

Economy follows its own track

The forecast made by GKI Economic Research Co. in cooperation with Erste Bank assumes that the domestic political situation stabilizes, the adjustment will take place and the reforms will gradually start up and gain momentum. In this case the confidence of the investors will solidify and the forint will gradually strengthen further. Nevertheless, a marked improvement in the judgment of Hungary's economic situation can be expected not sooner than next year.

Gross domestic product is likely to expand by 4% this year (following the 4.2% growth rate last year and the 4.1% growth rate in the first half of 2006). Domestic demand will be increasing at a slower pace, while exports, the major engine of economic growth, will be expanding fast. The terms of trade will deteriorate by at least 2%, thus the trade balance will be around the last year's figure: approx. □2.8 bn. (3.3% of GDP). The combined deficit of the current and capital accounts is expected to be around the last year's □5.3 bn., i.e. somewhat more than 6% of GDP.

The fiscal adjustment won't have any significant effect on the growth rate of the economy in this year. Nevertheless, it will significantly moderate the growth of domestic demand in the fourth quarter. The growth rate of the gross wages will slow down and that of the net wages will decelerate even more - due to the increase in the individual contributions. At the same time, inflation will pick up due to the rising VAT rate and increasing domestic energy prices. As a result, the more than 5% increase in real wages in the first half of the year will end in a decline by the end of the year; yielding a 3% growth in real wages for the year as a whole. Pensions will rise by approximately 4% in real terms. As of the second half of the year, households are more inclined to accumulate monetary savings; new investments (e.g. homes) are declining, as is the volume of new loans, while households are trying to maintain their consumption level. Consumption growth will drop to 2-2.5%, and will just barely be positive by the end of the year. Investments will increase by 5% at the most, which is similar to last year's level.

In Hungary, general government tends to spend 120 forints out of every 100 forints of its income. Improvement is underway, but nevertheless, the 2006 deficit will be significantly higher (9.5% of GDP) than that of last year (7.5%) and the new estimate modified due to methodological changes (7.5-8%).

Inflation changed significantly in the middle of the year. Over the first half of 2006, inflation was fluctuating between 2.5% and 3%. As a result of the adjustment, however, inflation started to surge sharply at midyear, with a rate close to 6% in September. For 2006 as a whole, the average price increase is expected at 3.9%, while the December inflation rate will likely be as high as 6-6.5%. In early 2006, the forint was still getting stronger and interest rates were dropping. From midyear onward, however, the forint weakened by some 10%, and interest rates started to rise markedly, due to the global and regional economic developments as well as to the initial opacity of the economic policy shift. GKI Co. anticipates that the money markets will assign more credibility to the economic policy. As a result, the forint will strengthen against the euro by the end of the year. The exchange rate will fluctuate between 260 and 275 over the rest of the year, and the annual figure will be around 266. The central bank base rate - which presently is 8% - probably will not change this year.

Forecast of GKI Economic Research Co. on Developments in the Hungarian Economy in 2006

	2004.	2005.	2006. Jan-Aug.	2006. (forecast)
1. Volume of GDP (%)	105.2	104.2	104.1*	104
2. Industrial production (constant prices, %)	107.4	107.3	110.3	110
3. Investment in the national economy (constant prices,%)	107.9	105.6	101.8*	105
4. Construction (constant prices %)	106.8	116.6	98.4	104
5. Retail trade (volume index %)	105.8	105.8	105.1	104
6. Exports (current prices in euro %)	115.3	111.4	116.0	115
7. Imports (current prices in euro %)	113.2	108.3	114.0	113
8. Trade deficit (□ bn.)	3.9	2.8	1.7	2.8
9. Combined deficit of the current & capital accounts (□ bn.)	6.7	5.3	2.9*	5.3
10. Average exchange rate of euro (in forints)	251.7	248.0	265.5**	266
11. Deficit of the general government (cash flow basis without local governments; bn. forints)	1284.1	984.4	1457**	2000***
12. Index of average gross earnings	106.1	108.8	107.8	106.7
13. Consumer price index	106.8	103.6	103.1**	103.9
14. Consumer price index at the end of the period (corresponding month of the previous year=100)	105.5	103.3	105.9**	106.2
15. Rate of unemployment (at the end of the period, %)	6.3	7.3	7.5****	7.5

* H1

** January-September 2006

*** Including the assumption of debt of the National Highway Co.

**** Q3 2006

Sources of actual data: Central Statistical Office, National Bank of Hungary, Ministry of Finance