COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.2.2005
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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 updated 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. 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 Member States that joined the EU on 1 May 2004 do not participate in the single currency, but are required to fulfil in due time the convergence criteria, including the one on the sustainability of the government financial position, in order to qualify for the adoption of the euro. In view of a general government deficit of 3.9% of GDP recorded in 2003, the Council decided that Poland was in excessive deficit on 5 July 2004 and recommended that the excessive deficit be corrected by 2007 at the latest in line with the May 2004 convergence programme. In particular, Poland was recommended to implement with vigour the measures envisaged in the May convergence programme, in particular those contained in the so-called *Hausner plan*. It was recommended to take effective action regarding the measures envisaged to achieve the 2005 deficit target by the deadline of 5 November 2004 in line with the Stability and Growth Pact (SGP). In addition, Polish authorities were invited to allocate possible extra revenues to decrease the general government deficit and to ensure the rise in the debt ratio is brought to a halt. In its Communication of 22 December 2004, the Commission concluded that the Polish government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target[2].

The Member States which joined the EU on 1 May 2004 committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004. The first convergence programme of Poland, covering the period 2004-2007, was submitted on 17 May 2004 and assessed by the Council on 5 July 2004. Poland submitted an update of its convergence programme on 1 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[3], the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 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 coordination of budgetary policies[4]. This evaluation warrants the following assessment:

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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 SEC(2004) 1630 final, 22.12.2004.

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01–REV 1 of 27.6.2001, endorsed by the ECOFIN Council on 10.7.2001.

4 COM(2002) 668 final, 27.11.2002.

- Poland submitted to the European Commission its updated convergence programme covering the period 2004-2007 on 1 December 2004, following the approval by the Council of Ministers on 30 November 2004. The document incorporates the measures taken in the 2005 budget and draws upon the government's "*Programme of Rationalisation and Reduction of Public Expenditure*" (the so-called *Hausner plan*) endorsed in January 2004. The programme partly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes" and adheres to ESA95 standards. The quality of ESA95 data on the composition of the general government revenue and expenditure is not fully in line with ESA95 statistical standards. Accordingly, Poland is invited to achieve compliance with the data requirements.

- The macroeconomic framework presented in the programme predicts a deceleration in real GDP growth from 5.7% in 2004 to 5.0% and 4.8% in 2005 and 2006, respectively, followed by a rebound to 5.6% in 2007. Throughout the forecast period, growth will be driven by domestic demand, while the contribution of net exports is expected to turn negative from 2005 onwards. The macroeconomic scenario up to 2006 is plausible and is close to the Commission services autumn 2004 forecasts, although the latter predict a somewhat lower GDP growth for 2006. By contrast, the growth forecast for the last year of the programme appears on the high side. The projected acceleration in GDP growth in 2007 reflects optimistic assumptions about the growth of both potential output and domestic demand. In particular, the programme assumes a strengthening of potential growth from 3.6% in 2004 to 4.7% in 2007 (according to Commission services calculations), resulting in an estimated output gap of over 2% at the end of the programme period. This suggests also that price pressures could be stronger than expected in the programme.

- During 2004, inflation in Poland has been increasing from the very low levels recorded in 2003, but the pace has recently slowed. The surge in inflation observed between April and August 2004 was mostly due to temporary factors (food and oil prices, accession-related tax increases), while continued moderate wage growth and a stronger zloty help to underpin prospects for a slowing of inflation in 2005. The zloty appreciated strongly during most of 2004, gaining some 13% against the euro relative to December 2003. In effective terms, both nominal and real, the zloty also recorded an appreciation of more than 10% in the course of 2004 (year-end vs. year-end). Yield spreads between Polish and euro area benchmark bonds widened between mid-2003 and mid-2004 due to investor concerns about economic policy governance, but narrowed again in recent months, down to about 200 basis points at year-end. 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.

- The budgetary strategy underlying the updated 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 update foresees a gradual reduction of the deficit to 2.2% of GDP in 2007 from 5.4% of GDP in 2004. The open pension funds (estimated annual impact of 1.5% of GDP) are classified within the general government sector as allowed by the transition period granted by Eurostat. Compared with the previous programme, the most significant difference is the upward revision of the general government deficit target in 2007 by 0.7 percentage points of GDP, despite the projected rebound in economic growth. The fiscal consolidation would result from the implementation of a comprehensive set of measures contained in the *Hausner plan,* which, if fully implemented, would have an estimated total budgetary impact of 4.7% of GDP over the period 2005-2007 (revised downwards by 0.6 percentage points compared with the previous programme).

– The reduction of the headline deficit between 2004 and 2007 is less ambitious than in the May convergence programme and amounts to 3.2 instead of 4.2 percentage points. Many risks surround the planned consolidation strategy. The risk of a delayed or incomplete implementation of the envisaged measures of the *Hausner plan*, described in the assessment of the May 2004 programme, is already materialising. There is still uncertainty over the implementation of the remaining measures contained already in the budget for 2005, but requiring legislative action. Despite the rejection by Parliament of two important measures, the deficit targets remained unchanged. Almost half of the measures aiming at additional revenue and expenditure savings described in the update are unspecified. Contingent liabilities constitute an additional risk to the sustainability of public finances. The achievement of the deficit targets is also conditional on projected high GDP growth throughout the programme period. In addition, the funded pension scheme continues to be recorded inside the general government sector. With a change in classification in 2007, the deficit figures for each year will be adjusted upwards by 1.5 percentage points. In the absence of additional savings measures, the fulfilment of the Council recommendation to bring the deficit below 3% in the end year of the programme is not ensured, based on the new 2007 deficit target of 2.2% of GDP. Based on the risk assessment, the budgetary outcome could be worse than projected.

– The government debt ratio is projected to increase by a cumulative 2.6 percentage points between 2004 and 2006 to peak at 48% of GDP at the end of 2006, before declining by 0.8 percentage points in 2007. The Commission services autumn 2004 forecasts show a less favourable debt development. The classification of the open pension funds outside the general government sector in accordance with the Eurostat ruling would lead to an increase in the debt figures by about 6 percentage points on average each year over the period 2005-2007. The debt ratio would thus remain below the 60% of GDP reference value even with this change in classification. The debt forecast for 2004 has been revised downwards by some 3 percentage points compared to the May programme, mainly due to stronger than expected nominal GDP growth and valuation effects following the appreciation of the zloty. Over the rest of the programme period, improving primary balances and a large nominal growth dividend would partly offset the net debt-increasing impact of the stock-flow adjustment, in part reflecting the pre-financing of EU funds. The planned slowdown and eventual reversal of the increase in the debt ratio is also conditional on sizeable privatisation proceeds. Contingent liabilities also represent a risk to the planned path of debt reduction. The stock of treasury guarantees amounted to 3.9% at the end of 2004 and is expected to increase in the coming years. In addition, the outstanding debt of the health-care system continues to grow and expectations for a bail-out by the government are rising.

– The update outlines only briefly the measures envisaged in the *Hausner plan* to curb social spending and improve public expenditure management. The adjustment path described in the programme hinges critically on the implementation of the planned reform of social protection. The update complements the May convergence programme, where most of the measures were discussed, with the estimates of the budgetary impact of the measures. 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. They also address the challenge of decreasing the relatively high share of the legally determined expenditure. Due to the public finance reform and the rationalisation of expenditure, the share of mandatory (legally determined) expenditure is expected to decrease from 42.5% in 2003 to 39.3% in 2007.

- The lack of budgetary projections beyond 2020 makes it very difficult to assess the long-term sustainability of the Polish public finances, as most of the budgetary impact of aging is likely to take place after 2020. However, on the basis of the available information, some risks cannot be ruled out. Major uncertainties regarding the budgetary impact of policies aimed at strengthening the long-term budgetary trends remain.

- While the strategy outlined in the programme relies mainly on the impact of the pension reform and the necessary budgetary consolidation in the medium-term, additional reform measures need to be implemented in the future to improve the capacity to cope with an ageing population. Thus, a successful implementation of the planned measures, a strict monitoring of outstanding contingent liabilities and the resolute implementation of the planned budgetary consolidation in the medium-term should contribute to a sustainable position in the longer term.

- Overall, the economic policies outlined in the update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. On the one hand, the programme is in line with the reduction of the general government deficit recommended by the Council and the reduction is based on the implementation of the *Hausner plan*. On the other hand, the programme does not present concrete steps to safeguard the long-term sustainability of public finances, and to address the issue of the rising stock of contingent liabilities.

- In view of the above assessment and in the light of the recommendations made by the Council under Article 104(7), it would be appropriate that Poland strengthens the fiscal adjustment and lowers the deficit target for 2007. In order to bring the deficit below 3% of GDP in 2007 in a credible and sustainable manner, it should ensure a full implementation of the structural measures contained in the *Hausner plan* and take additional fiscal consolidation measures. If risks related to implementation materialized, additional effort should also be made to introduce alternative measures. Furthermore, Poland should be invited to undertake efforts to address the issue of the rising stock of contingent liabilities.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated 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 updated 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 DELIVERED THIS OPINION:

(1) On [17 February] 2005 the Council examined the updated convergence programme of Poland, which covers the period 2004 to 2007. The programme complies partly with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". The quality of ESA95 data on the composition of the general government revenue and expenditure are not fully in line with ESA95 statistical standards. The programme also deviates from the data requirements in the area of the long-term sustainability of public finances. Accordingly, Poland is invited to achieve compliance with the data requirements.

(2) The macro-economic scenario underlying the programme envisages real GDP growth to decelerate from 5.7% in 2004 to 4.9% on average in 2005 and 2006, before rebounding to 5.6% in 2007. On the basis of currently available information, this scenario seems to reflect rather favourable growth assumptions. If the growth projections for 2005 and 2006 are plausible, the growth forecast for the last year of the programme appears on the high side. In particular, the projected acceleration in GDP growth in 2007 reflects optimistic assumptions about the growth of potential output and the strength of domestic demand. The programme's projections for inflation appear on the low side.

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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.

(3) On 5 July 2004, the Council decided that an excessive deficit existed in Poland and recommended that this be corrected by 2007. The budgetary strategy underlying the updated 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 update foresees a gradual reduction of the deficit to 2.2% of GDP in 2007 from 5.4% of GDP in 2004, including the surplus of the open pension funds (estimated annual impact of 1.5% of GDP). Compared with the previous programme, the most significant difference is the upward revision of the general government deficit target in 2007 by 0.7 percentage points of GDP, despite the projected rebound in economic growth.

(4) The fiscal consolidation over the period 2005-2007 would result from the implementation of a comprehensive set of measures contained in the *Hausner plan,* which, if fully implemented, would have an estimated total budgetary impact of 4.7% of GDP (revised downwards by 0.6 percentage points compared with the previous programme). At the same time, a significant programme of public investment is being implemented, which lifts public investment from 3.4% of GDP in 2003 to an average of 4.1% over the programme period against an EU-average of 2.4% of GDP in 2004.

(5) There are clear risks that the budgetary outcome could be worse than projected in the programme. The risk of a delayed or incomplete implementation of the envisaged measures of the *Hausner plan*, described in the assessment of the May 2004 programme, is already materialising. There is still uncertainty over the implementation of the remaining measures that require legislative procedures but contained already in the budget for 2005. Despite the rejection by Parliament of two important measures, the deficit targets remained unchanged. Almost half of measures aiming at additional revenue and expenditure savings described in the update are unspecified. Contingent liabilities constitute an additional risk to the sustainability of public finances. The achievement of the deficit targets is also conditional on projected high GDP growth throughout the programme period. In addition, the funded pension scheme continues to be recorded inside the general government sector as allowed by the transition period granted by Eurostat. With a change in classification, the deficit figures for each year will be adjusted upwards by 1.5 percentage points. Hence, in the absence of additional savings measures, the fulfilment of the Council recommendation to bring the deficit below 3% in the end year of the programme is not ensured, based on the new 2007 deficit target of 2.2% of GDP.

(6) In view of this risk assessment, the budgetary stance in the programme seems insufficient to reduce the deficit to below 3% of GDP by 2007, and additional measures may be needed on top of the *Hausner plan* described in the updated programme.

(7) The debt ratio is estimated to have reached 45.9% of GDP in 2004, below the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase by a cumulative 1.8 percentage points over the period 2004-2007, with the increase coming to a halt only in the last year of the programme.

(8) The lack of budgetary projections beyond 2020 makes it difficult to assess the long-term sustainability of the Polish public finances, as most of the budgetary impact of aging is likely to take place after 2020. However, on the basis of the available information, some risks cannot be ruled out. Major uncertainties regarding the budgetary impact of policies aimed at strengthening the long-term budgetary trends

remain. While the strategy outlined in the programme relies mainly on the impact of the pension reform and the necessary budgetary consolidation in the medium term, additional reform measures need to be implemented in the future to improve the capacity to cope with an ageing population. Thus, a successful implementation of the planned measures, a strict monitoring of outstanding contingent liabilities and the resolute implementation of the planned budgetary consolidation in the medium term should contribute to a sustainable position in the longer term.

(9) Overall, the economic policies outlined in the update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. On the one hand, the programme is in line with the reduction of the general government deficit recommended by the Council and the reduction is based on the implementation of the *Hausner plan*. On the other hand, the programme does not present concrete steps to safeguard the long-term sustainability of public finances, specifically through addressing the issue of the rising stock of contingent liabilities.

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In view of the above assessment and in the light of the recommendations made by the Council under Article 104(7), the Council is of the opinion that Poland should:

(i) strengthen the fiscal adjustment and lower the deficit target for 2007;

(ii) ensure a full implementation of the structural measures contained in the Hausner plan and make further efforts to introduce alternative measures if implementation risks were to materialize; and

(iii) address the issue of the rising stock of contingent liabilities.

Comparison of key macroeconomic and budgetary projections

		2004	**2005**	**2006**	**2007**
Real GDP (% change)	**CP Dec 2004**	**5.7**	**5.0**	**4.8**	**5.6**
	COM Oct 2004	5.8	4.9	4.5	n.a.
	CP May 2004	*5.0*	*5.0*	*5.6*	*5.6*
HICP inflation (%)	**CP Dec 2004**	**3.5**	**3.0**	**2.7**	**2.5**
	COM Oct 2004	3.5	3.3	3.0	n.a.
	CP May 2004	*2.2*	*2.8*	*<3*	*<3*
General government balance (% of GDP)	**CP Dec 2004**	**-5.4**	**-3.9**	**-3.2**	**-2.2**
	COM Oct 2004	-5.6	-4.1	-3.1	n.a.
	CP May 2004	*-5.7*	*-4.2*	*-3.3*	*-1.5*
Primary balance (% of GDP)	**CP Dec 2004**	**-2.6**	**-1.3**	**-0.5**	**0.4**
	COM Oct 2004	-2.5	-1.0	-0.0	n.a.
	CP May 2004	*-2.8*	*-1.1*	*-0.3*	*1.3*
Government gross debt (% of GDP)	**CP Dec 2004**	**45.9**	**47.6**	**48.0**	**47.3**
	COM Oct 2004	47.7	49.8	49.3	n.a.
	CP May 2004	*49.0*	*51.9*	*52.7*	*52.3*
Sources: *Convergence programme (CP); Commission services autumn 2004 forecasts (COM)*					