COUNCIL OPINION

of 24 January 2006

on the updated convergence programme of Hungary, 2005-2008

(2006/C 55/04)

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 [1], 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.

(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 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 to 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

[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). 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

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 [1]. 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 a revised target for 2005 was within reach. Latest available cash data support this view.

(4) The update broadly follows the model structure and the data provision requirements, with some exceptions, for stability and convergence programmes specified in the new code of conduct [2].

(5) 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 is not explicitly set in the programme, but can be inferred from it and is a structural deficit of between -0,5 % and -1 % of GDP.

(6) The budgetary outcome could be much worse than projected in the programme. Following an expected deficit in 2005 of 6,1 % of GDP, the programme specifies in detail tax reductions summing up to 3,5 % of GDP. The consolidation in the programme relies on a very large cut in expenditures of 7,5 % of GDP, the implementation of which is not backed by concrete measures.

(7) In view of this risk assessment, the policy behind 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.

(8) 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 of GDP over the programme period. The evolution of the debt ratio could be less favourable than projected in the programme in the light of the above-mentioned risks to the budgetary targets.

(9) 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 [3].

(10) 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. Even if the objectives are consistent with the guidelines, their implementation is subject to major risks. 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 the budgetary outcome could be much worse unless the fiscal measures underpinning the fiscal objectives are specified and strictly implemented.

(1) 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.

(2) The update provides all compulsory and most optional data prescribed by the new code of conduct. Exceptions concern the recording of military expenditure which is not in line with ESA requirements and the treatment of FISIM.

(3) 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

(11) 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 considers that effective fiscal action is required. In accordance with the second paragraph of Art. 9 of section 3 of Council Regulation (EC) no 1466/97 as amended, the Council invites Hungary to present as soon as possible and by 1 September 2006 at the latest an adjusted convergence programme update which 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** ([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** ([8])	**– 3,3** ([8])	**– 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.*

		2004	2005	2006	2007	2008
Structural balance ([3]) (% of GDP)	**CP Dec 2005** ([4])	**– 4,8**	**– 5,7**	**– 4,5**	**– 3,3**	**– 2,2**
	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 2006 and 2007.

Source:

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