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 Poland, 2004-2007

(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.

Poland's convergence programme covering the period 2004-2007 was submitted on 17 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:

> Poland's first convergence programme covering the period 2004-2007 was submitted on 17 May 2004. The programme does not specify the Polish authorities' intentions as regards the envisaged timing of ERM II entry or euro adoption.
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> The programme only partly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes" and adheres to ESA95 standards[4]. In particular, the quality of ESA95 data on the composition of the general government revenue and expenditure needs to be further improved.

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1 OJ L 209, 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.

4 The programme deviates from data requirements in the area of the long-term sustainability of public finances; information needed to fill table 6 of Annex 1 of the code of conduct has not been regrouped and is not complete. Table 2/Annex 1 on the general government budgetary developments points to a misclassification. In addition, inflation is still reported on the basis on the consumer price index (CPI) although table 1 of Annex 1 requires projections for the harmonised index of consumer prices (HICP).

The general government deficit increased to 4.1% of GDP in 2003, above the 3% of GDP Treaty reference value. The Commission initiated the excessive deficit procedure for Poland on 12 May 2004, 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 Poland and to make recommendations to Poland to bring this situation to an end. The deficit figures will have to be adjusted upward if the open pension funds are excluded from the general government sector following the EUROSTAT decision on the classification of funded pension schemes.

The macroeconomic framework presented in the programme predicts a gradual acceleration of GDP growth from 3.7% in 2003 to 5.0% in 2004 and 2005 and to 5.6% in 2006 and 2007. Net exports will continue to support economic growth this year, while domestic demand is expected to take over this role from 2005 onwards. The scenario up to 2005 is very close to the Commission Spring 2004 forecasts. And recent information points to even higher GDP growth in 2004 than projected in the programme. In the outer years of the programme period, the projected acceleration in GDP growth reflects strong expansion of domestic demand. This projection rests on perhaps optimistic assumptions about both investment and private consumption. Nevertheless, the dissipation of uncertainties surrounding fiscal policy, through the full implementation of the *Hausner plan,* would be instrumental in achieving the projected double-digit investment growth rates as well as the expected strong acceleration of private consumption growth. The programme includes estimates of potential output growth and projects that actual GDP growth will exceed potential over the whole programme period.

HICP inflation dropped from 10.1% in 2000 to 0.7% in 2003. The fall in inflation largely reflected tight monetary policy, the widening of the output gap and declining food and oil prices. Although inflation has picked up since mid-2003, it remains low. Much of the increase in headline inflation observed recently has been due to rising oil prices and an end to the fall in food prices, while limited price pressures have emerged so far from the demand side. The real effective exchange rate of the zloty has depreciated sharply since mid-2001. This decline is to a large extent the consequence of the continuous disinflation path and the nominal depreciation of the zloty against the euro. Yield spreads between Polish and euro area benchmark bonds narrowed between 2001 and mid-2003, but widened again in the second half of 2003 and early 2004. No change to the existing monetary and exchange rate arrangements, i.e. a direct inflation-targeting framework combined with a floating exchange rate regime, is foreseen before entry into ERM II.

The budgetary strategy underlying the programme aims at reducing the general government deficit to below 3% of GDP by 2007 and maintaining the debt ratio below 60% of GDP. The general government deficit is expected to increase in 2004 from 4.1% of GDP in 2003 to 5.7% and to decrease steadily thereafter. For 2005, 2006 and 2007, the projections are for headline deficits of 4.2%, 3.3% and 1.5% respectively. The programme incorporates a comprehensive set of measures (the so-called *Hausner plan),* which, if fully implemented, would result in a cumulative correction of the deficit over the period 2005-2007 by 5.3% of GDP of additional revenues and savings (3.3% of GDP in the social area and 2% of GDP in public administration and state-owned enterprises). The achievement of the deficit targets is also conditional on projected high GDP growth throughout the programme period. In comparison to the August 2003 pre-accession economic programme the most significant difference is the upward revision of the general government deficit in 2004 by 0.7 percentage points of GDP, despite the confirmed economic recovery, ascribed in the programme inter alia to EU-accession-related expenditure.

The reduction of the deficit between 2004 and 2007 is ambitious amounting to more than 4 percentage points of GDP. Many risks surround the planned consolidation strategy. Besides the downside macroeconomic risk highlighted above, a delayed or incomplete implementation of the envisaged measures seems a distinct possibility in view of the uncertain political situation. The planned adjustment is not only heavily back-loaded but also appears only in part consistent with the sequence announced in the *Hausner plan*. In particular, in the run-up to the elections, savings stemming from the measures already voted by Parliament could be used for consumption and the fulfilment of some pre-election promises rather than for deficit reduction, all the more so as the *Hausner plan* is socially sensitive as most of the savings are expected in the social area. In turn, the monetary authorities may respond to a lax fiscal policy with a more cautious stance keeping interest rates at a relatively high level in order to maintain a stable macroeconomic environment. In the medium-term, a combination of large deficits and high real interest rates can be damaging for growth by hampering investment and backfire on the attainment of the budgetary targets. Finally, as a consequence of a recent Eurostat decision on the classification of the funded pension scheme, the planned figures for the deficit may have to be revised upwards by 1.6 percentage points of GDP.

The government debt ratio increased from 36.7% of GDP in 2001 to 45.4% in 2003. The debt ratio is projected to increase further up to 2006, reaching 52.7% of GDP at the end of 2006, before declining to 52.3% of GDP in 2007. The Commission Spring 2004 forecasts show a similar steady increase in the debt ratio up to 2005. The classification of the open pension funds outside the general government sector would lead to a further increase in the debt figures by approximately 4.5 percentage points. Even under this scenario, the debt ratio would remain below the 60% of GDP reference value over the programme period. The planned slowdown and eventual reversal of the increase in the debt ratio would reflect the combined effect of improving primary balances and an increasing nominal growth dividend, partially offsetting the persistent net debt-increasing impact of the stock-flow adjustment. It is also conditional on sizeable privatisation proceeds. The programme assumes that privatisation receipts in the period 2004-06 would amount to about 0.8% of GDP on average each year, i.e. twice the level reached in 2003. This assumption appears optimistic given the experience of the past three years, when actual privatisation receipts turned out to be significantly lower than planned.

The programme presents the measures envisaged in the *Hausner plan* to curb social spending and improve public expenditure management. The proposed reforms are ambitious and, if fully implemented, would constitute a major step towards addressing Poland's fiscal problems. The adjustment path described in the programme hinges critically on the implementation of the planned reform of social protection. In particular, important savings would result from the reform of the two most important social benefit systems in Poland, the disability pension system and the special farmers' social security system. Also, the envisaged revision or suppression of automatic indexation mechanisms of social benefits would contribute to easing expenditure pressures. Besides their budgetary impact, these reforms would pave the way for reducing the high labour tax wedge, which is a major impediment to job creation and discourages labour market participation.

Poland faces a risk of budgetary imbalances in meeting the projected costs of an ageing population. Securing an adequate primary surplus in the medium term together with the implementation of measures to stem the pension system deficit and to limit the assumption of liabilities of the state-enterprises and the health care system is essential to place public finances on a sustainable footing.

Table: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP	**CP**	**3.7**	**5.0**	**5.0**	**5.6**	**5.6**
(% change)	COM	3.7	4.6	4.8	n.a	n.a
	PEP	*3.0*	*5.0*	*5.0*	*5.6*	*n.a*
HICP/CPI	**CP**	**0.8**	**2.2**	**2.8**	**< 3**	**< 3**
(% change) 1/	COM	0.7	2.3	3.0	n.a	n.a
	PEP	*0.8*	*2.2*	*2.8*	*2.9*	*n.a*
General government balance	**CP**	**-4.1**	**-5.7**	**-4.2**	**-3.3**	**-1.5**
(% of GDP) 2/	COM	-4.1	-6.0	-4.5	n.a	n.a
	PEP	*-4.1*	*-5.0*	*-4.0*	*-3.4*	*n.a*
Primary balance	**CP**	**-1.0**	**-2.8**	**-1.1**	**-0.3**	**1.3**
(% of GDP) 2/	COM	-1.0	-2.8	-1.2	n.a	n.a
	PEP	*-1.1*	*-2.3*	*-1.5*	*-0.8*	*n.a*
Government gross debt	**CP**	**45.3**	**49.0**	**51.9**	**52.7**	**52.3**
(% of GDP) 2/	COM	45.4	49.1	50.3	n.a	n.a
	PEP	*44.3*	*46.9*	*49.2*	*49.1*	*n.a*

1/ CPI for PEP and CP, HICP for COM
2/ Open pension funds are considered part of the general government sector.
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 Poland 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 Poland, 2004-2007

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 ADOPTED THIS OPINION:

On [5 July 2004] the Council examined the convergence programme of Poland, which covers the period 2004 to 2007. The programme only partly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes" and with ESA 95 standards.

The budgetary strategy underlying the programme aims at reducing the general government deficit to below 3% of GDP by 2007 (with the following intermediary annual targets: 5.7% of GDP in 2004, 4.2% of GDP in 2005, 3.3% in 2006 and 1.5% in 2007) and maintaining the debt ratio below 60% of GDP. To this end, the programme incorporates a comprehensive set of measures (the so-called *Hausner plan)* endorsed by the government in January 2004*,* which, if fully implemented, would result in a cumulative correction of the deficit by 5.3% of GDP of additional revenues and expenditure savings over the period 2005-2007 (3.3% of GDP in the social area and 2.0% of GDP in public administration and state-owned enterprises). The achievement of the deficit target is also conditional on projected high growth throughout the programme period.

On the basis of currently available information, the macro-economic scenario underlying the programme seems to reflect rather favourable growth assumptions. If the growth forecast of 5.0% for 2004 and 2005 appears plausible and could even be exceeded in 2004, the evolution of growth in the medium term projected in the programme, i.e. an acceleration of GDP growth

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5 OJ L 209, 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.

to 5.6% in 2006 and 2007, reflects somewhat optimistic assumptions about both private consumption and investment. In this regard, the full implementation of the *Hausner plan* and the ensuing dissipation of fiscal uncertainties are crucial to achieve the projected strengthening of growth. The projection for inflation appears broadly realistic.

The programme projects the deficit to be reduced to below the 3% of GDP reference value in 2007. Several risks surround the programme targets. Besides the downside macroeconomic risks highlighted above, there is a lack of information on the envisaged measures and uncertainty over their implementation, with the planned adjustment not only being heavily back-loaded but also only partly consistent with the corrections announced in the *Hausner plan*. Finally, as the effect of a recent Eurostat decision on the classification of the funded pension scheme, the planned figures for the deficit may have to be revised upwards by 1.6 percentage points of GDP. Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to below 3% of GDP during the programme period.

In the programme, the debt ratio is projected to increase by 7 percentage points of GDP over the period 2004-2007, with the increase coming to a halt only in the final year of the programme. The evolution of the debt ratio is likely to be less favourable than projected given the risks to the deficit outcomes mentioned above and significant uncertainties about the realisation of planned privatisation proceeds.

Poland faces a risk of budgetary imbalances in meeting the projected costs of an ageing population. While the pension reform dating back to 1999 and establishing a progressive three-tier pension system – including parametric changes to the pay-as-you-go pillar, e.g. limiting the possibility of early retirement - 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 stem the pension system deficit and to limit the assumption of liabilities of the state-enterprises and the health care system is essential to place public finances on a sustainable footing.

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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 Poland in accordance with Article 104(6) of the Treaty and made recommendations under Article 104(7) to Poland 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 Poland

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	3.7	5.0	5.0	5.6	5.6
Employment growth (%)	-2.3	-0.2	1.0	1.8	2.5
HICP inflation (%)	0.8	2.2	2.8	<3	<3
General government balance (% of GDP)	-4.1	-5.7	-4.2	-3.3	-1.5
Government gross debt (% of GDP)	45.3	49.0	51.9	52.7	52.3