# CONVERGENCE PROGRAMS OF THE CEE COUNTRIES

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*Member States have continued to make progress, at differing rates. In most cases, steps have been taken towards meeting the commitments contained in the country specific recommendations agreed collectively by the Member States in 2007. Having examined the updated convergence program of most CEE analyzed countries, the European Commission finds that their planned budgetary consolidation is consistent with a correction of the excessive deficits.*

*Key words:real convergence, nominal convergence, Central and Eastern European countries.*

## 1. RECENT DEVELOPMENTS IN AN ENLARGED EU

The Lisbon Strategy is working. It is creating growth and jobs. It is helping position Europe and European citizens to succeed in the age of globalization. It has given Europe a common, pragmatic economic agenda, fully respecting national differences. But complacency would be fatal to Europe's prospects of shaping globalization. Much more remains to do. Progress is uneven between policy areas and some Member States are moving much faster than others.

Economic growth was 3.0% in EU-27 in 2006 and it remained at 2.9% in 2007. Structural reforms have helped increase the potential estimated growth rate of GDP in the euro zone by 0.2 percentage points since 2005 to 2.25% in 2007. Almost 6.5 million new jobs have been created in the last two years. Another 5 million jobs are expected to be created up to 2009. Unemployment is expected to fall to under 7%, the lowest since the mid 1980s. For the first time in a decade, strong increases in employment have gone hand in hand with robust productivity growth.

EU 27 budget deficits have been significantly reduced, from 2.5% of GDP in 2005 to almost 1.1% in 2007. EU 27 public debt has declined from 62.7% in 2005 to just below 60% in 2007.

It is now possible in all but a few Member States to start up a business within one week by means of a "one-stop shop" and there have been important steps in implementing the EU better regulation agenda.

About half of the Member States have developed - or are developing - policies based on a flexicurity approach. Agreement has been reached on a common set of flexicurity principles which Member States should now implement, tailoring them to their own specific situations. All Member States have now set a national R&D investment target. If all of these targets are met, the EU will reach an R&D level of 2.6% of GDP in 2010 (up from 1.9% in 2005). This would be a significant improvement even if the key EU target of 3%.

However, the proportion of GDP spent on R&D in the EU has recently failed to keep up with stronger economic growth rates and decreased to 1.85 % in 2006, with large differences between Member States. This trend moves the EU further away from 3% target. Despite the deficit and debt improvements, the opportunity to use the relatively strong growth conditions to reduce structural deficits has not been fully seized, especially in the euro area.

Many labor markets remain segmented, with well-protected insiders and more precarious outsiders on contracts with uncertain prospects. Education systems are not doing enough to give young people the skills they and employers need. Worker mobility remains still relatively low. Only 2% of working age citizens live and work in another Member State. In some Member States workers still face significant barriers when changing jobs. The Commission has therefore proposed a Job Mobility Action Plan.

Europe is still lagging behind other leading economies in investment in information and communication technologies and in their use to enhance productivity. Many Member States are not on course to fulfill their

Kyoto targets and will need to make a major effort to reach the ambitious targets agreed by EU leaders at the 2007 Spring European Council and to be implemented through the energy and climate change package the Commission will bring forward at the beginning of 2008. Member States have continued to make progress, at differing rates. In most cases, steps have been taken towards meeting the commitments contained in the country specific recommendations agreed collectively by the Member States in 2007.

## 2. SOME CEE COUNTRIES' CONVERGENCE PROGRAMS

Romania submitted a new update of its convergence program on 5 December 2007, covering the period 2007-2010. The budgetary strategy outlined in the program is not in line with the prudent fiscal policy necessary to contain the growing external deficit and inflationary pressures which put the convergence process at risk. The program envisages a continuation of high deficits, entailing the risk of an excessive deficit. (See table no. 1 for CEE countries) Progress towards Romania's medium-term objective (MTO) of a deficit just below 1% by 2011 is clearly insufficient and is left until the last year of the program period despite strong growth prospects. In view of the risks to the budgetary targets and the significant adjustment that would be necessary after the program period, the MTO is unlikely to be achieved by 2011 as planned.

| | | *2006* | *2007* | *2008* | *2009* | *2010* |
|---|---|---|---|---|---|---|
| *Romania* | *Real GDP (% change)* | *7.7* | *6.1* | *6.5* | *6.1* | *5.8* |
| | *HICP inflation (%)* | *6.6* | *4.8* | *5.7* | *4.0* | *3.3* |
| | *Output gap (% of potential GDP)* | *2.2* | *2.1* | *2.1* | *1.8* | *1.1* |
| | *General government balance (% of GDP)* | *-1.9* | *-2.9* | *-2.9* | *-2.9* | *-2.4* |
| | *Government gross debt (% of GDP)* | *12.4* | *11.9* | *13.6* | *14.2* | *14.9* |
| *Slovak Republic* | *Real GDP (% change)* | *8.3* | *8.8* | *6.8* | *5.8* | *5.0* |
| | *HICP inflation (%)* | *4.3* | *1.7* | *2.3* | *2.6* | *2.7* |
| | *Output gap (% of potential GDP)* | *-0.5* | *1.8* | *2.3* | *2.1* | *1.4* |
| | *General government balance (% of GDP)* | *-3.7* | *-2.5* | *-2.3* | *-1.8* | *-0.8* |
| | *Government gross debt (% of GDP)* | *30.4* | *30.6* | *30.8* | *30.5* | *29.5* |
| *Poland* | *Real GDP (% change)* | *5.4* | *5.1* | *5.1* | *5.6* | *-* |
| | *HICP inflation (%)* | *1.4* | *2.1* | *2.5* | *2.5* | *-* |
| | *Output gap (% of potential GDP)* | *0.5* | *0.5* | *0.3* | *0.4* | *-* |
| | *General government balance (% of GDP)* | *-3.9* | *-3.4* | *-3.1* | *-2.9* | *-* |
| | *Government gross debt (% of GDP)* | *48.9* | *50.0* | *50.3* | *50.2* | *-* |
| *Hungary* | *Real GDP (% change)* | *3.9* | *1.7* | *2.8* | *4.0* | *4.1* |
| | *HICP inflation (%)* | *4.0* | *7.9* | *4.8* | *3.0* | *2.9* |
| | *Output gap (% of potential GDP)* | *0.8* | *-0.8* | *-1.4* | *-1.0* | *-0.4* |
| | *General government balance (% of GDP)* | *-9.2* | *-6.2* | *-4.0* | *-3.2* | *-2.7* |
| | *Government gross debt (% of GDP)* | *65.6* | *65.4* | *65.8* | *64.4* | *63.3* |
| *Bulgaria* | *Real GDP (% change)* | *6.1* | *6.4* | *6.4* | *6.8* | *6.9* |
| | *HICP inflation (%)* | *7.4* | *7.2* | *6.9* | *4.4* | *3.7* |
| | *Output gap (% of potential GDP)* | *0.8* | *0.6* | *0.0* | *-0.4* | *-0.2* |
| | *General government balance (% of GDP)* | *3.2* | *3.1* | *3.0* | *3.0* | *3.0* |
| | *Government gross debt (% of GDP)* | *22.8* | *19.8* | *18.3* | *17.4* | *16.9* |
| *Czech Republic* | *Real GDP (% change)* | *6.4* | *5.9* | *5.0* | *5.1* | *5.3* |
| | *HICP inflation (%)* | *2.1* | *2.4* | *3.9* | *2.3* | *2.1* |
| | *Output gap (% of potential GDP)* | *0.9* | *1.8* | *1.4* | *0.7* | *0.5* |

| | | | | | | |
|---|---|---|---|---|---|---|
| | *General government balance (% of GDP)* | ***-2.9*** | ***-3.4*** | ***-2.9*** | ***-2.6*** | ***-2.3*** |
| | *Government gross debt (% of GDP)* | ***30.1*** | ***30.4*** | ***30.3*** | ***30.2*** | ***30.0*** |
| ***Estonia*** | *Real GDP (% change)* | ***11.9*** | ***10.5*** | ***7.5*** | ***7.0*** | ***6.8*** |
| | *HICP inflation (%)* | ***6.6*** | ***10.1*** | ***12.5*** | ***7.2*** | ***4.9*** |
| | *Output gap (% of potential GDP)* | ***2.0*** | ***2.8*** | ***1.3*** | ***-0.3*** | ***-1.7*** |
| | *General government balance (% of GDP)* | ***-0.3*** | ***0.3*** | ***0.7*** | ***1.0*** | ***1.2*** |
| | *Government gross debt (% of GDP)* | ***10.6*** | ***9.4*** | ***8.3*** | ***7.2*** | ***6.4*** |
| ***Latvia*** | *Real GDP (% change)* | ***11.2*** | ***7.4*** | ***5.2*** | ***6.1*** | ***6.7*** |
| | *HICP inflation (%)* | ***4.4*** | ***6.6*** | ***8.6*** | ***5.6*** | ***3.6*** |
| | *Output gap (% of potential GDP)* | ***3.6*** | ***2.7*** | ***0.1*** | ***-1.2*** | ***-1.5*** |
| | *General government balance (% of GDP)* | ***3.6*** | ***2.6*** | ***1.3*** | ***1.0*** | ***0.9*** |
| | *Government gross debt (% of GDP)* | ***4.0*** | ***2.7*** | ***2.3*** | ***2.0*** | ***1.8*** |

***Table no. 1 Convergence Programs of the CEE Countries***

The long-term sustainability of Romania's public finances has not yet been assessed as calculations on age-related cost projections are still under way. The national debt was 12.4% in 2006, well below the 60% reference value set in the EU Treaty, but it is increasing. In view of the Commission assessment and the need to ensure sustainable convergence, Romania is invited to: (i) significantly strengthen the pace of adjustment by aiming for substantially more demanding budgetary targets in 2008 and subsequent years; (ii) restrain the envisaged high increase in public spending, review its expenditure composition so as to enhance the economy's growth potential and improve the planning and execution of expenditure within a binding medium-term framework; (iii) adopt policies to contain inflationary pressures, complementing the recommended tighter fiscal stance, with appropriate public wage policy and further structural reforms.

Slovakia submitted a new update of its convergence program on 29 November 2007, covering the period 2007-2010. The program is consistent with a correction of the excessive deficit by 2007. Progress towards Slovakia's medium-term objective of a deficit just below 1% slows down, however, in 2008, and the MTO is planned to be reached only at the end of the program period despite strong growth outcomes and prospects (see Table no. 1).

Slovakia is advised to stand ready to adopt a tighter fiscal stance, in particular in view of possible inflationary pressures after the disinflation effect of past exchange rate appreciation fades out. As regards the long-term sustainability of public finances, Slovakia appears to be at medium risk. In view of the Commission assessment and the recommendation under Article 104(7) of 5 July 2004 and also given the need to ensure sustainable convergence and smooth participation in ERM II, Slovakia is invited to: (i) exploit the strong growth conditions to strengthen the pace of structural adjustment in 2008 and strictly implement the envisaged structural consolidation thereafter, (ii) introduce further structural reforms to improve the labor market performance and stand ready to adopt a tighter fiscal stance, in particular in order to contain possible inflationary pressures, especially after the disinflation effect of past substantial exchange rate appreciation fades out.

Having assessed the budgetary developments in Poland since the adoption of a new Council recommendation, last February, the European Commission concludes that the deficit is likely to be below 3% this year. But, at the same time, it is expected to rebound above 3% in 2008, according to the Commission's autumn economic forecasts based, inter alia, on the draft budget adopted by the outgoing government. This calls for additional measures to put the Polish budget firmly on a sustainable path, especially in view of the positive economic outlook enjoyed by the country. In February 2007, European Union finance ministers (ECOFIN Council), on a recommendation by the Commission, found that the budgetary situation had improved in Poland, but not sufficiently to correct the excessive deficit situation by 2007. This deadline was agreed back in 2004, when Poland joined the EU, according to a first ECOFIN Council recommendation under Article 104(7) of the EU Treaty.

Poland informed, in September this year, that it expected a deficit of 3.0% of GDP in 2007 after an outcome of -3.8% in 2006. According to the autumn forecast of the Commission services, the 2007 deficit

outturn will be even better, reaching 2.7% of GDP, mainly thanks to an incomplete execution of planned expenditure (see Table no. 1). Also the structural improvement will reach 0.9 percentage point of GDP, which more than satisfies the Council recommendation. Against this background, the planned budgetary adjustment fulfils the Council recommendation concerning 2007.

But the autumn forecast published by the Commission on 9 November points to the risk that the deficit may rebound and breach the 3% reference value in 2008 and 2009, if no additional policy actions are taken. This is because a number of deficit increasing measures were adopted without counteracting measures by the Parliament before the October 2007 elections. The Polish authorities are, therefore, invited to submit, as soon as possible after the new government has taken office, an updated convergence program describing additional consolidation measures for 2008 and the following years. The updated fiscal strategy should be geared towards making permanent the correction of the excessive deficit in 2007 and making progress towards the medium-term objective of a structural deficit of 1% of GDP.

Hungary submitted a new update of its convergence program on 30 November 2007, covering the period 2007-2011. Hungary must take adequate action to ensure the correction of the excessive deficit as planned, where necessary through additional measures. Reinforcing fiscal governance and completing the structural reforms which are essential to improve the long-term sustainability of public finances are crucial in moving towards lasting convergence. The program plans to continue the correction of the high deficits of the past years through a frontloaded adjustment effort (see Table no. 1).

Thanks to the consolidation measures and structural reforms, Hungary is set to considerably outperform its 6.8% of GDP deficit target for 2007. It also improves the target for 2008 to 4% of GDP compared to the previous program which, in view of the better-than-expected outcome in 2007, is both feasible and desirable. 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 increasing risks, linked mainly to possible expenditure overruns if the wide-ranging reform agenda is not fully carried out. Ensuring the adjustment is durable requires a strengthening of fiscal governance and the completion of structural reforms. This is also crucial in order to improve the long-term sustainability of public finances, for which Hungary remains at high risk, and to move towards lasting convergence.

In view of the Commission assessment and of the recommendation under Article 104(7) of 10 October 20063 and given the need to ensure sustainable convergence, the Council should invite Hungary to: (i) rigorously implement the 2008 budget, take adequate action to ensure the correction of the excessive deficit by 2009 as planned; 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 permanent expenditure moderation by continuing to enhance fiscal rules and institutions and by adopting and swiftly implementing measures announced in the fields of public administration, healthcare, and the 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 and continue to reform the pension system as announced after the initial steps taken in 2006-2007.

Bulgaria submitted a new update of its convergence program on 7 December 2007, covering the period 2007-2010. Bulgaria, which has enjoyed high growth since 2003, has carefully refrained from a pro-cyclical fiscal stance and is aiming for ambitious but necessary budgetary surpluses. To ensure sustainable convergence with the rest of the EU, it is vital that it continues on this path with a view to containing inflation and external imbalances, in particular by saving all unexpected revenues (see Table no. 1).

The program proposes an upward revision of the MTO2 from a balanced budget to a surplus of 1½% of GDP, which will be comfortably met throughout the program period. Safeguarding macroeconomic stability and sustaining catching-up in a context of rising external imbalances and high inflation will require the continuation of tight fiscal policies and further improvements in the quality of public spending, including in health care. Fiscal institutions and public sector wage policy need to contribute to overall wage moderation in line with productivity gains. The long-term sustainability of Bulgaria's public finances has not been assessed as calculations on age-related cost projections are still under way. But the current and planned structural surpluses are helping and will help reduce the already low level of public debt.

In view of the Commission assessment and also given the need to ensure sustainable convergence, Bulgaria is invited to: (i) continue avoiding a pro-cyclical fiscal stance with a view to helping contain existing external imbalances, notably by saving all proceeds from any budgetary over-performance and respecting

expenditure ceilings; (ii) adopt policies to contain inflationary pressures, including by contributing to wage moderation through a prudent public sector wage policy and preserving competitiveness; (iii) further strengthen the efficiency of public spending, in particular through full implementation of program budgeting, reinforced administrative capacity, and a reform of the health care system.

The Czech Republic submitted a new update of its convergence program on 30 November 2007, covering the period 2007-2010. In view of an expected general government deficit below 2% in 2007 – much less than estimated by the program itself – the budgetary developments and strategy are consistent with a correction of the excessive deficit in 2008 – by a wider margin than initially planned. However, this is conditional on continuing expenditure restraint and a close monitoring of the possible fall in revenues following the introduction of a flat tax in 2008 (see Table no. 1).

Owing to the positive macroeconomic outlook and a better-than-expected 2007 budgetary outturn, the Czech Republic also ought to achieve stronger-than targeted fiscal consolidation afterwards. The main risks are in its reliance on reductions in public sector employment and the lack of information on the consolidation measures after 2008. The Czech Republic remains at high risk with respect to the sustainability of public finances. Initial steps have been taken to reform the health care system, but further measures are still awaited regarding reforms in this field and in the field of pensions. The debt remains at around 30%.

In view of the Commission assessment and also in the light of the recommendation under Article 104(7) of 10 October 2007, and given the need to achieve sustainable convergence, the Czech Republic is invited to: (i) exploit the likely better-than-expected 2007 budgetary outcome to bring the 2008 deficit below the 3% of GDP reference value by a larger margin; (ii) exploit the high rate of growth in the economy by strengthening the pace of adjustment; (iii) in view of the projected increase in age-related expenditure, improve the long-term sustainability of public finances through the necessary pension and health care reforms.

Estonia submitted a new update of its convergence program on 29 November 2007, covering the period 2007-2011. Estonia's program plausibly aims to maintain a sound budgetary position throughout the period with continued surpluses above the MTO. However, macroeconomic imbalances that have accumulated in the economy are expected to moderate only gradually. The budgetary targets seem plausible. But the macroeconomic imbalances that have accumulated during the years of very high growth of close to 10% or more – notably wage growth exceeding that of productivity, price pressures and high net borrowing vis-à-vis the rest of the world – are expected to moderate only gradually and the deceleration path of the economy is surrounded by downward risks (see Table no. 1).

The long-term sustainability of the Estonian finances is good with almost no public debt, and age-related expenditure costs having already been dealt with. In view of the Commission assessment and also given the need to ensure sustainable convergence and a smooth participation in ERM II, Estonia is invited to contribute to reducing risks to macroeconomic stability by: (i) aiming for a broadly neutral fiscal stance in 2008 and beyond so as to contribute to an orderly adjustment towards a balanced convergence path, (ii) complementing the recommended fiscal stance with appropriate public wage policy and further labor market reforms so as to contain inflationary pressures and sustain rapid productivity growth.

Latvia submitted a new update of its convergence program on 29 November 2007, covering the period 2007-2010. For Latvia, the risks to the budgetary targets are high owing to large macroeconomic uncertainty and past slippages from expenditure plans. A considerably tighter fiscal stance is urgently needed to meet the programs aims in a context of large economic imbalances and excessive demand pressure. Latvia urgently needs to adopt a tighter fiscal stance to meet the programs aims in a context of strong inflationary pressures (Latvia had the highest inflation rate in the EU at about 10% in 2007 and increasing), deteriorating cost competitiveness and sharply increasing net foreign liabilities. While medium-term expenditure ceilings have been introduced, they remain to be tested (see Table no. 1).

By contrast the long-term sustainability of the Latvian public finances is good, with a public debt of around 10% and low exposure to the future age-related expenditure costs on account of past pension reforms. In view of the Commission assessment and given the need to ensure sustainable convergence and a smooth participation in ERM II, Latvia is invited to reduce overheating pressures and risks to macroeconomic stability by: (i) aiming for significantly more ambitious budgetary targets in 2008 and beyond; (ii) carefully prioritizing public expenditure within the overall public sector expenditure limits set within the medium-term budget planning framework, and re-examining taxation instruments to avoid demand stimulus in

sectors which do not significantly strengthen the economy's medium- and long term supply potential; (iii) adopt further policies to contain inflationary pressures, including through responsible public sector wage-setting, thus contributing to the sharp reduction in whole-economy wage growth needed to break the current cost-price dynamics and put a stop to the rapid deterioration in Latvia's competitiveness.

## 3. CONCLUSIONS

Having examined the updated convergence program of CEE countries, the European Commission finds that its planned budgetary consolidation is consistent with a correction of the excessive deficit in 2007. But it should speed up consolidation thereafter so as to create a safe budgetary margin more quickly and to counter any possible inflationary pressures. Romanian convergence program projects a continuation of high deficits despite strong growth. This creates the risk of an excessive deficit and is not in line with prudent fiscal policy. All CEE countries have been experiencing a period of strong economic growth. The increasing deficit of Romania since it joined the EU and its volatility are a matter of serious concern. Romania needs to aim for more healthy budgetary targets to avoid breaching the rules of the Stability and Growth Pact and to contain the growing external deficit and inflationary pressures which pose a risk to macroeconomic and financial stability. Some CEE countries' planned budgetary consolidation is consistent with a correction of the excessive deficit in 2007. But looking beyond the correction of the excessive deficit, faster progress towards the medium-term objective is advised, in particular to contain possible inflationary pressures.

## References:


1. http://ec.europa.eu/