COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Hungary, 2004-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not yet participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

Hungary’s convergence programme covering the period 2004-2008 was submitted on 14 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the Spring 2004 forecasts and having regard to the Code of Conduct[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> On 14 May 2004, Hungary submitted its first convergence programme, which was adopted by the government on 13 May and covers the period from 2004 to 2008. It largely complies with the code of conduct on the content and format of stability and convergence programmes. The programme makes reference to the planned adoption of the euro in 2010 (possibly in 2009 if economic conditions turn out more favourable than expected). Accordingly, the fulfilment of the convergence criteria is foreseen by 2008.
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> The general government deficit decreased from 9.3% of GDP in 2002 to 5.9% of GDP in 2003, but it is still well above the 3% of GDP Treaty reference value. On 12 May 2004, the Commission initiated an excessive deficit procedure for Hungary, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on this report on 25 May. On 5 July 2004, the Council is expected, on the basis of two Commission recommendations, to decide that an excessive deficit exists in Hungary and to make recommendations to Hungary to bring this situation to an end.

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1 OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 COM (2002) 668 final, 27.11.2002.

The convergence programme contains two different scenarios for the macroeconomic and budgetary projections: a "baseline" and a "more optimistic" scenario. The budgetary projections are based on the baseline scenario. It foresees real GDP growth of about 3½-4% in 2004 and 2005, followed by an increase in the growth rate by some ½ percentage point each year until 2008. The recovery in economic activity is expected to be driven by strong growth in exports and fixed investment, compensating for lower private consumption growth, based on the significant deceleration of the previously high real wage growth. This would be also reflected in a gradual though moderate narrowing of the current account deficit. The briefly outlined "more optimistic" scenario shows higher growth rates based on higher exports. Taking as a benchmark the Commission 2004 Spring forecast confirms that the "baseline" scenario should be considered as the reference scenario reflecting the more plausible growth assumptions. However, while on the basis of currently available information, this seems reasonable in the short term, even this scenario seems to be somewhat optimistic as far as the medium-term is concerned. In line with the robust growth and measures to increase employment, unemployment is anticipated to decrease further to around 5½% by 2008 and the participation rate is expected to increase up to 64% in 2008 (from somewhat below 6% and 60% respectively in 2003).

The convergence programme assumes a resumption of disinflation after a peak of 6½% annual average inflation in 2004 and projects inflation at about 3% by 2008. While the sharp drop in inflation in 2005 would be the result of tapering off price hikes due to indirect taxes, disinflation would be supported during the entire period by moderate real wage growth (in particular in the public sector) and restrictive fiscal policies. These projections are broadly in line with the Commission's assumptions. The convergence programme does not give indications of planned changes in the monetary or exchange rate regime for the observed period (consisting of an inflation targeting framework in combination with a +/-15% fluctuation band around the central parity). Moreover, contrary to the 2003 pre-accession economic programme, the convergence programme does not declare the aim of achieving ERM II membership immediately after EU accession. It rather acknowledges that ERM II participation needs to be supported by a credible and sustainable fiscal adjustment path.

The medium-term budgetary strategy represents a considerable departure from that in the 2003 pre-accession economic programme. While the latter aimed for a deficit below 3% of GDP by 2005, this target is postponed until 2008 in the convergence programme. The consolidation envisaged in the programme is frontloaded with the deficit decreasing from 5.9% of GDP in 2003 to 4.6% of GDP in 2004, followed by a yearly adjustment of some ½ percentage point (4.1% of GDP in 2005, 3.6% in 2006, 3.1% in 2007 and 2.7% of GDP in 2008). The consolidation strategy is expenditure-based, underpinned by structural reforms, in particular in the areas of public administration, education and health. However, neither the impact of these reforms, nor the state of their implementation is known with the necessary precision. The projected decline of the overall expenditure ratio by more than 4 percentage points between 2003 and 2008[4] would allow for a rise in the GDP share of public

[4] This would occur abstracting from the expenditure effects of EU transfers (which are expected to increase from some 0.5% of GDP in 2004 to 2.5% of GDP in 2008).

investment, supported by EU funding. At the same time, the fiscal consolidation is planned to be accompanied by a reduction of the weight of the public sector in the economy. This would manifest itself also in a reduction of the overall tax burden from 39% in 2004 to 37% in 2008.

A consolidation pace of some ½ percentage points of GDP annually from 2005 onwards may appear relatively modest, in particular against the background of robust growth forecast over the entire period, the relatively high level of deficit and debt ratios and the expected decline in the interest rate burden. However, this has to be set against at least three offsetting considerations. First, it is important for Hungary to restore the credibility of fiscal policy by setting objectives that are within reach and achieving them. Second, the structural reforms underpinning the strategy would, once further specified and carried out, enhance the sustainability of the fiscal consolidation and improve the quality of public finances. Third, the government budget is burdened by the costs of the pension reform (which are expected to rise from 0.7% in 2003 to 0.9% of GDP by 2008).

Nevertheless, the fact that the planned deficit should be reduced below 3% of GDP only in 2008, and then only by a small margin, is a source of concern. Any unfavourable development on the macroeconomic or on the budgetary side would compromise the achievement of this objective, with a potentially serious impact on the government's overall adjustment strategy. Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to below the 3% of GDP deficit reference value by the end of the programme and all opportunities should be seized to accelerate the fiscal adjustment. In this context, both the experience of expenditure overruns in the past two years and the absence of clear indications about the ambitious expenditure-reducing measures for 2005-2008 are worrying signs. In addition, the whole adjustment strategy depends crucially on the success of carrying out the planned ambitious adjustment in 2004. Missing the budgetary target this year would set the whole strategy at risk. Given that unexpected expenditures, such as those seen in recent years cannot be excluded, it is important that the government sticks to its intention as announced in the convergence programme, and adopts additional and timely corrective measures if necessary in order to ensure that the 2004 deficit target is met.

Overall, the consolidation strategy in the convergence programme seems conducive to a better quality of public finances. It is generally acknowledged that fiscal consolidation is more sustainable when based on expenditure cuts, especially if underpinned by structural reforms. Also a reduction of the high tax burden, especially on labour, seems appropriate. However, for a virtuous circle to be set in motion, it is essential that the expenditure targets are respected. Therefore, a cautious approach seems advisable regarding tax cuts, making them conditional upon the implementation of the planned reforms and the achievement of the deficit targets. Furthermore, should economic growth fall short of the expectations in the programme, additional measures are likely to be needed to keep the consolidation on track.

After peaking at nearly 60% of GDP in 2004, the debt ratio is projected in the programme to decline in line with the planned budgetary adjustment but also benefiting from a falling interest burden and negative stock-flow adjustments. Provided that the consolidation takes place as planned, and assuming no significant weakening of the exchange rate and a reduction of the interest burden as forecast in the programme, this seems plausible. The need for the consolidation to take place as planned is underscored by the necessity to ensure that public borrowing requirements continue to be met smoothly, and that debt service costs are well-contained.

Especially in view of the relatively high debt level, Hungary faces some risk of budgetary imbalances in meeting the projected costs of an aging population. While the pension reform dating back to 1998 and establishing a progressive three-tier pension system – including parametric changes to the pay-as-you-go pillar e.g. increase in the retirement age, pension indexation – has significantly mitigated the risks of long-term budgetary imbalances, it has not removed them entirely. Securing an adequate primary surplus in the medium term together with the implementation of measures to further stem the rise of age-related expenditure, particularly concerning health care, is essential to place public finances on a sustainable basis.

Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007	2008
Real GDP (% change)	**CP**	**2.9**	**3.3-3.5**	**3.5-4**	**ca.4**	**4-4.5**	**4.5-5**
	COM	2.9	3.2	3.4	n.a.	n.a.	n.a.
	PEP	ca.3.5	ca.3.5	4-4.5	4.5-5	n.a.	*n.a.*
HICP inflation (%)	**CP**	**4.7**	**ca.6.5**	**ca.4.5**	**ca.4**	**ca.3.5**	**ca.3**
	COM	4.7	6.9	4.6	n.a.	n.a.	n.a.
	PEP	4.8-5	ca.5	ca.4	ca.3	n.a.	*n.a.*
General government balance (% of GDP)	**CP**	**-5.9**	**-4.6**	**-4.1**	**-3.6**	**-3.1**	**-2.7**
	COM	-5.9	-4.9	-4.3	n.a.	n.a.	n.a.
	PEP	-4.8	-3.8	-2.8	-2.5	n.a.	*n.a.*
Primary balance (% of GDP)	**CP**	**-2.0**	**-0.5**	**-0.2**	**0.1**	**0.3**	**0.4**
	COM	-1.8	-0.9	-0.5	n.a.	n.a.	n.a.
	PEP	-1.2	-0.4	0.4	0.4	n.a.	*n.a.*
Government gross debt (% of GDP)	**CP**	**59.1**	**59.4**	**57.9**	**56.8**	**55.6**	**53.7**
	COM	59	58.7	58.0	n.a.	n.a.	n.a.
	PEP	57.2	55.3	54.0	n.a.	n.a.	*n.a.*

Sources: Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of Hungary and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

on the convergence programme of Hungary, 2004-2008

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July 2004] the Council examined the convergence programme of Hungary, which covers the period 2004 to 2008. The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".

The budgetary strategy underlying the programme aims at reducing the general government deficit to below 3% of GDP by 2008, while at the same time reducing the weight of the public sector in the economy. To this end, the programme envisages a frontloaded consolidation with the government deficit decreasing from 5.9% of GDP in 2003 to 4.6% of GDP in 2004, followed by a yearly adjustment of some ½ percentage point of GDP (4.1% of GDP in 2005, 3.6% in 2006, 3.1% in 2007 and 2.7% of GDP in 2008). The consolidation is expenditure-based, underpinned by structural reforms, predominantly in the areas of public administration, health and education. However, these reforms still have to be specified and implemented. The decline of the overall expenditure ratio would allow for a rise in the GDP share of public investment, supported by EU funding. At the same time, a reduction of the overall tax burden is planned from 39% of GDP to 37% of GDP.

The programme contains two different scenarios for the macroeconomic and budgetary projections: a "baseline" scenario and a "more optimistic" scenario. The baseline scenario should be considered as the reference scenario for assessing budgetary projections as reflecting the more plausible growth assumptions of real GDP growth about 3½-4% in 2004 and 2005, followed by a rather optimistic rise in the growth rate by about ½ percentage point each year until 2008. The projection of rapid disinflation after 2004, when indirect tax hikes

5 OJ L209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

taper off, appears broadly realistic, provided that real wage growth is moderating significantly to be in line with productivity.

The programme foresees the general government deficit to be reduced to below the 3% of GDP reference value only in 2008. The deficit reduction foreseen in the programme seems within reach. Risks to the budgetary outcome stem from possibility that growth could turn out lower than forecast, from the experience with expenditure overruns in the past, and the lack of information on the envisaged expenditure-reducing measures in the outer years of the programme. The achievement of the frontloaded adjustment in the first year of the programme is crucial for the credibility of the adjustment strategy; missing it, might put the whole adjustment path at a risk. Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to the below 3% of GDP deficit threshold by the end of the programme period and all opportunities should be seized to accelerate the fiscal adjustment. At the same time, the projected balances reflect to a significant extent the implementation of an intensive programme of public investment, bringing the government investment-to-GDP ratio up from 4.0% of GDP in 2004 to 5.5% of GDP in 2008.

After peaking at nearly 60% of GDP in 2004, the debt ratio is projected in the programme to fall to 54% of GDP by 2008. This would be in line with the planned budgetary adjustment but also benefiting from a falling interest burden and negative stock-flow adjustment. While this seems plausible, the positive development might be put in danger by a slower-than-forecast lowering in interest rates.

Hungary faces some risk of budgetary imbalances in meeting the projected costs of an aging population. While the pension reform dating back to 1998 and establishing a progressive three-tier pension system – including parametric changes to the pay-as-you-go pillar e.g. increase in the retirement age and pension indexation – has mitigated the risks of long-term budgetary imbalances, it has not entirely removed them. Securing an adequate primary surplus in the medium-term together with the implementation of measures to further stem the rise of age-related expenditure, particularly concerning health care is essential to place public finances on a sustainable basis.

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[On 5 July 2004], on the basis of recommendations from the Commission, the Council decided that an excessive deficit existed in Hungary in accordance with Article 104(6) of the Treaty and made recommendations under Article 104(7) to Hungary with a view to bringing that situation to an end, in which the Council expresses its policy advice.

Key projections from the convergence programme of Hungary

	2003	**2004**	**2005**	**2006**	**2007**	**2008**
Real GDP growth (%)	2.9	3.3-3.5	3.5-4	ca.4	4-4.5	4.5-5
Employment growth (%)	1.0	0-0.5	0.5-1	ca.1	ca.1	ca.1.5
HICP inflation (%)	4.7	ca.6.5	ca.4.5	ca.4	ca.3.5	ca.3
General government balance (% of GDP)	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
Government gross debt (% of GDP)	59.1	59.4	57.9	56.8	55.6	53.7