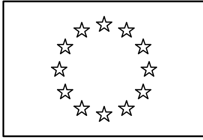

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DECEMBER 2005 UPDATE OF THE CONVERGENCE PROGRAMME OF HUNGARY (2005-2008)

AN ASSESSMENT

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Summary and conclusions[1]

The 2005 update of the Hungarian convergence programme was submitted on 1 December to the Council and the Commission. The period covered by the programme is from 2005 to 2008. The update broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. The update provides all compulsory and most optional data prescribed by the new code of conduct; however, there are some inconsistencies with ESA95, concerning the treatment of FISIM and the recording of military expenditure. The programme does not provide detailed data on previous and foreseen one-off items. It also does not explicitly identify the medium-term objective (MTO) for the budgetary position as required by the code of conduct.

On 5 July 2004, the Council decided that Hungary was in excessive deficit and issued a recommendation for its correction under Article 104(7). Following a decision of no compliance in January 2005, the Council issued new recommendations under Article 104(7) on 8 March 2005, reiterating that the excessive deficit had to be corrected by 2008, the target year set by the Hungarian authorities in the convergence programme of May 2004 and confirmed in its December 2004 update, in line with the path set out in this update. In particular, the Council recommended to the Hungarian authorities to take effective action in order to achieve the deficit target for 2005 and to make the timing and implementation of any tax cuts conditional upon the achievement of the deficit targets for 2005 to 2008. The same was reflected in the Council opinion of the 2004 update of the convergence programme also adopted on 8 March 2005. On 8 November 2005 based on Article 104(8) the Council decided that Hungary did not comply with the March Council recommendations. A new Council recommendation under Article 104(7) for the correction of the excessive deficit will have to be issued.

Following the adoption of a comprehensive economic reform package in the mid-nineties, sound macroeconomic policies and appropriate structural reforms supported stable and high rates of growth and a reduction in inflation. However, starting in 2001, public expenditure increased significantly and generous wage settlements resulted in large macroeconomic imbalances. While growth has become more balanced and inflation and wage growth have decelerated as from 2003, Hungary continues to struggle with high budget and external deficits. In the update, real GDP growth is projected to stabilise at around 4%, driven by investment and export in the programme period. This growth scenario is broadly in line with the projections of the Commission services autumn forecast[2]. However, the last year of the programme horizon, showing a positive output

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[1] This technical analysis, which is based on information available up to 4 January 2006, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on [11 January 2006]. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Viktoria.kovacs@cec.eu.int, Reka.Rozsavolgyi@cec.eu.int, Barbara.kauffmann@cec.eu.int. The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct (Opinion of the Economic and Financial Committee on the "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), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines for the period 2005-2008.

[2] It should be noted that the Commission forecast was still made on the basis of time series not including the FISIM allocation while the update shows a growth break-down including the FISIM allocation (while simultaneously also showing the headline growth rate without FISIM for comparison

gap based on Commission calculations using the commonly agreed methodology, seems to be on the optimistic side. Against this background, the growth assumptions included in the update seem to be plausible, but rather favourable towards the end of the programme period. The update's medium-term projection for the external deficit appears to be plausible, although the projected reduction is conditional upon the fulfilment of the strict fiscal tightening outlined in the update together with the implementation of structural reforms boosting potential output. The update's inflation projections are fully in line with those of the Commission.

Hungarian monetary policy continues to combine inflation targeting with an exchange rate peg. The convergence programme confirms that Hungary maintains 2010 as the target year to join the euro area. After peaking at above 7% year-on-year in mid-2004, inflation fell rapidly to below 4% in the first half of 2005. The slowdown of real wage growth, weaker domestic demand, as well as intensified import competition following EU accession contributed to stabilise inflation at a lower rate. The forint/euro exchange rate appreciation trend was reversed in October 2005, as heightened worries among investors about fiscal slippages and increased uncertainty about the euro adoption date initiated a gradual depreciation. Compared to the beginning of the year, the forint was 3% lower in mid-December 2005. Hungarian long-term interest rates remain significantly higher than in other new Member States. Following a gradual decrease from 7.2% in January to 5.6% in September 2005, helped by an improved risk perception in the markets, bond yields (and spreads) with the euro area increased sharply in October and stood around 7% since then, partly in response to increased worries on the part of investors about fiscal slippages.

The update continues to target ending the excessive deficit by 2008. The foreseen deficit path is 6.1% in 2005, 4.7% in 2006, 3.3% in 2007 and 1.9% of GDP in 2008, representing a yearly cut of 1.4 percentage point of GDP. The time profile of the primary surplus is similar. These budgetary projections exclude one-offs (in particular military purchases of 0.3 percentage point of GDP in both 2006 and 2007) and the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, ranging from 1 to 1.5% of GDP, which will be taken into account by the time of the spring 2007 notification[3]. The strong decline in the revenue ratio of some 3½ percentage points of GDP, mainly the result of the newly introduced five-year tax cut strategy, is projected to be overcompensated by a reduction of the expenditure-to-GDP ratio by some 7½ percentage points of GDP between 2005 and 2008.

The 2005 target was increased in September 2005 by the Hungarian authorities from the 3.6% of GDP contained in the 2004 December update to 6.1% of GDP. The Commission services' autumn 2005 forecast indicated that such revised target for 2005 was within reach. Latest available cash data support this view.

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reasons). The deficit and debt ratios are calculated on the basis of the GDP series before the FISIM allocation.

3 Including this impact, the general government balance according to the updated programme would be 7.4% of GDP in 2005, 6.1% in 2006, 4.7% in 2007 and 3.4% in 2008, while government gross debt would be 60.3% of GDP in 2004, 61.5% in 2005, 63.0% in 2006, 63.2% in 2007 and 62.3% in 2008. This does, however, still not include the purchase of military airplanes of an additional 0.3 percentage point of GDP in both 2006 and 2007.

The update foresees an improvement in the structural balance from -5.7% of GDP in 2005 to -2.1% of GDP in 2008 (excluding the effect of the pension reform and one-offs). The MTO cannot be inferred from the budgetary projections presented in the programme.

However, the structural measures outlined in the programme regarding in particular the public, health and education sectors lack the necessary quantifications to judge their short- and medium-term budgetary effects. Moreover, the budgetary outcome could be much worse than projected in the programme, also in view of the repeatedly missed targets in the past. The Commission services autumn forecast projected a 2005 deficit of 6.7% of GDP (including the accounting of military fighters) which may mean that the trend deficit for 2006 may be higher than in the programme. In 2006, tightening expenditure by 4 percentage points of GDP compared to the 2005 budget is not based on clearly defined and quantified measures. In the outer years, the shift of public motorway investment to PPP schemes might be subject to accounting problems and related costs; the projected decline in interest rates may not materialise; there is uncertainty regarding the effects of the tax reform, possibly resulting in lower revenue income.

Taking into account the risk assessment above, the budgetary strategy in the programme needs to be substantiated to ensure its consistency with the correction of the excessive deficit by 2008 as recommended by the Council.

The debt ratio is forecast to increase to 58.4% of GDP in 2006 and to decline thereafter to 56.2% of GDP by the end of the programme period triggered by the continuous decrease of the general government deficit. Including the cumulated pension reform burden ranging from 3% in 2004 to 6% in 2008 the debt level would surpass the 60% reference value. The comparison between the Commission services autumn 2004 forecast and the current update confirms that the main differences in the evaluation of the path of the debt-to-GDP ratio arise from the higher optimism of the budgetary projections of the update.

With regard to the sustainability of public finances, Hungary appears to be at high risk on grounds of the projected budgetary costs of ageing populations. The gross debt-to-GDP ratio is currently close to the reference value and is projected to increase in the period up to 2050. Hungary reformed its pension system in the late 1990s, aimed at contained future rises in expenditure on pensions, which helped to reduce the budgetary impact of ageing. However, increases in government expenditure on pensions could be higher than projected in the update, suggesting that a close monitoring of factors that are assumed to offset such higher expenditures as well as developments in pension and other age-related expenditures is important. Moreover, the currently high structural deficit contributes to increasing sustainability risks. It is therefore necessary to carry out a large consolidation of public finances over the medium-term and to further strengthen the budgetary position in order to reduce risks to public finance sustainability[4].

The envisaged measures in the area of public finances are not consistent with the broad economic policy guidelines, included in the integrated guidelines for the period 2005-2008. Hungary has not complied with the second 104(7) recommendations of the Council of 8 March 2005 under the excessive deficit procedure, as decided by the Council on 8

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[4] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services, to be published at the website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

November 2005 based on Article 104(8) of the Treaty. The update retains a multi-annual framework for correcting the excessive deficit by 2008, although a worse-than-projected budgetary outcome is likely and the necessary detailed specifications and quantifications are missing to judge the short- and medium-term budgetary effects of the structural measures.

The National Reform Programme of Hungary submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs identifies the gradual and continued decrease of the size and deficit of the general government sector as a main challenge. The budgetary implications of the reform measures of the National Reform Programme are reflected in the budgetary projections of the convergence programme as far as the tax reductions are concerned. The update explains the recently adopted five-year tax cut programme and presents a number of plans for the reform of the public sector without, however, providing the necessary specifications and quantifications. These plans are broadly in line with the National Reform Programme submitted on 14 October 2005.

In view of the above assessment, it would be appropriate for Hungary to present by 1 September 2006 at the latest a revised convergence programme update that identifies concrete and structural measures that are fully consistent with its medium-term adjustment path. In the meantime, Hungary should do the necessary to achieve its budgetary objectives for 2006 and beyond.

Comparison of key macroeconomic and budgetary projections[1]

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Dec 2005[6]**	**4.2**	**4.0**	**4.1**	**4.0**	**4.0**
	COM Nov 2005	4.2	3.7	3.9	3.9	n.a.
	CP Dec2004	*3.9*	*4.0*	*4.2*	*4.3*	*4.6*
HICP inflation (%)	**CP Dec 2005**	**6.8**	**3.5**	**2.1**	**3.0**	**2.4**
	COM Nov 2005	6.8	3.7	2.0	3.0	n.a.
	CP Dec2004	*6.8*	*4.5*	*4.0*	*3.5*	*3.0*
Output gap (% of potential GDP)	**CP Dec 2005[2]**	**-1.3**	**-1.0**	**-0.5**	**-0.1**	**0.4**
	COM Nov 2005[7]	-0.9	-0.7	-0.3	0.2	n.a.
	CP Dec2004[2]	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Dec 2005**	**-5.4**	**-6.1**	**-4.7**	**-3.3**	**-1.9**
	COM Nov 2005	-5.4	-6.1	-6.7	-6.9	n.a.
	CP Dec2004	*-4.4*	*-3.6*	*-2.9*	*-2.2*	*-1.6*
Primary balance (% of GDP)	**CP Dec 2005**	**-1.1**	**-2.5**	**-1.5**	**-0.3**	**+0.8**
	COM Nov 2005	-1.5	-2.2	-3.0	-3.4	n.a.
	CP Dec2004	*-0.5*	*0.0*	*0.2*	*0.6*	*1.0*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2005[2]**	**-4.8**	**-5.7**	**-4.5**	**-3.3**	**-2.1**
	COM Nov 2005	-5.3	-5.8	-6.6	-7.0	n.a.
	CP Dec2004[2]	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**CP Dec 2005[4]**	**-4.8**	**-5.7**	**-4.5**	**-3.3**	**-2.1**
	COM Nov 2005[5]	-5.3	-6.3	-7.6	-8.5	n.a
	CP Dec2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2005**	**57.2**	**57.7**	**58.4**	**57.9**	**56.2**
	COM Nov 2005	57.4	57.2	58.0	59.2	n.a.
	CP Dec2004	*57.3*	*55.5*	*53.0*	*50.6*	*48.3*

Notes:

[1]The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated program would be 6.5% of GDP in 2004, 7.4% in 2005, 6.1% in 2006, 4.7% in 2007 and 3.4% in 2008, while government gross debt would be 60.3% of GDP in 2004, 61.5% in 2005, 63.0% in 2006, 63.2% in 2007 and 62.3% in 2008 (both debt and deficit figures also exclude 0.3 percentage point of GDP impact for military fighters in 2006 and 2007). Deficit and debt ratios are calculated on the basis of the GDP series without FISIM allocation.

[2]Commission services calculations on the basis of the information in the programme.

[3]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

[4]The programme provides no information on one-off and other temporary measures, except on the impact of 0.3 percentage points of GDP per year for the accounting of military fighters in both 2006 and 2007.

[5]One-off and other temporary measures taken from the Commission services' autumn 2005 forecast

[6]For the sake of comparison, this table shows the update's GDP figures before FISIM allocation, since the previous figures and the Commission Services forecast have not yet included the FISIM allocation (after FISIM allocation the updates' GDP projections are 4.6%, 4.2%, 4.3%, 4.1% and 4.1% between 2004 and 2008).

[7]Based on estimated potential growth of 3.7%, 3.5%, 3.5% and 3.4% respectively in the period 2004-2007.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The 2005 update of the Hungarian convergence programme was submitted to the Council and the Commission on 1 December 2005[5]. It covers the period between 2005 and 2008. The programme was approved by the Hungarian government on 30 November and incorporates the 2006 budget adopted by parliament on 20 December.

The update broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. It provides all compulsory and most optional data prescribed by the new code of conduct. Exceptions concern the recording of military expenditure which are not in line with ESA requirements and the treatment of FISIM. The programme also does not provide comprehensive information on previous and foreseen one-off items. Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC OUTLOOK

Following the adoption of a comprehensive economic reform package in 1995, sound macroeconomic policies and appropriate structural reforms supported stable and high rates of economic growth and a reduction in inflation. As a result of the stabilisation measures, real GDP increased by 4-5% per year between 1995-2000, inflation dropped at the same time from about 30% to less than 10%, the forint was stabilised thanks to the new exchange rate system, the current account deficit narrowed to around 5% of GDP in 2000 and the budget deficit was reduced from 8% in 1998 to 3.5% of GDP in 2001. However, starting in 2001, public expenditure increased significantly and generous wage policies were implemented, resulting in large macroeconomic imbalances, with a high government deficit, accelerating inflation and a widening current account deficit by 2003. The general government deficit increased from 3.5% in 2001 to 8½% of GDP in 2002, the current account deficit rose markedly from 6.2% in 2001 to 8.9% in 2005. Following three years of strong real wage increases, averaging more than 10% per year, wage growth decelerated in 2004, mainly due to a significant real wage decrease in the public sector. This contributed to the deceleration of private consumption growth, falling to 3.5% in 2004 from 8% in 2003, and resulting in a more balanced composition of overall GDP growth.

The macroeconomic scenario presented in the 2005 December update assumes a relatively balanced composition of GDP growth throughout the programme period alongside a gradual closure of a currently negative output gap. Investment and exports are the main driving forces behind economic growth, while private consumption is expected to increase by less than real GDP. The update projects real GDP growth of 4.2% in 2005, 4.3% in 2006 and 4.1% in both 2007 and 2008 including the FISIM allocation and 4.0%, 4.1%, 4.0%, 4.0% between 2005 and 2008 excluding it. Until 2007 the projections of the update are very similar to the Commission services' autumn 2005 forecast (still excluding the FISIM allocation), which projects real GDP to grow by 3.7% in 2005 and by 3.9% in both 2006 and 2007. However, for the last year of the programme period the forecast for real GDP growth presented in the update is significantly above the Commission services' estimate of potential output growth. The growth assumption included in the update seems to be plausible, but rather favourable in the outer year.

[5] The English translation was submitted on 10 December.

Cyclical conditions, as measured by the output gap, may be less adverse than implied by the programme[6].

The composition of economic growth assumed in the programme is broadly in line with the assessment of the Commission services' autumn 2005 forecast with the notable exception of government consumption expenditures. The external assumptions underlying the update's macroeconomic scenario are broadly in line with those underpinning the Commission services' autumn 2005 forecast. However, the interest rate assumptions appear to be on the low side.

Against the background of sound economic growth, the update predicts favourable labour market developments. Measures foreseen under the so-called "100 -steps programme" are aimed at promoting employment by increasing the number of jobs and further improving the qualification structure and the adaptation of labour demand. As a result of these forthcoming measures, employment is expected to increase by 2-2.5% during the entire programme period compared to an average GDP growth rate of 4%. The projected average labour content of GDP growth is broadly in line with historical values, though slightly higher than expected by the Commission services' autumn 2005 forecast. The participation rate is projected to increase to about 62.7% in 2008 (from around 60% in 2004) and the unemployment rate is expected to decrease to 6.9% by 2008 following an expected peak of around 7.3% in 2005. This is in line with the Commission assessment. The outlook for the labour market is broadly in line with the Commission services' autumn 2005 forecast.

The update presents a benign medium-term inflation outlook. The demand side is not expected to generate inflationary pressure. This is in view of intensified competition following the EU accession, with only gradually easing monetary policy applying the system of inflation targeting and decreasing inflationary expectations as well as a favourable income policy assuring wage increases in line with productivity. As a one-off effect of the top VAT rate reduction from 25% to 20% in 2006, annual average HICP inflation is expected to decline to around 2% in 2006 from about 3½% projected in 2005, followed by a slight increase to about 3% in 2007 and a decrease to about 2.4% in 2008 (from 6.8% year-on-year in 2004). This is in line with the Commission services' autumn 2005 forecast.

Table 1: Comparison of macroeconomic developments and forecasts

	2005	2006	2007	2008

6 The calculation of potential growth (and therefore the output gap) needs to be interpreted with caution, in particular for countries going through a rapid catch-up process.

	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Real GDP (% change)	3.7	4.2	3.9	4.3	3.9	4.1	4.1
Contributions:							
- Final domestic demand	3.6	4.2	4.2	4.3	3.9	3.9	3.9
- Change in inventories	-0.4	-1.4	0.4	0.0	0.4	0.1	0.1
- External balance on g&s	1.4	1.5	-0.4	0.0	0.1	0.0	0.0
Output gap[1]	-0.7	-1.0	-0.3	-0.5	0.2	-0.1	0.4
Employment (% change)	0.4	0.2	0.6	0.3	0.3	0.8	0.9
Unemployment rate (%)	7.0	7.3	6.9	7.1	6.7	7.0	6.9
Labour productivity growth (%)	3.3	4.0	3.3	4.0	3.5	3.2	3.1
HICP inflation (%)	3.7	3.5	2.0	2.1	3.0	3.0	2.4
GDP deflator (% change)	3.3	2.5	2.7	2.7	3.0	2.9	2.7
Compensation of employees (% change)	5.8	7.5	5.7	5.2	4.7	3.6	5.9
External balance (% of GDP)	-7.8	-7.7	-7.3	-7.1	-5.9	-5.5	-4.8

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.
[2] CP figures on real GDP growth and respective contributions are with FISIM allocation while the Commission services forecast figures are without.

Source:
Commission services' autumn 2005 economic forecasts (COM); convergence programme update (CP)

Based on the Commission services' calculations according to the commonly agreed methodology the potential output growth underlying the programme is estimated to slightly decline from around 3 ¾ % at the beginning of the programme period to around 3 ½ % in 2008. This estimate is slightly higher than the one implied by the Commission services' autumn 2005 forecast (see Table 2).

Table 2: Sources of potential output growth

	2005		2006		2007		2008
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Potential GDP growth[1]	3.5	3.7	3.5	3.6	3.4	3.5	3.5
Contributions:							
- Labour	-0.1	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3
- Capital accumulation	2.3	2.3	2.3	2.3	2.3	2.3	2.3
- TFP	1.3	1.5	1.3	1.4	1.3	1.4	1.4

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

The updated programme assumes a gradual decline in the external account deficit from 7.7% of GDP in 2005 to 4.8% of GDP in 2008 including a continuously growing surplus of the capital account also as a result of increasing EU transfers. A shift in the structure of the external financing need of the economy is expected towards non-debt-creating financing such as foreign direct investments, while debt-creating financing is expected to decrease on account of the projected decrease in the financing needs of the government. Although there are some risks, the update's medium-term projection for the external balance appears to be plausible. However, the reduction of the external account deficit is conditional upon the fulfilment of the strict fiscal tightening outlined in the convergence programme, together with the implementation of structural reforms.

Table 3: Comparison of macroeconomic developments and forecasts

	2005	2006	2007	2008

	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Real GDP (% change)	3.7	4.2	3.9	4.3	3.9	4.1	4.1
Contributions:							
- Final domestic demand	3.6	4.2	4.2	4.3	3.9	3.9	3.9
- Change in inventories	-0.4	-1.4	0.4	0.0	0.4	0.1	0.1
- External balance on g&s	1.4	1.5	-0.4	0.0	0.1	0.0	0.0
Output gap[1]	-0.7	-1.0	-0.3	-0.5	0.2	-0.1	0.4
Employment (% change)	0.4	0.2	0.6	0.3	0.3	0.8	0.9
Unemployment rate (%)	7.0	7.3	6.9	7.1	6.7	7.0	6.9
Labour productivity growth (%)	3.3	4.0	3.3	4.0	3.5	3.2	3.1
HICP inflation (%)	3.7	3.5	2.0	2.1	3.0	3.0	2.4
GDP deflator (% change)	3.3	2.5	2.7	2.7	3.0	2.9	2.7
Compensation of employees (% change)	5.8	7.5	5.7	5.2	4.7	3.6	5.9
External balance (% of GDP)	-7.8	-7.7	-7.3	-7.1	-5.9	-5.5	-4.8

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.
[2] CP figures on real GDP growth and respective contributions are with FISIM allocation.

Source:
Commission services' autumn 2005 economic forecasts (COM); convergence programme update (CP)

Box 1: Statistical technicalities with relevance for the assessment of update

Upward revision in GDP series and the sectoral allocation of FISIM. In October 2005 the Hungarian central statistical office published for the first time revised national account figures including the sectoral allocation of financial intermediation services indirectly measured (FISIM) . This change consists in breaking down interest paid to banks and other financial intermediaries by each sector in 'pure' interest and the implicit price of financial intermediation. From now on, the latter will be registered as consumption of services. As a result, the GDP and consumption series are slightly revised upwards. For Hungary, for 2004, the nominal GDP level has been revised upwards by 0.7% of GDP. This is similar to the revisions observed in other Member States. Though the sectoral allocation of FISIM mainly consists in an upward shift of nominal GDP, the real growth rates may also slightly change. For 2004, the real GDP growth of has been revised from 4.2% to 4.6%. For 2005 to 2008, the sectoral allocation of FISIM is expected to increase the real growth rates by 0.1 to 0.2 points per year.

The sectoral allocation of FISIM has some impact on the structure of government expenditure, but no consequences for the deficit and debt levels, or for expenditure and revenue totals. However, since the nominal GDP is now slightly higher than it used to be, the debt ratios (as well as the expenditure and revenue ratios) are revised downwards. For 2004, the impact on the debt ratio is 0.4% points of GDP. The same phenomenon applies to the deficit ratio, but the numerical effect is barely perceptible with the usual presentation of the deficit ratio with one decimal. The Commission services autumn forecast was still made on the basis of time series not including the FISIM allocation. The presentation of the programme's budgetary figures (not yet including FISIM) and its GDP data (already including it) creates a small temporary inconsistency in the ESA figures.

Acquisition of military equipments under financial lease. In 2006 and 2007, the Hungarian army will take delivery of a squadron of military jets. From a formal viewpoint, the planes are not bought, but leased. However, according to the ESA95 rules, financial leases are booked as conventional purchases, since the ownership is de facto, though not de jure, transferred to the lessee. Therefore, the value of the planes delivered in 2006 and 2007 (around 0.3% of GDP each year) should be booked as government expenditure, thus increasing the government deficit in these two years. As there is no payment at delivery – rentals will be paid to the lessor over 10 years – the counterpart of the expenditure is an imputed loan, which is considered as government debt. Therefore, at the end of 2007, the Hungarian government debt will include around 0.6% of GDP of liabilities in relation to this transaction. The part of rentals to be paid in future which is considered as interest will be recorded as deficit-increasing over the lease period; the remainder of the rentals consists in the progressive reimbursement of the liability vis-à-vis the lessor and will be booked as a debt-reducing financial transaction. The convergence programme shows two deficit series, including and excluding these transactions. The deficit series without the military planes can be

understood as a series excluding an exceptionally large non-recurrent transaction. The programme also reports two sets of debt projections, including and excluding this transaction.

Sectoral classification of pension schemes and cost of pension reforms. On 2 March 2004, Eurostat published a decision which clarifies the ESA95 rules on the sectoral classification of pension schemes. In particular, Eurostat clarified that funded defined-contribution pension schemes should be classified in a sector other than government. As a result, when a government reforms its pension system and establishes a 2nd-pillar pension scheme – that is a pension scheme which is mandatory, funded with a defined-contribution nature – the government deficit increases by the amount of the social contributions which are diverted from social security into the new scheme. This increase in the deficit ratio is often called the net cost of the reform. On 23 September 2004, after bilateral discussions with Member States, Eurostat decided to grant a transitory period expiring with the fiscal notification of spring 2007. During this time Member States may still report their government accounts including the 2nd-pillar pension schemes; as if the 2nd-pillar schemes were classified in social security. Hungary decided to benefit from the transitory period granted by Eurostat. Therefore, the government deficit and debt figures which are now reported by Hungary do not include the net cost of the pension reform. The deficit and debt series will have to be revised upwards by April 2007. Accordingly, the government deficit is expected to be revised upwards by 1.4 percentage points of GDP in 2007 and 1.5 percentage points of GDP in 2008. The government debt will be revised by 5.3 and 6.1 percentage points of GDP respectively in 2007 and 2008.

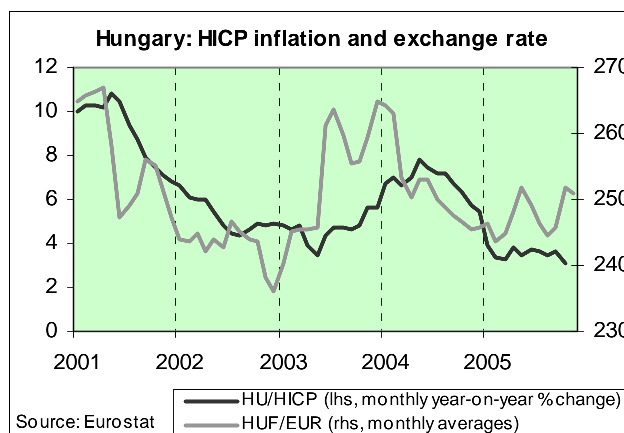
Shifting infrastructure investment into PPPs. Hungary intends to shift a significant share of investment in public-use infrastructure into private-public partnerships (PPPs). According to the convergence programme update, the government investment-to-GDP ratio – notably in the motorway network – will structurally fall by around 1% of GDP in 2006. According to the ESA95 rules, investments under PPP schemes will be booked as corporate investment, rather than government expenditure, if most risks and rewards have been effectively transferred to the partner. More specifically, statisticians should pay a specific attention to construction risks, availability risks and demand risks of each project. In this assessment, the Commission services assume that the planned investment under PPP schemes is eligible to be recorded as corporate investment, rather than government investment. However, at this stage, there is not enough information for Eurostat to be in a position to confirm the accounting of PPPs in Hungary. A specific issue, which will have to be carefully assessed by the statistical authority in due time, concerns the fact that some of the partners for these projects are enterprises controlled by the government itself. PPP schemes usually involve the payment of rentals to the partner in the future. These may depend on the effective usage of infrastructure or on other criteria. These payments are recorded as procurement of services, that is, as government consumption. (In some cases, the effective users also have to pay usage fees; e.g. motorists paying tolls.) Therefore, PPP schemes involve exchanging a present reduction in government investment against higher future expenditure in consumption. The convergence programme of Hungary provides no information on the rentals to be paid to partners in future, and whether these were properly considered in the projections of government consumption.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Hungarian monetary policy continues to combine inflation targeting with an exchange rate peg. The forint is pegged to the euro with a ±15% fluctuation band around a central parity, but has always been in the stronger half of the band. Inflation targets, jointly defined by the government and the central bank, are set with a tolerance band of ± 1% at 4 % and 3½% for December 2005 and 2006, respectively. In August 2005 a continuous inflation target of 3%, with a tolerance band of 1% on either side, was set for the period from 2007 onwards. The convergence programme confirms that Hungary maintains 2010 as the target year to join the euro area. This target is underpinned by the fiscal consolidation strategy.

After peaking at above 7% year-on-year in mid-2004, inflation fell rapidly to below 4% in the first half of 2005. The slowdown of real wage growth, weaker domestic demand, as well as intensified import competition following EU accession contributed to stabilising inflation at a lower rate. In the third quarter of 2005, consumer price inflation

declined to 3.7%, followed by a further decrease to 3.2% in October; it is thus possible that the end-year inflation target of 4% will be undershot. The same applies for the 2006 end-year inflation target of 3.5%. Since the beginning of the year, core inflation has continued to hover around 1% (based on the annualised quarterly growth rates), with the difference with the overall inflation rate due to high prices for fuel and unprocessed food. The inflation projections for 2006 and 2007 (2.0% and 3.0% respectively) are broadly in line with the Commission Autumn forecast.



The forint/euro exchange rate appreciated by around 8.3% between January 2004 and early March 2005; it subsequently weakened a few months and then strengthened again over the summer of 2005. The appreciation trend was reversed in October 2005, as heightened worries among investors about fiscal slippages and increased uncertainty about the euro adoption date initiated a gradual depreciation. Compared to the beginning of the year, the forint was 3% lower in mid-December 2005. However, the slight depreciation took place from a level close to the strong edge of the band. Following sharp policy interest rate increases of a cumulative 600 basis points in the second half of 2003, the Hungarian central bank gradually eased interest rates in 2004 and 2005 by a total of 650 basis points to their present level of 6%. The convergence programme assumes a gradual further reduction of short-term interest rates to 4% by 2008, which should reflect progress in fiscal consolidation and inflation.

Hungarian long-term interest rates remain significantly higher than in other new Member States. Following a gradual decrease from 7.2% in January to 5.6% in September, helped by an improved risk perception in the markets, bond yields and spreads with the euro area increased sharply in October, partly in response to increased worries on the part of investors about fiscal slippages. Long-term interest rates stood since then at around 7% on 20 December, with the spread vis-à-vis the euro area widening to around 340 basis points. The average 2005 bond yield until mid-December reached 6½% compared with 3.4% in the euro area. The convergence programme assumption of an average bond yield of 6.4% for 2005 as a whole therefore seems on the low side.

4. General government balance

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous convergence programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis

4.1. Targets in successive programmes and implementation in 2005

With a view not to change the euro adoption date of 2010, the December 2005 update of the convergence programme confirms the 2008 target for the correction of the excessive deficit. However, in the light of the upward revisions acknowledged at the time of the September 2005 fiscal notification of the 2005 and 2006 deficit targets, the update changes the programme's adjustment path vis-à-vis the previous programmes, further backloading the consolidation effort to the outer years of the programme horizon. After an estimated deficit increase of 0.7 percentage point of GDP from 5.4% in 2004 to 6.1% of GDP in 2005 the update envisages a sharp and continuous reduction of the deficit by 1.4 percentage point of GDP per year over the programme period. This compares with the ½ percentage point of GDP annual reduction originally planned in the May 2004 convergence programme, following a front-loaded reduction of 1.3 percentage point of GDP in 2005.

Following a decision of the Hungarian authorities in December 2004, the December 2005 update (like the previous update) reports government deficit figures excluding the cost of the 1998 pension reform; thus, the 2nd-pillar pension scheme is classified inside the government sector includes a temporary methodological change compared to the May 2004 programme. This temporary re-classification, which is permitted by Eurostat until the March 2007 fiscal notification, lowers the yearly deficit figures compared to the May 2004 programme by 1.2-1.5 percentage point of GDP between 2004 and 2008.

While the original programme and the 2004 update aimed at correcting the excessive deficit by 2008 with a more frontloaded adjustment, (see Table 3 and Figure 1), the December 2005 update only targets a deficit reduction to 3.4% of GDP (including again the costs of the pension reform of 1.5% of GDP). Based on the revised Stability and Growth Pact, the programme assumes that if the deficit is close to 3% of GDP, the Council and the Commission will take the cost of the pension reform (40% of the pension reform burden of about 1½% of GDP, that is around 0.6% of GDP) into account in their assessments whether the excessive deficit has been terminated. Even if this is the case, there will be no safety margin for possible slippages.

Regarding the implementation of the 2005 budget, the Hungarian authorities took additional corrective measures in order to ensure meeting the 2005 deficit target. This was done in two steps. The first set of measures[7] was implemented shortly after the adoption of the Council opinion on the 2004 December update and the 104(7) recommendations by the Council in March 2005. The second set of measures[8] was taken in June, after the Hungarian authorities had acknowledged that several revenue and expenditure assumptions of the 2005 budget were considerably optimistic and would have to be corrected. In September 2005 the Hungarian authorities submitted a revised EDP notification announcing a 2005 deficit of 6.1% of GDP, which was subsequently confirmed in the Commission services autumn forecast, instead of the targeted 3.6% of GDP, although no significant change in the macroeconomic scenario had occurred. This revised notification took into account that (i) the planned sale of existing motorways to the state owned motorway company (AAK), including those under construction until end 2005, could not be considered as a deficit-reducing measure, and (ii) that the payment of the 13th-month public salary should still be recorded in the year to which it pertains despite the actual cash disbursements taking place at the beginning of the following year, worsening the deficit in 2005 by 1.9% and 0.1% of GDP, respectively. The notification also contained an additional slippage of 0.5% of GDP. About half of this shortfall comes from lower VAT revenues, in part due to policy action; the other half reflects an expenditure overrun. The Government informed the Commission that it had no intention to take action to correct the slippage in 2005, contrary to earlier commitments. Against this background, and in view of further slippages regarding the 2006 deficit, the Commission recommended to the Council in October to decide for the second time in 2005 that Hungary did not comply with a Council recommendation under the excessive deficit procedure. The Council adopted a decision to that effect in November (see Box 2).

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[7] On 12 March the government announced the increase of the "emergency reserve package" from 0.5 percentage point of GDP (that had already been included in the 2005 budget as a safe-guard against a possible missing of the 2005 target) to 0.8 percentage point of GDP. This package consisted of a general across-the-board cut of some main expenditure items. Some additional revenues were also identified, notably 0.1 percentage point of GDP from the extension of already existing mobile phone licences. The Commission services 2005 spring forecast, which took these new measures partly into account, came to a projection of a deficit of 3.9% of GDP for 2005 compared with the official target of 3.6% of GDP. This forecast was based on a projection for GDP growth of 3.9% in 2005, also incorporating the information contained in the 2005 budget and in the convergence programme update of December 2004: in particular, the expectation that the interest burden and public investment would decline by ½ and 1 ½ percentage point of GDP, respectively, and that an increased recourse to public-private partnership (PPP) projects would be sought. The forecast also pointed to a number of risks for further slippages in the area of revenues (mainly VAT and social security) and operational expenditure.

[8] A re-shuffling of the planned sale of existing motorways (later annulled by a decision of Eurostat), an increase in the gambling tax, the widening of the social security base, and the permanent freeze of expenditures of 0.6% of GDP set aside in the emergency reserve fund, since the government committed itself to take these lower levels as a basis for the 2006 budget.

Table 3: Evolution of budgetary targets in successive programmes[1]

		2004	2005	2006	2007	2008
General government balance (% of GDP)	**CP Dec 2005**	**-5.4**	**-6.1**	**-4.7**	**-3.3**	**-1.9**
	CP Dec2004	-4.4	-3.6	-2.9	-2.2	-1.6
	CP May 2004	-4.6	-4.1	-3.6	-3.1	*-2.7*
	COM Nov 2005	-5.4	-6.1	-6.7	-6.9	n.a.
General government expenditure (% of GDP)	**CP Dec 2005**	**49.8**	**51.2**	**47.2**	**45.8**	**43.6**
	CP Dec2004	49.3	47.4	46.9	45.6	45.2
	CP May 2004	48.8	47.5	46.5	46.3	46.7
	COM Nov 2005	49.9	49.5	48.3	47.6	n.a.
General government revenues (% of GDP)	**CP Dec 2005**	**44.4**	**45.1**	**42.5**	**42.5**	**41.7**
	CP Dec2004	44.9	43.8	44.0	43.4	43.6
	CP May 2004	44.2	43.4	42.9	43.2	44.0
	COM Nov 2005	44.5	43.4	41.6	40.7	n.a.
Real GDP[2] (% change)	**CP Dec 2005**	**4.2**	**4.0**	**4.1**	**4.0**	**4.0**
	CP Dec2004	3.9	4.0	4.2	4.3	4.6
	CP May 2004	3.3-3.5	3.5-4	Cca. 4	4-4.5	4.5-5
	COM Nov 2005	4.2	3.7	3.9	3.9	n.a.

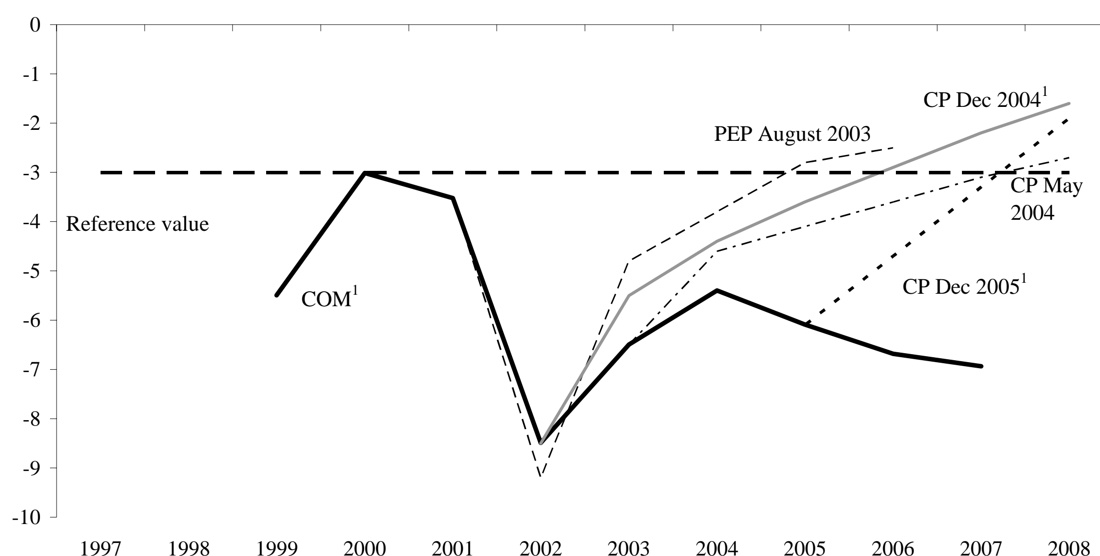
Notes:

[1]The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated programme would be 6.5% of GDP in 2004, 7.4% in 2005, 6.1% in 2006, 4.7% in 2007 and 3.4% in 2008, while government gross debt would be 60.3% of GDP in 2004, 61.5% in 2005, 63.0% in 2006, 63.2% in 2007 and 62.3% in 2008 (these figures do not take into account the 0.3 percentage point of GDP impact of the purchase of military fighters in both 2006 and 2007). Deficit and debt ratios are calculated on the basis of the GDP series without FISIM allocation.

[26] Without FISIM allocation (after FISIM allocation 4.6 % in 2004; 4.2 % in 2005; 4.3% in 2006; 4.1% in 2007 and 4.1% in 2008).

Source:
Convergence programmes (CP) and Commission services' autumn 2005 economic forecasts (COM)

Figure 1: General government balance projections in successive convergence programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive convergence programmes

[1] Excluding the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007

Box 2: The excessive deficit procedure for Hungary

On 5 July 2004, the Council decided that Hungary had an excessive deficit. At the same time, the Council addressed a recommendation to Hungary under Article 104(7) specifying that this situation should be corrected by 2008 at the latest in line with the adjustment path outlined in the country's May 2004 convergence programme. However, the Council decided on 18 January 2005 based on Article 104(8) that, despite the adoption of some measures reducing the deficit in 2004 and 2005, Hungary did not comply with the recommendations of July 2004, since both the 2004 and the 2005 targets were expected to be missed by a sizeable margin.

On 8 March 2005, the Council issued another recommendation based on Article 104(7), since Hungary is not yet a member of the euro area and therefore the next two steps of the excessive deficit procedure under Article 104(9) and 104(11) do not apply. The Council recommended the Hungarian authorities to "take effective action by 8 July 2005 regarding additional measures, as far as possible of a structural nature, in order to achieve the deficit target for 2005 as set in the updated convergence programme". In particular, the "emergency" reserve package in the 2005 budget could be increased substantially and its use be as limited as possible and made conditional upon clear evidence on the attainment of the deficit target for 2005." Furthermore, the Hungarian authorities should make the timing and implementation of any tax cuts conditional upon the achievement of the deficit targets of the convergence programme update submitted in December 2004 that were endorsed in the Council Opinion thereupon also on 8 March 2005.

On 13 July 2005, the Commission adopted an assessment stating, based on the information available at the time that the Hungarian authorities had taken effective action regarding the 2005 budget deficit within the 4-month deadline set by the Council in its new 104(7) recommendations of 8 March 2005. The assessment underlined that the achievement of the deficit target of 3.6% of GDP might require further action later in the year and that important adjustments and decisive action would be needed to achieve the target of 2.9% of GDP in 2006 of the authorities.

However, given a substantial deterioration of the budgetary outlook in Hungary, based on a Commission recommendation of 2 October 2005 incorporating the new information, the Council decided on 8 November 2005 for the second time based on Article 104(8) that Hungary did not comply with the new 104(7) recommendations of March. Thereby it notably took into account the fact that both deficit targets of 3.6% of GDP in 2005 and of 2.9% of GDP in 2006 would be missed by a sizable margin and that the implementation of the tax cuts starting from 2006 is contrary to the Council recommendation regarding tax cuts.

More details can be found at:

http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/edphu_en.htm

4.2. The programme's medium-term budgetary strategy

This section covers the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

Compared with the previous programme, the fiscal adjustment is back-loaded against a broadly unchanged macroeconomic scenario. The update continues to target a correction of the excessive deficit by 2008. This would be achieved by a steep deficit reduction of

1.4 percentage point of GDP each year. The deficit targets are 6.1% of GDP in 2005, 4.7% of GDP in 2006, 3.3% of GDP in 2007 and 1.9% of GDP in 2008. These targets exclude, however, the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented starting from the spring 2007 notification. Taking this into account, the general government balance would be 7.4% in 2005, 6.1% in 2006, 4.7% in 2007 and 3.4% in 2008, while government gross debt would be 60.3% of GDP in 2004, 61.5% in 2005, 63.0% in 2006, 63.2% in 2007 and 62.3% in 2008. In addition, the purchase of military planes is not included in the 2006 and 2007 targets. Thus, the Government projections for 2006 and 2007 are not in line with ESA rules and are, therefore, underestimated.

The deficit target of 3.4% of GDP in the final year of the programme period (including the pension reform burden) would still exceed the 3% of GDP threshold in the Treaty. As indicated above, the programme assumes that if the deficit is close to 3% of GDP, the Council and the Commission would take into account 40% of the yearly burden on the budget arising from the funded second-pillar pension reform when deciding about ending the excessive deficit procedure for Hungary. The time profile of the primary balance is similar to the profile of the overall balance, with a somewhat lower improvement projected at 1.0, 1.2 and 1.1 percentage points of GDP, in 2006, 2007 and 2008, respectively (see table 4).

Table 4: Composition of the budgetary adjustment

(% of GDP)	**2004**	**2005**	**2006**	**2007**	**2008**	**Change: 2008-2005**
Revenues	44.4	45.1	42.5	42.5	41.7	**-3.4**
of which:						
- Taxes & social contributions	39.2	39.0	37.1	36.5	35.5	**-3.5**
- Other (residual)	5.2	6.1	5.4	6.0	6.2	**0.1**
Expenditure	49.8	51.2	47.2	45.8	43.6	**-7.6**
of which:						
- Primary expenditure	45.5	47.6	44.0	42.8	40.9	**-6.7**
of which:						
Consumption	23.9	23.1	22.0	20.9	19.9	**-3.2**
Transfers other than in kind & subsidies	15.8	16.5	16.2	15.4	15.0	**-1.5**
Gross fixed capital formation	3.6	3.6	2.6	2.8	2.6	**-1.0**
Other (residual)	2.2	4.4	3.2	3.7	3.4	**-1.0**
- Interest expenditure	4.3	3.6	3.2	3.0	2.7	**-0.9**
General government balance (GGB)	**-5.4**	**-6.1**	**-4.7**	**-3.3**	**-1.9**	**4.2**
- excluding second-pillar pension scheme[1]	**-6.5**	**-7.4**	**-6.1**	**-4.7**	**-3.4**	**4.0**
Primary balance	**-1.1**	**-2.5**	**-1.5**	**-0.3**	**0.8**	**3.3**
One-off and other temporary measures[2]	n.a.	n.a.	(0.3)	(0.3)	n.a.	n.a.
GGB excl. one-off & other temporary measures	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**

Note:
[1]This shows the general government balance as it will be after the Eurostat decision of 2 March 2004 on the classification of funded pension schemes has been implemented, which needs to be done by the time of the spring 2007 notification.

[2] The update does not indicate one-offs, except for the 0.3 percentage point of GDP expenditure increasing effect of the purchase of military fighters in 2006 and 2007 which are, however, not included in the officially submitted figures.

Source:
Convergence programme update; Commission services' calculations

4.2.2. The composition of the budgetary adjustment in the programme

The planned reduction of the nominal deficit of 4.2 percentage points of GDP between 2005 and 2008 is projected to be achieved while reducing the revenue and expenditure per GDP ratios in parallel, as was also foreseen in the May 2004 programme and its December update. However, notably in view of the new five-year tax cut strategy, which, compared to previous programmes, foresees a significantly stronger fall in revenues amounting to some 3½ percentage points of GDP, the expenditure-to-GDP ratio is projected to decline by 7½ percentage points of GDP over the programme period. The previous programme projected a reduction in expenditure by about 2 percentage points of GDP in the same period. Expenditure cuts would be mainly achieved by a decrease of 3.2 percentage points in government consumption spread evenly over the programme period and a frontloaded 1 percentage points decrease in public investment expenditure due to the shift of motorway investment into PPP arrangements. Since the motorway construction is planned to continue in subsequent years in a PPP framework, no return in the public investment figures to the previously high levels is foreseen. The category "other expenditures", including decreased capital transfers to companies for projects not co-financed by the EU, would drop in 2006 by 1 percentage point of GDP and remain broadly at this level.

Projections on the revenue side are influenced by the new tax cut strategy starting in 2006 (see section 6 for details). The tax and social contribution revenue-to-GDP ratio would already drop by almost 2 percentage points of GDP in 2006, the first year of the five-year tax plan, by another 0.6 percentage point of GDP in 2007 and an additional 1 percentage point in 2008.

The foreseen expenditure cuts of 7½ percentage point of GDP are expected to be achieved through the following measures: (i) savings on the wage bill and other operational expenditures of about 2 and 1 percentage points of GDP, respectively; (ii) the shift of motorway investments during the whole programme period into a PPP framework, reducing public investment expenditure by 1 percentage point of GDP from 2006 onwards; (iii) saving of about 1 percentage point of GDP in interest expenditure during the entire programme period; finally (iv) the elimination of previously existing duplications in development programmes and the financing of new programmes only if they are co-financed by the EU.

Box 3: The budget for 2006

The draft budget for 2006 was presented on 30 September 2005 and was approved by parliament end-December. It targets a general government deficit of 4.7% of GDP in 2006, not taking into account the correct accounting of military fighters in ESA-terms. This would increase the deficit by 0.3 percentage point of GDP in 2006. The target has been increased compared to the December 2004 convergence programme update which still targeted a deficit of 2.9% of GDP.

On the revenue side, the budget calculates with the revenue-reducing effects amounting to about 1% of GDP resulting from the first steps of the comprehensive five-year tax cut package.

The compensation of the lower revenue and increased social security expenditures (family benefits and pensions), as well as the planned deficit reduction of 1.4 percentage points of GDP in 2006 is expected to be achieved by strict expenditure cuts amounting to 4 percentage points of GDP. The main measures are a 1 percentage point of GDP reduction in total government consumption expenditure, a ½ percentage point of GDP decline in the interest burden, and a decline of more than 1 percentage point of GDP in the category "other expenditures", including the decreased capital transfers to companies for projects not co-financed by the EU. Furthermore, 1 percentage point of GDP expenditure reduction is expected to be achieved by the substitution of public motorway investment by public-private partnership projects.

4.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The update does not explicitly identify an MTO as meant in the Stability and Growth Pact although the Pact and the code of conduct expect stability and convergence programmes to present such an objective. But the MTO can be inferred from the programme which indicates that after the correction of the excessive deficit in 2008, the correction of the deficit will be pursued to reach in cyclically-adjusted terms and net of one-offs and other temporary measures 0.5-1% of GDP.

The update's projections do not provide complete information about one-offs, or, as in the case of the purchase of military fighters, their effect is excluded from the programme figures. Contrary to this approach, the Commission services autumn 2005 forecasts included one-offs: in 2006, it calculated with the deficit increasing one-off of around ½ percentage point of GDP accounting for the military fighters[9], a deficit reducing one-off of 0.3 percentage point of GDP resulting from the sale of government property and it calculated, since at that time it was not yet known that the building of motorways would become structural, another deficit reducing one-off of about 1 percentage point for the shift of motorway investment into PPP arrangements; in 2007, it incorporated a deficit increasing one-off expenditure amounting to ½ percentage point of GDP accounting for the military fighters and again an expenditure reducing one-off of about 1 percentage point for the shift of motorway investment into PPP arrangements.

Based on the Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the planned improvement of the cyclically-adjusted budget balance is evenly spread over the programme period, against the backdrop of an initially slightly negative yet closing output gap, turning positive in the last year. In view of the favourable growth assumptions in the outer year of the programme mentioned in Section 2, cyclical conditions may turn out somewhat more favourable than implied by the programme.

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[9] This is now estimated at 0.3% of GDP in 2006 and 2007, see footnote 7 in table 5.

Table 5: Output gaps, cyclically-adjusted and structural balances

% of GDP	2004		2005		2006		2007		2008	Change: 2005-08
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Gen. gov't balance	-5.4	-5.4	-6.1	-6.1	-6.7	-4.7[7]	-6.9	-3.3[7]	-1.9	4.2
One-offs[2]	0.0	0.0	0.5	0.0	1.0	0.3	1.5	0.3	0.0	0.0
Output gap[3]	-0.9	-1.3	-0.7	-1.0	-0.3	-0.5	0.2	-0.1	0.4	-
CAB[4]	-5.3	-4.8	-5.8	-5.7	-6.6	-4.5	-7.0	-3.3	-2.1	3.6
change in CAB	0.6	-0.5	-0.5	0.1	-0.8	-1.1	-0.4	-3.7	0.9	
CAPB[4]	-0.9	-0.5	-1.9	-2.1	-2.9	-1.3	-3.5	-0.3	0.6	2.7
Structural balance[5]	-5.3	-4.8	-6.3	-5.7	-7.6	-4.8	-8.5	-3.6	-2.1	3.6
change in struct. bal.			-1.0	-0.9	-1.4	1.2	-0.7	1.3	1.3	
Struct. prim. bal.[6]	-5.3.	-0.5	-2.4	-2.1	-3.9	-1.3[7]	-5.0	-0.3[7]	0.6	2.1

Notes:
[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme
[2] The update does not indicate one-offs, except for the 0.3% of GDP per year expenditure increasing effect for military fighters in 2006 and 2007 which are, however, not included in the officially submitted figures.
[3] In percent of potential GDP. See Table 1 above.
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.
[5]CAB excluding one-off and other temporary measures
[6]Structural primary balance = CAPB excluding one-off and other temporary measures
[7] Not including 0.3 percentage point of GDP one-off expenditure accounting for the delivery of military fighters.
Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

4.3. Assessment

This assessment is in three parts. The first part assesses the appropriateness of the programme's medium-term objective. The second part analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

4.3.1. Appropriateness of the programme's medium-term objective

Although the update does not foresee to reach the MTO within the programme period, under the current assessment the inferred MTO for the period thereafter (-0.5% to -1% of GDP) would be at an appropriate level because it adequately reflects the debt ratio and average potential output growth in the long term and respects the minimum benchmark (-2% of GDP).

4.3.2. Risks attached to the budgetary targets

The following risks can be identified regarding the present update.

Firstly, Hungary has repeatedly missed revenue targets and experienced expenditure overruns in recent years, leading to upward revisions of fiscal targets. This is also reflected in the 2005 December update which, vis-à-vis previous programmes, changes the fiscal adjustment path for the second time and further backloads the necessary fiscal adjustment. Hungary has also repeatedly disregarded the Council's opinions and recommendations on the correction the excessive deficit. A prominent example is the recently adopted comprehensive tax cut programme, increasing the fiscal adjustment

required to achieve the deficit target at the end of the programme period by about 3 percentage points of GDP. This is in clear contrast with the Council opinion on the December 2004 update, re-enforced in the Council recommendations of 8 March 2005, based on Article 104(7), according to which "the timing and implementation of any tax cuts should be conditional upon the achievement of the deficit targets of the convergence programme update submitted in December 2004."

Secondly, the main risks attached to the 2006 budget outcome refer to the implementation of the expenditure cuts. A reduction of 4 percentage points of GDP compared to the 2005 budget seems to be very ambitious, in particular, since it is not based on clearly defined and quantified measures. The Commission services' autumn 2005 forecasts projected a 2006 deficit of 6.7% of GDP (including ½ percentage point of GDP in relation to the accounting of the acquisition of military fighters under financial lease), which would amount to a total slippage of 1½% of GDP compared to the new government target of 4.7% of GDP augmented by the correct recording of military purchases. In addition, the transitory period granted by Eurostat in relation to the classification of pension schemes will expire by the spring 2007 notification; at that time the cost of the pension reform will have to be included in the government deficit. Therefore, the projected target of 1.9% of GDP has to be revised to 3.4% of GDP. Even if the Council and the Commission take into consideration 40% of the pension reform burden in case the general government deficit is close to 3% of GDP when deciding about the abrogation of the excessive deficit procedure, as explicitly assumed in the programme, there will be no safety margin for possible slippages.

Thirdly, several uncertainties can also be identified for the outer years. (i) While assuming a recurrent decrease in expenditures due to the shift of public motorway investment to PPP schemes, the update does not provide information about the foreseen yearly rentals (booked as purchase of goods and services) that will have to be paid to PPP partners already in the programme period, thereby possibly underestimating the expenditure targets. The shift of public investment might, in addition, be subject to accounting problems in the course of the programme period, thus increasing the general government deficit. (ii) The projected decline in interest rates might turn out too optimistic for the whole adjustment period. (iii) There is uncertainty regarding the yield of the substantially reformed tax system, which might generate lower than projected revenues.

Fourthly, the structural measures spelled out in the update (regarding the public, health and education sectors) lack the necessary specifications and quantifications to judge their short- and medium-term budgetary effects, and presently may not be sufficient to support medium-term expenditure control (see also section 6).

Against this background, the budgetary outcome described in the update could be much worse than projected.

4.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

Taking into account the risk assessment above, the budgetary strategy in the programme needs to be substantiated to ensure its consistency with the correction of the excessive deficit by 2008 as recommended by the Council.

4.4. Sensitivity analysis

According to the calculations of the updated programme, the sensitivity coefficient of the government balance to cyclical changes in GDP is 0.21. This implies that the balance of the general government changes by 0.21% in response to a 1% change in GDP. The calculations of the update reveal that the deficit is less sensitive to changes in inflation, with a 1% additional inflation resulting in a 0.04 percentage point smaller deficit.

Commission services' simulations of the cyclically-adjusted balance under assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2008 period; (ii) trend output based on the HP-filter[10] and (iii) no policy response (notably, the expenditure level is as in the central scenario[11]), reveal that, by 2008, the cyclically-adjusted balance is 0.46 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower real growth, additional measures of nearly 1/2 percentage point of GDP would be necessary to keep public finances on the path targeted in the central scenario[12].

Taking into account the conclusions reached in Section 2 above, namely that the risks to the macroeconomic scenario of the programme are mainly on the downside in the outer year, the achievement of the budgetary targets in the programme might require a greater fiscal effort than envisaged in the programme.

5. General government gross debt

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

5.1. Debt developments in the programme

After the declining trend in the debt ratio reversed in 2002 with the debt-to-GDP ratio rising from 55.5% of GDP in 2002 to 57.1% of GDP in 2004, the update foresees a return to declining ratios from 2005 onwards, triggered by the continuous decrease of the general government deficit and the declining interest burden on the debt stock, while stock-flow adjustment is expected to be small. It projects a decline from 57.7% of GDP in 2005 to 56.2% of GDP in 2008. The estimated impact on the debt ratio of the classification of the second-pillar funded scheme outside the general government sector (which has to be implemented by the time of the spring 2007 notification) rises from 3 to 6% between 2004 and 2008. Including this impact, the government gross debt would be 60.3% of GDP in 2004, 61.5% in 2005, 63.0% in 2006, 63.2% in 2007 and 62.3% in 2008. Thus, including again the pension reform burden in 2007 and 2008 after the expiry

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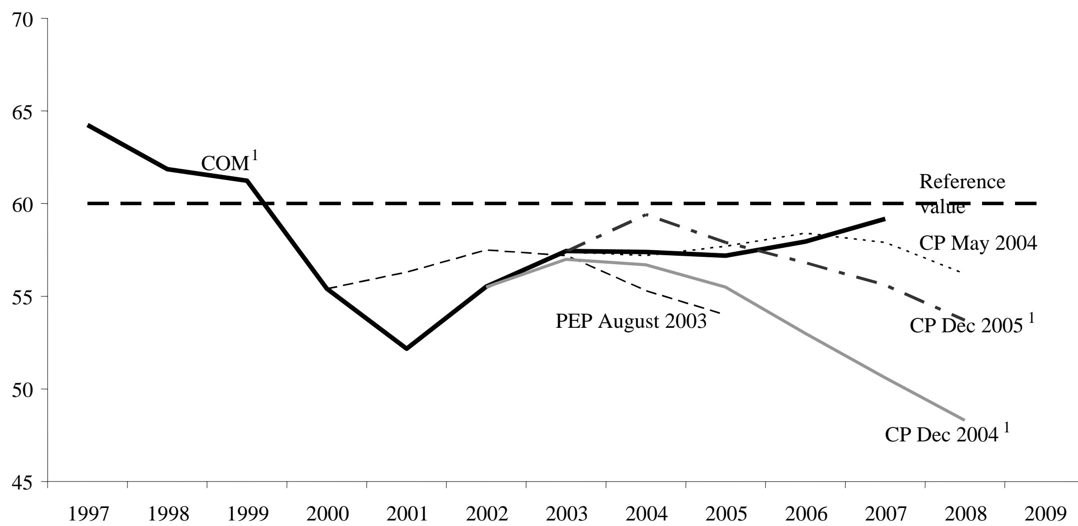
[10] In the absence of a fully specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[11] The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

[12] Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

of the temporary period granted by Eurostat, the debt level is expected to be above the 60% reference value.

Figure 2: Debt projections in successive convergence programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive convergence programmes

[1] *Excluding the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007*

Table 6: Debt dynamics

	average 2000-2004	2005		2006		2007		2008
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio[3]	**55.4**	**57.2**	**57.7**	**58.0**	**58.4**	**59.2**	**57.9**	**56.2**
Change in debt ratio (1 = 2+3+4)	-0.5	-0.2	0.3	0.8	0.7	1.2	-0.5	-1.7
Contributions[1]:								

- **Primary balance** (2)	**0.7**	**2.2**	**2.5**	**3.0**	**1.5**	**3.4**	**0.3**	**-0.8**
- **“Snow-ball” effect** (3)	**-1.6**	**0.1**	**-0.3**	**0.1**	**-0.6**	**-0.3**	**-0.9**	**-0.8**
- Interest expenditure	4.6	3.9	3.6	3.7	3.2	3.5	3.0	2.7
- Real GDP growth	-2.0	-2.0	-2.1	-2.1	-2.2	-2.1	-2.2	-2.2
- Inflation (GDP deflator)	-4.2	-1.8	-1.8	-1.5	-1.6	-1.7	-1.7	-1.3
- **Stock-flow adjustment** (4)	**0.3**	**-2.5**	**0.3**	**-2.3**	**-0.2**	**-1.9**	**0.1**	**-0.1**
- Cash/accruals	-0.1	0.0	n.a.	0.0	n.a.	0.0	n.a.	0.0
- Accumulation of financial assets	0.5							
of which: Privatisation proceeds	-0.7							
- Valuation effects & residual adj.	-0.1							
p.m.: Debt ratio excl. second-pillar pension scheme[2]	*n.a.*	*n.a.*	*61.5*	*n.a.*	*60.0*	*n.a.*	*63.2*	*62.3*

Notes:

[1]The change in the gross debt ratio can be composed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

[2]This shows general government gross debt as it will be after the Eurostat decision of 2 March 2004 on the classification of funded pension schemes has been implemented, which needs to be done by the time of the spring 2007 notification.

[3] Data for 2006 and 2007 do not include an imputed loan in relation to the acquisition of military planes under financial lease of 0.3% of GDP per year.

Source:

Convergence programme update (CP); Commission services’ autumn 2005 economic forecasts (COM); Commission services’ calculations

5.2. Assessment

The comparison between the Commission services autumn 2004 forecast and the current update confirms that the main differences in the evaluation of the path of the debt-to-GDP ratio arise from the higher optimism of the budgetary projections of the update.

In addition, to the extent that interest rates do not decline by as much as foreseen in the programme baseline, this may pose a risk to the projected path of interest payments by the government (around 30% of total Government borrowing). Given the relatively substantial share of foreign currency borrowing by the government, unanticipated rises in foreign interest rates, possibly in combination with a weaker forint, may also lead to a higher interest burden, and to an upward revaluation of the foreign-currency denominated debt.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The update presents a number of plans for the reform of the public sector. They include downsizing as well as geographic and functional re-structuring on both central and local government levels. The necessary specifications and quantifications are, however missing. In addition, the success of this rationalisation is also based on the need to overcome the deadlock in the reform of the local government system, also needed for a substantial efficiency improvement in the health and education sectors.

With the adoption of the 2006 budget, the government adopted a five-year tax cut programme with the following main elements: (i) the reduction of the main VAT rate from 25% to 20% with a partial compensation in the increase of the majority of the excise taxes and the registration tax; (ii) a change in the personal income tax burden by raising, on a yearly basis, the ceiling of the lowest income bracket, while reducing the top rate from 38% to 36%; (iii) increased family support; (iv) a reduction of the corporate tax rate for small enterprises and making as a general rule the local business tax deductible from the tax base; (v) introduction of a so-called luxury tax on high- value residential property; and (vi) changes in the social security scheme, including the complete abolition of the flat rate health contribution as of November 2006. At the same time, further measures were taken to improve the efficiency of tax collection.

A risk to the quality of the public finances might result from the planned strong recourse to the PPP framework for motorway investments. While these investments are to substitute a significant share of public investment (about 1 percentage point of GDP per year until the end of the programme period), the update lacks details about their future financial burden. These, however, might constitute a significant liability, limiting the budgetary room of manoeuvre in the long term, while it is not certain that the recourse to partnerships with the private sector will increase efficiency and reduce costs as compared to the conventional financing of public-use infrastructure.

The measures in the update are in line with the National Reform Programme submitted on 14 October 2005 and updated in December. However, the economic policies outlined in the update are not consistent with the broad economic policy guidelines in the area of public finances, in particular with the integrated guidelines No 2 and No 3 (annex 3).

7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Hungary's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance[13] remains unchanged at the 2005 level throughout the programme period.

In the case of Hungary, the Commission's analysis is based on government expenditure on pensions, which is the only age-related expenditure projection included in the update. The other age-related items covered in the common projections (health care, long-term care, education and unemployment benefits) are not provided in the programme. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period. On the basis of the programme information, pension expenditure is

[13] The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out. Moreover, the revenue side is also corrected for the impact of the switch to second-pillar pensions; it therefore differs from the structural balance published in the medium-term analysis.

foreseen to increase by 1.7% of GDP between 2008 and 2050 (see Table A2 in Annex 4)[14].

The gross debt-to-GDP ratio is currently close to the reference value of 60% of GDP. It is projected to rise continuously throughout the projection period, reflecting the high structural deficit[15] (see Table A 4 in Annex 4).

In the ‘2005’ scenario, the sustainability gap (S1) that ensures a debt level at 60% of GDP in 2050 would be around 4½% of GDP. The government’s inter-temporal budget constraint, captured by the S2 indicator, points to a considerable sustainability gap of around 5½% of GDP. The estimated future budgetary impact of ageing – due to increases in pension expenditure - is rather limited according to the update, reflecting in particular the reform of the pension system implemented in the late 1990s. However, the initial budgetary position is not sufficiently high to offset the future budgetary impact of ageing. The need to consolidate the budgetary position is therefore a priority.

The planned budgetary consolidation over the programme period is consistent with reducing risks to public finance sustainability. Indeed, in the “programme” scenario the sustainability gaps, measured either by the S1 or S2 indicator are reduced, indicating that a part of the budgetary challenge posed by ageing populations can be dealt with by sticking to the medium-term budgetary plans as set down in the convergence programme. Nevertheless, the planned fiscal consolidation is insufficient to significantly reduce sustainability risks. The sustainability gap as measured by the S2 indicator translates into a required primary balance (RPB) of about 2% of GDP, higher than the structural primary balance of about -1% of GDP of the last year of the programme period. Moreover, as elaborated below, the programme misses crucial information on the evolution of other ageing-related expenditure, such as healthcare and long-term care.

Moreover, the sustainability gap, as measured by the S1 indicator, would increase by at least ¼% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later (see Table A3 in Annex 4).

Table 7: Sustainability indicators and the required primary balance

[14] In the sustainability analysis, only pensions paid by social security pensions were included. The funded scheme will, according to Eurostat’s decision on the classification of funded defined-contribution pension schemes, be classified outside government from 2007 onwards.

[15] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast.

	Sustainability indicators and RPB									
	2005 Scenario					Programme scenario				
	S1	S2		RPB		S1	S2		RPB
Value (of which)	**4.5**	**5.6**		**1.9**		**1.4**	**2.7**		**1.9**
initial budgetary position	*3.7*	*4.1*				*0.8*	*1.2*		
debt requirement in 2050	*0.2*	*:*				*0.1*	*:*		
future changes in budgetary position	*0.5*	*1.5*				*0.5*	*1.5*		

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[16]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission (2005), European Economy, 'Public finances in EMU – 2005, Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

GDP growth and labour productivity are projected to be considerably stronger in the update compared with the EPC projections from 2020 up to 2050; in the case of GDP, by about 1 percentage point per annum. In addition, the projected profile of ageing population is somewhat more favourable in the programme projections (see Table A1 in Annex 4). Overall, the underlying assumptions in the programme may therefore be considered to be optimistic.

No information is available in the update on other age-related expenditures than pensions, which significantly underestimates the budgetary impact of ageing populations.

The update points out some recent measures that involve increased pension expenditures (the introduction of the 13th-month pension, upward correction of pension benefits). Higher expenditure is assumed to be partially moderated by an increase of the retirement age as well as measures aiming at increasing the employment rate. According to the update a reduction of contributions to the public (pay-as-you-go) pillar is expected to result in a substantial additional deficit in the pay-as-you-go system projected to increase until 2020.

A recent study suggests that the estimated budgetary savings of the pension reform included in the update might be overly optimistic, influenced by subsequent changes to the pension system mentioned above, indicating that the budgetary impact of ageing populations could be higher than projected by the Hungarian authorities in the programme[17].

Concerning the health care system, the update also stresses the objective of decreasing the intensive expenditure growth trend in the field of pharmaceutical subsidies supported by some proposed measures presented in the update. However, the impact of the

[16] The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

[17] See 'The sustainability of the Hungarian pension system: a reassessment', Gábor Orbán-Dániel Palotai, Magyar Nemzeti Bank, 2005.

measures on the long-term sustainability of public finances is uncertain, given the absence of information on long-term dynamics of health-care expenditure in the update.

With regard to the sustainability of public finances, Hungary appears to be at high risk on grounds of the projected budgetary costs of ageing populations. The gross debt/GDP ratio is currently close to the reference value and is projected to increase in the period up to 2050. Hungary reformed its pension system in the late 1990s, aimed at containing future rises in expenditure on pensions. However, increases in government expenditure on pensions could be higher than projected in the update, suggesting that a close monitoring of factors that are assumed to offset such higher expenditures as well as developments in pension and other age-related expenditures is important. Moreover, the currently high structural deficit contributes to increase sustainability risks. It is therefore necessary to carry out a large consolidation of public finances over the medium-term and to further strengthen the budgetary position in order to reduce risks to public finance sustainability.

* * *

Annex 1: Summary tables from the convergence programme update

Table 1

Macroeconomic prospects

	ESA code	2,004	2004	2005	2006	2007	2008
		HUF bn	percentage change				
1. Real GDP at 2000 prices	B1g	15,554.1	4.6	4.2	4.3	4.1	4.1
2. Nominal GDP	B1g	20,413.5	9.5	6.9	7.1	7.1	6.9
Components of real GDP							
3. Private consumption expenditure	P3	8,992.5	3.2	3.1	4.3	3.6	3.8
4. Government consumption expenditure	P3	3,546.7	1.8	1.8	-0.8	-0.7	-0.4
5. Gross fixed capital	P51	3,984.8	8.4	7.5	7.5	7.1	6.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	-186.2	-1.2	-2.5	-2.4	-2.2	-1.9
7. Exports of goods and	P6	13,814.5	16.4	10.2	11.0	9.7	9.2
8. Imports of goods and	P7	14,598.2	13.2	8.1	10.7	9.3	8.9
Contribution to real GDP growth							
9. Final domestic demand		-	4.4	4.2	4.3	3.9	3.9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	-1.4	-1.4	0.0	0.1	0.1
11. External balance of goods and services	B11	-	1.7	1.5	0.0	0.0	0.0
Price developments							
12. GDP deflator		-	4.6	2.5	2.7	2.9	2.7
13. Private consumption		-	4.5	3.1	2.2	2.7	2.2
14. HICP		-	6.8	3.5	2.1	3.0	2.4
15. Public consumption		-	4.3	5.3	3.8	2.2	2.4
16. Investment deflator		-	2.8	3.1	3.0	3.2	3.0
17. Export price deflator (goods and services)		-	-1.4	-1.4	1.4	1.0	1.0
18. Import price deflator (goods and services)		-	-0,9	-0.7	1.4	0.9	0.8
Labour market developments							
19. Employment ('000)		3,900.4	-0.5	0.2	0.3	0.8	0.9
20. Unemployment rate (%)		-	6.1	7.3	7.1	7.0	6.9
21. Labour productivity,		-	5.2	4.0	4.0	3.2	3.1
22. Compensation of	**D.1.**	9,281.7	8.0	7.5	5.2	3.6	5.9
Sectoral balances (in percent of GDP)							
23. Net lending/borrowing vis-à-vis the rest of the world	**B.9.**	**-**	-8.4	-7.7	-7.1	-5.5	-4.8
of which:							
- Balance of goods and		-	-3.1	-2.2	-2.2	-2.0	-1.8
- Balance of primary incomes and transfers		-	-5.7	-6.0	-5.7	-5.2	-4.9
- Capital account	**B.9./EDP**	-	0.4	0.5	0.8	1.7	1.9
24. Net lending/borrowing of the private sector	**B.9.**	-	-3.0	-1.6	-2.4	-2.2	-2.9
25. Net lending/borrowing of general government		**-**	-5.4	-6.1	-4.7	-3.3	-1.9

Table 2

General government budgetary prospects

	ESA code	**2,004**	**2004**	**2005**	**2006**	**2007**	**2008**
		HUF bn	Percentage of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13.	-1,098.2	-5.4	-6.1	-4.7	-3.3	-1.9
2. Central government	S.1311.	-1,221.7	-6.0	-6.6	-5.5	-3.9	-3.1
3. Local government	S.1313.	-48.6	-0.2	-0.3	-0.2	-0.1	-0.3
4. Social security funds	S.1314.	172.1	0.8	0.9	1.0	0.7	1.5
General government (S13)							
5. Total revenue	TR	9,059.4	44.4	45.1	42.5	42.5	41.7
6. Total expenditure	TE	10,157.6	49.8	51.2	47.2	45.8	43.6
7. Net lending/borrowing	EDP B.9.	-1,098.2	-5.4	-6.1	-4.7	-3.3	-1.9
8. Interest expenditure (incl. FISIM)	EDP D.41.+	883.8	4.3	3.6	3.2	3.0	2.7
pm: 8a. FISIM		20.8	0.1	0.1	0.1	0.1	0.1
9. Primary balance		-214.4	-1.1	-2.5	-1.5	-0.3	0.8
Selected components of revenue							
10. Total taxes		5,206.0	25.5	25.5	23.8	24.2	23.2
11. Social contributions	D.61.	2,772.5	13.6	13.5	13.3	12.3	12.3
12. Property income	D.4.	280.9	1.4	0.9	0.9	0.8	0.6
13. Others (13=14-		800.0	3.9	5.2	4.5	5.2	5.6
14.=5. Total revenue	TR	9,059.4	44.4	45.1	42.5	42.5	41.7
Tax burden (D.2.+D.5.+D.61.+D.91.-D.995.)		7,997.5	39.2	39.0	37.1	36.5	35.5
Selected components of expenditure							
15. Collective consumption	P32	2,200.1	10.8	10.6	9.9	9.4	8.9
16. Total social transfers	D.62 +	5,582.0	27.3	27.6	26.8	25.8	25.1
16a. Social transfers in kind	D63	2,681.4	13.1	12.5	12.1	11.5	11.0
16b. Social transfers other than in kind	D62	2,900.6	14.2	15.1	14.7	14.3	14.1
17.=8. Interest expenditure (incl. FISIM)	D41+ FISIM	883.8	4.3	3.6	3.2	3.0	2.7
18. Subsidies	D3	316.7	1.6	1.4	1.5	1.1	0.9
19. Gross fixed capital	P51	730.7	3.6	3.6	2.6	2.8	2.6
20. Other (20=21-(15+16+17+18+19))		444.3	2.2	4.4	3.2	3.7	3.4
21=6. Total expenditure	TE	10,157.6	49.8	51.2	47.2	45.8	43.6
Pm: compensation of	D.1.	2,619.2	12.8	12.6	12.1	11.4	10.8

Table 3

General government debt developments

Percentage of GDP	ESA cod	**2004**	**2005**	**2006**	**2007**	**2008**
1. Gross debt		57.2	57.7	58.4	57.9	56.2
2. Change in gross debt ratio		5.4	4.3	4.5	3.4	2.0
Contributions to changes in gross debt						
3. Primary balance		1.1	2.5	1.5	0.3	-0.8
4. Interest expenditure (incl. FISIM)		4.3	3.6	3.2	3.0	2.7
5. Stock-flow adjustment		0.0	-1.8	-0.2	0.1	0.1
Implicit interest rate on debt (%)		8.4	6.8	5.9	5.5	5.0

Table 4

Cyclical developments

Percentage of GDP	ESA code	**2004**	**2005**	**2006**	**2007**	**2008**
1. Real GDP growth at 2000 prices (%)[1]		4.2	4.0	4.1	4.0	4.0
2. Net lending of general government	**B9**	-5.4	-6.1	-4.7	-3.3	-1.9
3. Interest expenditure (incl. FISIM recorded as consumption)	**D41 + FISIM**	4.3	3.6	3.2	3.0	2.7
4. Potential GDP growth (%)		3.9	4.0	4.1	4.2	4.1
contributions:						
- labour		0.4	0.4	0.4	0.4	0.3
- capital		1.8	1.9	2.1	2.2	2.3
- total factor productivity		1.7	1.7	1.6	1.6	1.5
5. Output gap		-0.2	-0.1	-0.1	-0.2	-0.2
6. Cyclical budgetary component		0.0	0.0	0.0	-0.1	0.0
7. Cyclically-adjusted balance (2-6)		-5.4	-6.1	-4.7	-3.2	-1.9
8. Cyclically-adjusted primary balance (7-3)		-1.1	-2.5	-1.5	-0.2	0.8

[1] Without reallocation of FISIM

Table 5

Divergence from previous update

	2004	2005	2006	2007	2008
Real GDP growth (%)					
Previous update[1]	3.9	4.0	4.2	4.3	4.6
Current update[2]	4.6	4.2	4.3	4.1	4.1
Difference	0.7	0.2	0.1	-0.2	-0.5
General government net lending (% of GDP)					
Previous update	4.5	3.8	3.1	2.4	1.8
Current update	5.4	6.1	4.7	3.3	1.9
Difference	0.9	2.3	1.6	0.9	0.1
General government gross debt (% of GDP)					
Previous update	57.3	55.3	53.0	50.6	48.3
Current update	57.2	57.7	58.4	57.9	56.2
Difference	-0.1	2.4	5.4	7.3	7.9

[1] Without reallocation of FISIM
[2] With reallocation of FISIM

Table 6

Long-term sustainability of public finances

Percentage of GDP	2000	2005	2010	2020	2030	2050
Pension expenditure[1]	8.6	9.8	9.2	9.6	10.1	12.6
of which:						
Social security pension	8.6	9.8	9.2	9.5	9.8	11.1
Occupational pensions (if in general government)[2]	0.0	0.0	0.0	0.1	0.3	1.5
Pensions contributions [3]	7.8	7.6	7.0	6.2	5.3	4.6
Pension reserve fund assets[4]	1.3	5.0	10.1	18.4	24.2	27.6
Of which: consolidated public pension fund assets [5]	0.3	1.3	2.5	4.6	6.0	6.9
Assumptions						
Labour productivity growth	4.2	4.0	3.3	3.7	3.5	2.9
Real GDP growth	5.2	4.2	4.2	3.5	3.2	2.5
Participation rate, males[6]	69.8	69.8	72.0	74.8	75.5	77.2
Participation rate, females[6]	58.8	59.2	62.6	66.1	67.1	69.2
Total participation rate[6]	64.4	64.5	66.9	70.1	71.0	72.9
Unemployment rate	6.4	7.3	6.6	6.0	6.0	6.0
Population aged 65 +over / total population	15.0	15.6	16.6	19.8	21.5	26.8

[1] Social security pensions (from Pension Insurance Fund and Health Insurance Fund) and private pension funds expenditure without pension-type social allowances

[2] Pensions in private pension funds included in mandatory social security system

[3] Employers' and employees' pension contributions and contributions into private pension funds

[4] Assets of private pension funds including government bonds

[5] Without government bonds

[6]Economically active population from 15 to the actual retirement age

Table 7

Basic assumptions

	2004	2005	2006	2007	2008
Hungary: short-term interest rate (annual average)	11.1	6.7	5.2	4.6	4.0
Hungary: long-term interest rate (annual average)	8.2	6.4	5.3	4.9	4.4
HUF/EUR exchange rate (annual average)	251.7	249.0	252.5	254.0	254.0
World excluding EU, GDP growth	5.9	5.1	4.9	4.6	4.5
EU GDP growth	2.4	1.5	2.1	2.4	2.4
Growth of foreign markets of Hungary	7.6	4.8	5.9	5.9	5.8
World import volumes, excluding EU	13.9	8.6	8.7	8.4	8.4
Oil prices (Brent, USD/barrel)	38.3	55.0	61.4	60.3	60.0

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].	**X**		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		Titles are different. Sensitivity analysis are included in the different paragraphs of the chapters macro-economic outlook and fiscal policy
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.	X		
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.			n.a.
Significant divergences between the national and the Commission services' economic forecasts are explained[2].	X		
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		
c. Monetary/exchange rate policy			
The <u>convergence</u> programme presents the medium-term monetary policy objectives and their relationship to price and	X		

Guidelines in the new code of conduct	Yes	No	Comments
exchange rate stability.			
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			n.a.
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.		X	
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.	X		
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			n.a.
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			n.a.
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X X X X		 n.a.
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			n.a.
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the	X		

Guidelines in the new code of conduct	Yes	No	Comments
sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.			
Common budgetary projections by the AWG are included in the programme.	X		
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].		x	
– Member States should avoid pro-cyclical fiscal policies[2].			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].		x	
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.		x	
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.		X	
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	x		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between	x		

Integrated guidelines	Yes	No	Not applicable
public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.			
Notes: [1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times". [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Indicators of long-term sustainability

Sustainability of public finances in Hungary – quantitative scenarios

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	3.1	3.3	2.9	3.7	2.7	3.5	1.7	2.9
Real GDP growth	3.3	4.2	2.5	3.5	2.1	3.2	1.1	2.5
Participation rate males (aged 20-64)	77.3	72.0	79.1	74.8	78.8	75.5	77.3	77.2
Participation rates females (aged 20-64)	61.3	62.6	65.7	66.1	67.1	67.1	66.0	69.2
Total participation rates (aged 20-64)	69.1	66.9	72.3	70.1	72.9	71.0	71.6	72.9
Unemployment rate	4.8	6.6	4.8	6.0	4.8	6.0	4.8	6.0
Population aged 65+ over total population	16.7	16.6	20.3	19.8	22.3	21.5	28.1	26.8

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes	Impact on S2
Total age-related spending	9.4	9.2	9.5	9.8	10.5	11.1	1.7	1.5
Pensions	9.4	9.2	9.5	9.8	10.5	11.1	1.7	1.5
Health care	-	-	-	-	-	-	-	-
Long-term care	-	-	-	-	-	-	-	-
Education	-	-	-	-	-	-	-	-
Unemployment benefits	-	-	-	-	-	-	-	-
Total primary non age-related spending	31.5	31.5	31.5	31.5	31.5	31.5	0.0	0.0
Adjusted total revenues	39.9	39.9	39.9	39.9	39.9	39.9	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

	S1	S2
"2005" scenario	**0.6**	**0.1**
"Programme" scenario	**0.2**	**0.0**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	62.3	62.5	66.4	76.0	92.7	119.3	57.0
*Gross debt, i + 1**	*62.3*	*63.6*	*73.6*	*90.5*	*116.7*	*157.0*	*94.7*
*Gross debt, i - 1**	*62.3*	*61.3*	*59.8*	*63.9*	*74.2*	*92.4*	*30.1*
Adjusted gross debt	62.3	62.5	66.4	76.0	92.7	119.3	57.0
2005 Scenario							
Gross debt	70.3	76.1	106.9	143.6	188.8	247.6	177.3
*Gross debt, i + 1**	*70.3*	*77.4*	*116.8*	*166.1*	*229.5*	*315.2*	*244.9*
*Gross debt, i - 1**	*70.3*	*74.7*	*97.9*	*124.7*	*156.9*	*197.8*	*127.5*
Adjusted gross debt	70.3	76.1	106.9	143.6	188.8	247.6	177.3

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.