayment of first disbursement of the EU loan (implying a debt-reducing stock-flow adjustment of around 2% of GDP).

(13) Additional corrective measures for 2009 notably include further cuts in pension expenditures, in the housing subsidy systems as well as a further reduction in the public sector wage bill. In order to improve the long-term sustainability of public finances and the growth potential of the economy, the structural reform plans in the areas of pension and social support systems announced in February were strengthened and augmented. Moreover, further consolidation measures were announced for 2010 on the expenditure side, which, among others, include the areas of public sector wage bill and the energy, agricultural and public transport subsidy schemes. On the revenue side, the first phase of the tax reform is expected to be deficit-reducing by around 0.2% of GDP in 2009. In 2010, the Government plans to continue the tax reform in a broadly revenue-neutral way to reduce the tax wedge on labour, which is, inter alia, to be financed from an increase of consumption and wealth-related taxes.

(14) According to Article 3(5) of Council Regulation (EC) No 1467/97, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission and before taking into account the relevant factors mentioned in Article 2(3) of Regulation 1467/97, to adopt a revised recommendation under Article 104(7).

(15) For Hungary, the October 2006 104(7) recommendation asked for a cumulative structural adjustment of 6½ percentage points of GDP from 2006 to 2009, which translates into an annual structural improvement of close to 2¼ percentage points of GDP while GDP was expected to expand by around 3% on average. Based on the revised 2009 deficit target of 3.9% of GDP contained in the progress report, which can be considered plausible in view of the Commission services' Spring 2009 forecast and incorporating the most recent economic and budgetary developments, the achieved annual structural adjustment is 8¾ percentage points of GDP over the same period or close to 3 percentage points of GDP on annual average (Commission services' calculations on the basis of the information in the report according to the commonly agreed methodology) against the background of an average GDP decline of 1¾%.

Moreover, the implementation record of the budgetary consolidation measures both on the revenue and the expenditure side, as well as the structural reform steps adopted since September 2006 including in the area of fiscal governance appears to be good Overall, given the results of the fiscal adjustment programme since 2006, and specifically, the considerably higher-than-recommended structural adjustment achieved against the background of a much worse macro-economic environment, the Hungarian authorities can be considered to have taken effective action. On this basis, a revised recommendation for Hungary is justified.

(16) Despite the distinct improvement in Hungary's twin deficits in recent years, the country has remained vulnerable due to the high level of government and external debt. Consequently, the financial crisis had particularly strong adverse effects on the Hungarian economy and led to a sharp exchange rate depreciation and disruption in many segments of the financial markets in autumn 2008, which has since then been partly corrected. In order to foster the credibility of the economic policy, the structural reform programme was strengthened and augmented since the eruption of the crisis, building on the steps made since mid-2006. Following a cumulative 200 basis points rate cut between November 2008 and January 2009 that brought the main policy rate to 9.5%, the central bank maintained a prudent monetary policy stance as the volatility of the forint and macro-stability considerations limited the scope for further rate cuts. At the same time, new instruments were introduced to support the functioning of the financial intermediaries.

(17) In view of the depth of the unexpected adverse economic events, the target date of 2009 set in the Council recommendation of 2006 can no longer be regarded as realistic. Specifically, further corrective steps in 2009 on top of those decided in the context of the adoption of the 2009 budget, in February and in April 2009 (amounting together to around 2.5% of GDP), would ensue an even more procyclical policy stance, which seriously risks triggering a downward spiral with concerns for economic, financial and structural stability. Moreover, against the projected continuous downturn, the consolidation effort associated with a correction in 2010 could prolong the recession in the light of the adverse effects of additional budgetary measures on aggregate demand. Finally, account should also be taken of the fact that 2011 is also the target set in the context of the international assistance of the EU, the IMF and the World Bank. In view of all these exceptional elements as well as of the depth and length of the current recession, the new deadline to put an end to the excessive deficit should be set as 2011. Nevertheless, based on the government's most recent projection of 3.6% of GDP in 2011, a lower deficit than the new target of 2.8% of GDP included in the most recent EDP progress report would be appropriate, in order to ensure the necessary fiscal effort of a cumulative 0.5 percentage point of GDP over 2010 and 2011. Taking into account the exceptional structural improvement achieved since 2006, and especially the planned substantial structural effort of 2½% of GDP in 2009, this correction would represent an annual average fiscal effort of around 1% of GDP over the 2009-2011 period.

(18) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In the case of Hungary, the correction of the excessive deficit needs to be framed within a comprehensive reform strategy including the continuation of the structural reforms,

building on the significant steps achieved since mid-2006 and reinforced since late 2008.

(19) To this end, the Hungarian Government should (i) limit the deterioration of the fiscal position in 2009 by ensuring a rigorous implementation of the adopted and announced corrective measures to respect the target of 3.9% of GDP, and by allocating possible windfall gains for improving the headline balance; (ii) starting from 2010 (when the deficit should not exceed 3.8% of GDP), rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures in view of warranting a lasting improvement of public finances; (iii) spell out and adopt in a timely manner additional expenditure cuts which will be necessary to achieve the correction of the excessive deficit by 2011 and ensure a cumulative 0.5 percentage point of GDP fiscal effort over 2010 and 2011; (iv) stand ready to seize every opportunity to accelerate the fiscal adjustment, especially as regards 2011; and (v) incorporate sufficient reserve provisions in the forthcoming budget laws to avoid slippages even in case of unforeseen events. At the same time, the government debt ratio will have to be brought on a firm downward trajectory in line with the multi-annual path for deficit reduction laid down in the progress report and if possible before 2011.

(20) The planned correction of the excessive deficit by 2011 will require the Government to rigorously achieve its budgetary targets which hinges upon an effective implementation of all the consolidation measures announced in the progress report for the years 2009 to 2011 as well as upon timely decisions on and implementation with vigour of further structural reforms and the recently adopted fiscal responsibility law.

(21) Enhanced surveillance under the EDP will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. The Commission and the Council shall monitor the implementation of action taken by Hungary in response to this recommendation, in accordance with Article 10 of Regulation (EC) No 1467/97, including on the basis of the continued submission of regular progress reports by the authorities and the information contained in a separate chapter of the Hungarian convergence programme updates.

(22) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

HEREBY RECOMMENDS:

1. On the basis of the macroeconomic outlook of the Commission services' spring 2009 forecast, the Hungarian authorities should put an end to the present excessive deficit situation as rapidly as possible and by 2011 at the latest.

2. The Hungarian authorities should reduce the deficit in a credible and sustainable manner. Specifically, to this end, the Hungarian authorities should:

   (a) Limit the deterioration of the fiscal position in 2009 by ensuring a rigorous implementation of the adopted and announced corrective measures to respect

the target of 3.9% of GDP as presented in the most recent EDP progress report, and by allocating possible windfall gains for improving the headline balance;

(b) Starting from 2010 (when the deficit should not exceed 3.8% of GDP as foreseen in the EDP progress report), rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures, in view of warranting a lasting improvement of public finances;

(c) Spell out and adopt in a timely manner additional consolidation measures which will be necessary to achieve the correction of the excessive deficit by 2011 and ensure a cumulative 0.5 percentage point of GDP fiscal effort over 2010 and 2011.

3. The Council establishes the deadline of [7 January 2010] for the Hungarian authorities to take effective action regarding the measures to achieve the deficit targets for 2009 and 2010. In particular, the envisaged expenditure-reducing measures should be entirely incorporated into the 2010 budget law and timely implemented. Moreover, sufficient reserve provisions should be incorporated in the budget law to avoid slippages even in case of unforeseen events. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' spring 2009 forecast.

4. The Hungarian authorities should ensure that the government gross debt ratio is brought onto a firm downward trajectory, in line with the multi-annual path for deficit reduction laid down in the progress report and if possible before 2011. Also against this background, the country should stand ready to seize every opportunity to accelerate the fiscal adjustment, especially as regards 2011.

5. The Hungarian authorities should implement with vigour the recently adopted fiscal responsibility law, including the compliance with the new numerical rules, as well as improve budgetary planning procedures and monitoring of the budget execution with a view to enhance the medium-term budgetary framework.

In addition, the Council invites the Hungarian authorities to ensure that budgetary consolidation towards its medium-term objective of a structural deficit of ½ of GDP is sustained after the excessive deficit has been corrected.

The Council continues to welcome the commitment of the Hungarian authorities announced originally in the adjusted convergence programme update of 1 September 2006 to submit reports to the Commission and the Council examining progress made in complying with this recommendation on a six-monthly basis. Moreover, it invites the Hungarian authorities to report on progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes until the excessive deficit is corrected.

This recommendation is addressed to the Republic of Hungary.

Done at Brussels,

For the Council
The President