COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.1.2006
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Hungary, 2005-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of Hungary was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines, included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the convergence programme of Hungary and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website:http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 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.

Assessment

(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.

(2) 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.

(3) 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[3]. However, the last year of the programme horizon, showing a positive output 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

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

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.

(4) 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.

(5) 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[4]. 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.

(6) 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.

(7) 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.

[4] 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.

(8) 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.

(9) 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.

(10) 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.

(11) 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[5].

(12) 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 November 2005 based on Article 104(8)

[5] 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

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.

(13) 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.

(14) 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.

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Hungary, 2005-2008

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [24 January 2006] the Council examined the updated convergence programme of Hungary, which covers the period 2005 to 2008. 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; however, there are some inconsistencies with ESA95, concerning the treatment of FISIM and the recording of military expenditure. The programme does not provide 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.

(2) 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 policies were implemented resulting in large macroeconomic imbalances. While growth has become more balanced and inflation and wage growth have decelerated in recent years, Hungary continues to struggle with high budget and external deficits. The macroeconomic scenario presented in the 2005 December update envisages that real

[6] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website:http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

GDP growth remains stable at about 4% over the rest of the programme period, driven by investment and exports. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions, while it seems to be favourable in the outer year. The projected reduction in the external deficit is conditional upon the fulfilment of fiscal tightening together with the implementation of structural reforms boosting potential output. The programme's projections for inflation appear realistic.

(3) On 5 July 2004, the Council decided that Hungary was in excessive deficit and issued a recommendation under Article 104(7) that this situation should be corrected by 2008 at the latest in line with the adjustment path contained in Hungary's May convergence programme. Following a decision in January 2005 of no compliance under Article 104(8), the Council issued for the second time recommendations under Article 104(7) on 8 March 2005, maintaining 2008 as the target year by which the excessive deficit should be corrected. The Council recommended the Hungarian authorities to take effective action in order to achieve the deficit target for 2005 as set in the updated convergence programme, and to make the timing and implementation of any tax cuts conditional upon the achievement of the deficit targets of the same convergence programme update. The same was reflected in the Council opinion of the 2004 update of the convergence programme also adopted on 8 March 2005. The update continues to target ending the excessive deficit by 2008. The foreseen deficit path is 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, 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 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, taken into account by the time of the spring 2007 notification[7]. 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.

(4) 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). The MTO cannot be inferred from the budgetary projections presented in the programme.

(5) The budgetary outcome could be much worse than projected in the programme as the tightening of expenditure in 2006 as well as the structural retrenchment for the outer years of the programme are not based on clearly defined and quantified measures. Moreover, a number of risks surrounding the strategy may materialise.

(6) In view of this risk assessment, the budgetary stance in the programme needs to be substantiated to ensure its consistency with a correction of the excessive deficit by 2008 as recommended by the Council, which is the end-year of the programme.

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[7] 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.

(7) The debt ratio is estimated to have reached 57.7% of GDP in 2005. The programme projects the debt ratio to decline by about 1½ percentage points over the programme period. The evolution of the debt ratio is likely to be less favourable than projected in the programme given the risks to the budgetary targets mentioned above.

(8) 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 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[8].

(9) 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 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.

(10) 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.

In view of the above assessment, the Council is of the opinion that Hungary should 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.

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[8] 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

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[8]**	**-3.3[8]**	**-1.9**
	COM Nov 2005	-5.4	-6.1	-6.7	-6.9	n.a.
	CP Dec2004	*-4.5*	*-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**	**-2.2**
	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]**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
	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[8]**	**57.9[8]**	**56.2[8]**
	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 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 (see also footnote 8).

[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.

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

[6] Before 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).

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

[8] Not including military purchase of 0.3% of GDP in both 2007 and 2008.

Source:

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