

## Forint has regained strength

**According to the forecast made by GKI Economic Research Co. in cooperation with the Erste Bank inflation accelerates, but the equilibrium started to improve. The confidence of the investors and consequently the forint is again gaining strength.**

In 2006 the growth of the Hungarian economy is slowing down. Gross domestic product increased by 4.9% in the first quarter but slowed down to 3.8% in the second and third quarters. The expansion of the industry is fast but the output of construction industry is shrinking - although compared to a very high basis. The consumption of households slowed down and the volume of investments decreased in the Q2 and Q3. On the other hand, the exports are very dynamic, as well as the imports, although the growth of the latter is much slower. As a result domestic demand is increasing at a much slower pace than that of the GDP (in the Q2 and Q3 the domestic absorption declined).

The fiscal adjustment measures (tax increases and reduction of subsidies) did not have significant effect on this year's economic development. They will be felt mainly in 2007 - first of all in the public services and in those productive and service sectors that serve the domestic consumption. On the other hand, the fiscal discipline has improved significantly compared to the previous years (the personal income in kind, the public consumption and the state investments - with the exception of highway construction - started to markedly decline). As a result the (strongly export driven) growth of the economy will be around 4.1% in 2006, which is close to the 4.2% of the previous year. The growth of the consumption and investment is expected to be around 1.5 and 2% respectively.

The volume of exports grows by 5 percentage points faster than that of the imports, but the terms of trade deteriorates by approximately 2%. The combined deficit of the current and capital accounts will be basically similar to that of 2005, because, on the one hand, the trade deficit declines and the EU transfers increases, but, on the other hand, the outflow of income increases (a significant part of which returns as reinvested profit).

In the fourth quarter the adjustment already perceptibly moderates the growth of domestic demand. The growth rate of the gross wages slows down a little, and that of the net wages will decelerate even more - due to the increase in the individual social security contributions. At the same time, inflation has picked 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 3.5% growth in real wages for the year as a whole. Pensions will follow a comparable path and will increase by 3.6% in real terms.

The balance of the general government started to improve. Nevertheless, the 2006 deficit will be significantly higher (approx. 9.5% of GDP) than that of last year (7.5%) and the new estimate modified due to methodological changes (7.5-8%). Over the first half of 2006, inflation was fluctuating between 2% and 3%. As a result of the adjustment, however, inflation started to surge sharply at midyear and it reached 6.4% in November. 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 6.5%. From midyear onward the forint weakened by some 10%, and interest rates started to rise markedly. Beginning from September the money markets started to acknowledge the creditworthiness of the economic policy and - as a result - the forint regained almost all of its earlier strength. Thus, the annual average euro-forint exchange rate will be around 264 and the year-end rate 250-255.

**Forecast of GKI Economic Research Co. on Developments in the Hungarian Economy in 2005-2006**

	<b>2004.</b>	<b>2005.</b>	<b>2006. Jan- Oct.</b>	<b>2006. (forecast)</b>
1. Volume of GDP (%)	105.2	104.2	104.1*	104.1
2. Industrial production (constant prices. %)	107.4	107.3	110.2	110
3. Investment in the national economy (constant prices. %)	107.9	105.6	99.6*	102
4. Construction (constant prices %)	106.8	116.6	99	100
5. Retail trade (volume index %)	105.8	105.8	105.0*	104
6. Exports (current prices in euro %)	115.3	111.4	115.8	115
7. Imports (current prices in euro %)	113.2	108.3	113.5	113
8. Trade deficit (□ bn.)	3.9	2.8	2.0	2.3
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	265.1***	264
11. Deficit of the general government (cash flow basis without local governments; bn. forints)	1284.1	984.4	1701***	2000
12. Index of average gross earnings	106.1	108.8	107.9	107.3
13. Consumer price index	106.8	103.6	103.7***	103.9
14. Consumer price index at the end of the period (corresponding month of the previous year=100)	105.5	103.3	106.4***	106.5
15. Rate of unemployment (at the end of the period. %)	6.3	7.3	7.4****	7.5

\* Q1-Q3

\*\* H1 2006

\*\*\* January-November 2006

\*\*\*\* August-October 2006

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