COUNCIL OPINION

of 12 February 2008

on the updated convergence programme of Hungary, 2007-2011

(2008/C 49/06)

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 12 February 2008, the Council examined the updated convergence programme of Hungary, which covers the period 2007 to 2011.

(2) Over the last several years, Hungary has fallen behind in the catching-up process compared to its neighbours. This has been coupled with increasing fiscal laxity, which contributed to considerable internal and external imbalances and relatively tight monetary policy. Since mid-2006, the Government has taken comprehensive measures to consolidate public finances.

These have set the budget deficit on a decreasing trend from a peak of over 9 % of GDP in 2006 to around 6 % (and possibly below, according to the most recent estimates) in 2007 and have started to lead to an improvement of the external balance. At the same time, the indirect tax increases and hikes in regulated prices have temporarily put upward pressure on inflation, which should decelerate again from 2008. The continued fiscal consolidation supported by improved fiscal governance and enhanced structural reforms should form the basis of a return to robust and balanced growth. It could also contribute to providing more room for manoeuvre for monetary policy and to lowering the risk premia.

(3) The baseline macroeconomic scenario projects real GDP growth to decelerate to below its long-term average in 2007 and 2008 and to return to 4 % or above from 2009 onwards. In light of currently available information ([2]), the growth assumptions appear to be plausible for 2007 and 2008, but rather favourable thereafter. In particular, starting from 2009, the programme projects a rather quick recovery and hence a somewhat favourable evolution of domestic demand, in parallel with only a moderate decline in the contribution of net exports. The envisaged robust growth after 2008 hinges on a somewhat optimistic assumption for the increase of labour productivity and on the projected acceleration in private consumption and rebound in investment. The projected improvement in the external balance is plausible provided that fiscal consolidation is continued as planned. Although the foreseen decline in inflation from 7,9 % in 2007 to around 3 % in the outer years is broadly plausible, higher-than-projected wages and sustained pressure from commodity prices may pose risks to the programme's inflation trajectory and thus could further delay nominal convergence. In this context, the continued implementation of structural reforms plays an important role.

(4) For 2007, the general government deficit is estimated at 6,4 % of GDP in the Commission services' autumn 2007 forecast, against a target of 6,8 % of GDP set in the previous update of the convergence programme. The programme foresees an even lower deficit outcome of 6,2 % of GDP for 2007,

([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://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

([2]) The assessment takes notably into account the Commission services' autumn 2007 forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

which in light of the most recent information on budgetary implementation appears to be even surpassed. In mid-January, the Government announced yet again a lower deficit forecast of 5,7 % of GDP. The overachievement of the 2007 deficit target is chiefly due to a favourable base effect from 2006 as well as higher-than-expected revenues resulting from tax increases and the implementation of a set of measures addressing tax evasion. The reduction in the deficit would have been even higher had part of the additional room for manoeuvre not been used to raise expenditures more than planned. On the whole the budgetary implementation in 2007 was broadly in line with the invitation in the Council opinion of 27 February 2007 on the previous update of the convergence programme to rigorously implement the 2007 budget ([1]).

(5) The main goal of the update is to correct the excessive deficit by 2009 (reducing it from 6,2 % of GDP in 2007 to 3,2 % of GDP in 2009 ([2])), in line with the previous update against a background of a broadly similar macroeconomic scenario, and to further reduce it to 2,2 % of GDP in 2011. As interest expenditure is projected to progressively decline after 2008, the primary balance would improve slightly less, from a deficit of 2,2 % of GDP in 2007 to a surplus of 1,1 % of GDP in 2011. The update confirms the medium-term objective (MTO) for the budgetary position of a 0,5 % of GDP deficit in structural terms (i.e. cyclically-adjusted and net of one-off and other temporary measures), which is not expected to be achieved within the programme period.

The budgetary consolidation is planned to be realised by reducing the expenditure-to-GDP *ratio*, after a drop of 1,5 percentage points in 2007, by some 6 percentage points over the programme period; this would more than offset the decrease, from 2008, in the revenue-to-GDP *ratio* by around 2 percentage points (chiefly driven by a reduction in the tax burden owing to a tax-poor composition of GDP growth). After the expiry of expenditure freezes in 2009, the reduction in the expenditure *ratio* would be achieved through the progressive phasing-in of structural reforms in the areas of public administration, education, healthcare and pensions as well as further cuts in price subsidies. Government gross debt, estimated at around 65 % of GDP in 2007, i.e. above the 60 % of GDP Treaty reference value, is projected to decline by 3,6 percentage points over the programme period.

(6) The risks to the budgetary projections in the programme appear broadly balanced in 2008, due to an expected better outcome in 2007 than foreseen in the programme and since the reserves in the budget could offset possible slippages on the expenditure side. From 2009, the budgetary outcomes could be worse than targeted. The risks to the deficit path stemming from the macroeconomic outlook are neutral in 2008. There is a risk from 2009 of lower-than-expected GDP growth, which would lead to higher deficits. Some signs of relaxation in the enforcement of measures on expenditure are appearing, as since mid-2007 expenditures have been catching up with the higher-than-expected revenues and the nominal freeze of the public wage bill (due to expire in 2009) will not be respected in 2008 (as public sector wages were increased, partly referring to higher-than-expected inflation). Additional risks on the expenditure side may arise if the planned reorganisation of the heavily-indebted national railway company does not lead to a reduction in related government expenditure ([3]). Further plans and follow-up steps for structural reforms of the public administration, health, pension, price subsidies and education systems play a crucial role in curbing expenditures. Nevertheless, they need to be fully specified and adopted.

[1] OJ C 71, 28.3.2007, p. 23.

[2] The deficit target of 3,2 % of GDP in 2009 would still exceed the 3 % of GDP threshold specified in the Treaty. As in previous updates, it is assumed in the programme that the Council and the Commission take into account 20 % of the yearly burden on the budget arising from the pension reform (which is expected to amount to 0,3 % of GDP in that year) when taking a decision on abrogating the excessive deficit procedure for Hungary (in line with Council Regulation (EC) No 1467/97 as amended, Article 2, paragraph 7, which stipulates that if the general government deficit '… *has declined substantially and continuously and has reached a level that comes close to the reference value*', the Council and the Commission should consider the net cost of a pension reform that includes a fully-funded pillar on a linear degressive basis for a transitory period of five years, and taking into account the implementing provisions in the code of conduct).

[3] Indeed, the programme does not seem to include any possible takeover from the debt of MÁV, the State-owned railway company (over 1 % of GDP), nor any additional capital injections to MÁV; the same assumption was explicitly made in the Commission services autumn 2007 forecast. Moreover, both do not consider either any receipt in relation to the privatisation of the MÁV's cargo division, nor any consequence of the planned privatisation on the sectoral classification of the company.

An important reform proposal improving fiscal governance, submitted to Parliament in November 2007, should help enhance the credibility of the budgetary strategy and reduce budgetary risks; however it will require adoption by qualified majority and its effectiveness in reversing the recent pattern of budgetary slippages needs to be tested. Even though the recent budgetary performance has been better than planned, starting from 2009 there is a risk of a budgetary loosening compared to plans as evidenced by past experience. Risks to the budgetary targets equally apply to the debt *ratio*; therefore its evolution envisaged from 2009 might also be less favourable than projected in the programme.

(7) In view of this risk assessment, the budgetary stance in the programme seems broadly consistent with a durable correction of the excessive deficit by 2009 as recommended by the Council provided that the budgetary measures and structural reform steps announced in the programme are fully and effectively implemented. Even if the budgetary plans from 2009 include built-in reserves on the expenditure side, the planned 2009 deficit target of 3,2 % of GDP does not provide an adequate buffer against unforeseen negative budgetary developments. A sufficient safety margin against breaching the 3 % of GDP deficit threshold with normal macroeconomic fluctuations is not expected to be provided within the programme period. In the years following the correction of the excessive deficit, the pace of adjustment towards the MTO implied by the programme is inadequate and not sufficiently backed up with specific measures. Finally, taking into account the risks to the debt projections mentioned above, the debt *ratio* may not be sufficiently diminishing towards the reference value over the programme period.

(8) Though recent reforms in 2006 and 2007 have helped curb the increase in age-related expenditure, Hungary appears to be at high risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing on gross public expenditure continues to be above the EU average. The full materialisation of the budgetary savings expected from the planned introduction of the direct taxation of pensions from 2013 is conditioned on how this taxation will be implemented.

Moreover, and importantly, the budgetary position in 2007 as estimated in the programme, while significantly improved compared to 2006, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. In addition, the current level of gross debt is above the Treaty reference value. Further budgetary consolidation as planned in the programme would contribute to reducing risks to the sustainability of public finances.

(9) The convergence programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. Focusing on the measures with a direct budgetary impact, both programmes include the already adopted and planned steps to streamline the institutional system of the entire public sector, including through the rationalisation of capacities in the public administration and health-care system, as well as various measures to discourage early retirement. The new update provides some information on the direct budgetary implications of the structural reform plans and the recently adopted measures outlined in the implementation report. However, not all the envisaged measures are quantified in the budgetary projections of the convergence programme and furthermore their incorporation is neither comprehensive nor systematic.

(10) The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines in the area of budgetary policies issued in the context of the Lisbon strategy.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data ([1]).

([1]) In particular, data on the nominal effective exchange rate are not provided.

The overall conclusion is that the programme plans to continue the correction of high deficits of the past years through a necessary frontloaded adjustment effort and envisages modest progress towards the MTO after the planned correction of the excessive deficit in 2009. As a result of the consolidation measures and steps in structural reforms, Hungary is set to considerably outperform its deficit target for 2007 of 6,8 % of GDP and to increase progress towards convergence. It also improves somewhat the target for 2008 (to 4 % of GDP) compared to the previous programme, and in view of the expected better outcome in 2007 it should be feasible, and indeed desirable, to overachieve it. However, the lower deficit targets are combined with higher-than-previously-planned expenditures on the back of better-than-expected revenues, which cannot be counted on after 2008. Moreover, from 2009 the achievement of the budgetary targets is subject to larger risks, linked mainly to possible expenditure overruns in case the announced wide-ranging reform agenda is not fully carried out. Thus, the durability of the planned adjustment hinges on the reinforcement of fiscal governance as well as on completing the structural reforms which are key not only to attract foreign direct investment but also to improve the long-term sustainability of public finances, for which Hungary remains at high risk. Such achievements are also crucial in accelerating economic catching-up and ultimately moving towards lasting convergence.

In view of the above assessment and also the recommendation under Article 104(7) of 10 October 2006 and given the need to ensure sustainable convergence, Hungary is invited to:

(i) rigorously implement the 2008 budget, take adequate action to ensure the correction of the excessive deficit by 2009 as planned, where necessary through additional measures; and allocate the better-than-expected revenues to further deficit reduction, also given the insufficient margin in 2009 in view of the risks, thereby also contributing to accelerating the pace of debt reduction towards the 60 % of GDP threshold;

(ii) ensure expenditure moderation in a permanent manner by continuing to enhance fiscal rules and institutions and through the adoption and swift implementation of the remaining streamlining measures as announced in the fields of public administration, healthcare, and education system;

(iii) in view of the level of debt and the increase in age-related expenditure, improve the long-term sustainability of public finances by making rapid progress towards the MTO, and continue to reform the pension system as announced after the steps already taken in 2006-2007.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**CP Nov 2007**	**3,9**	**1,7**	**2,8**	**4,0**	**4,1**	**4,2**
	COM Nov 2007	3,9	2,0	2,6	3,4	n.a.	n.a.
	CP Dec 2006	*4,0*	*2,2*	*2,6*	*4,2*	*4,3*	*n.a.*
HICP inflation (%)	**CP Nov 2007**	**4,0**	**7,9**	**4,8**	**3,0**	**2,9**	**2,8**
	COM Nov 2007	4,0	7,7	4,9	2,8	n.a.	n.a.
	CP Dec 2006	*3,9*	*6,2*	*3,3*	*3,0*	*2,8*	*n.a.*
Output gap ([1]) (% of potential GDP)	**CP Nov 2007**	**0,8**	**– 0,8**	**– 1,4**	**– 1,0**	**– 0,4**	**0,2**
	COM Nov 2007 ([2])	1,1	0,1	– 0,3	0,0	n.a.	n.a.
	CP Dec 2006	*0,9*	*– 0,4*	*– 1,2*	*– 0,5*	*0,4*	*n.a.*
Net lending/borrowing *vis-à-vis* the rest of the world (% of GDP)	**CP Nov 2007**	**– 5,7**	**– 4,1**	**– 2,3**	**– 1,7**	**– 1,3**	**– 0,8**
	COM Nov 2007	– 5,7	– 3,9	– 1,5	– 0,4	n.a.	n.a.
	CP Dec 2006	*– 6,1*	*– 3,6*	*– 1,7*	*– 0,1*	*0,6*	*n.a.*

		2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	**CP Nov 2007**	**− 9,2**	**− 6,2**	**− 4,0**	**− 3,2**	**− 2,7**	**− 2,2**
	COM Nov 2007	− 9,2	− 6,4	− 4,2	− 3,8	n.a.	n.a.
	CP Dec 2006	*− 10,1*	*− 6,8*	*− 4,3*	*− 3,2*	*− 2,7*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2007**	**− 5,3**	**− 2,2**	**0,1**	**0,6**	**0,8**	**1,1**
	COM Nov 2007	− 5,3	− 2,4	− 0,2	0,1	n.a.	n.a.
	CP Dec 2006	*− 6,2*	*− 2,4*	*0,0*	*0,9*	*1,1*	*n.a.*
Cyclically-adjusted balance (1) (% of GDP)	**CP Nov 2007**	**− 9,6**	**− 5,9**	**− 3,4**	**− 2,7**	**− 2,5**	**− 2,3**
	COM Nov 2007	− 9,7	− 6,4	− 4,1	− 3,8	n.a.	n.a.
	CP Dec 2006	*− 10,5*	*− 6,6*	*− 3,8*	*− 3,0*	*− 2,9*	*n.a.*
Structural balance (3) (% of GDP)	**CP Nov 2007**	**− 8,9**	**− 4,8**	**− 3,5**	**− 2,8**	**− 2,5**	**− 2,3**
	COM Nov 2007	− 9,4	− 5,5	− 4,2	− 3,9	n.a.	n.a.
	CP Dec 2006	*− 9,8*	*− 5,6*	*− 3,7*	*− 3*	*− 2,9*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2007**	**65,6**	**65,4**	**65,8**	**64,4**	**63,3**	**61,8**
	COM Nov 2007	65,6	66,1	66,3	65,9	n.a.	n.a.
	CP Dec 2006	*67,5*	*70,1*	*71,3*	*69,3*	*67,5*	*n.a.*

Notes:

(1) Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

(2) Based on estimated potential growth of 3,2 %, 3,0 %, 3,0 % and 3,0 % respectively in the period 2006-2009.

(3) Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0,7 % of GDP in 2006 and 1,1 % in 2007; both deficit-increasing, and 0,1 % of GDP in 2008 and 0,1 % of GDP in 2009; both deficit-reducing according to the most recent programme and 0,3 % of GDP in 2006 and 0,9 % in 2007; both deficit-increasing and 0,1 % of GDP in 2008 and 0,1 % of GDP in 2009; both deficit-reducing according to the Commission services' autumn forecast.

Sources:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations.