

March 5. 2007.

## Roller coaster

**According to the forecast made by GKI Economic Research Co. in cooperation with the Erste Bank it is almost sure that the 2007 portion of the convergence program will be implemented successfully, the deficit of the general government will be around 6.5%, i.e. below the planned 6.8% of the GDP. Real earnings will decrease by 3-3.5%.**

Instead of the "U" shape path, which was characteristic for 2006, the inflation will follow a reversed "U" shape in 2007: there will be an 8.5% peak in the spring followed by a sharp decline between September and December to around 4.5% at the end of the year. Inflation - the pressure by the increasing costs and expectations - is moderated by the decreasing real earnings, the keen import and retail trade competition, the strong forint, the one-time, controlled character of majority of price increases.

The exchange rate of the euro has been fluctuating around 253 forints since the beginning of the year, with the exception of a few cases of weakening at the end of January or February. The most recent of these cases was a result of the fall in the worldwide stock markets.

The publication of favorable monthly fiscal data, the development of the reforms and the moderation of the political tension after the expected peak in March will lead most probably to an approximately 250 forints/euro exchange rate in April-May. In the monetary policy no significant change is expected in the "vigilant dove" line that has been followed since the enlargement of the Monetary Council two years ago. The base rate of the Central Bank will remain most probably at the present 8% in the first half of the year. In the second half of the year - as a result of the slowdown of inflation and persistent strengthening of the forint - the base rate may be reduced to 6-6.5%.

The much higher than the average December 2006 wage increase was probably a result of advance payments made in anticipation of the more severe rules expected for 2007. In the business sector the increase of gross earnings will be smaller than in 2006 (8.5%). It is expected to be around the higher edge of the band (5.5-8%) proposed by the National Reconciliation Council. The net earnings will increase by around 5%; the real earnings will decrease by 1.5-2%. In the public sector the salary agreement hasn't been fully concluded yet. In the second half of the year there will be an approximately 4% salary increase at the expense of the half of the 13th month salary due in January 2008. In this sector real earnings will decrease by 5-6% on annual average. (If there will be no compensation in January 2008, the agreement will not have any effect on the 2007 outlays and will not influence the fulfillment of the convergence program).

The deficit of the balance of payments, which was equal to 8.4% of GDP in 2004, will be 5.8% in 2007. This is a result of shrinking of the trade deficit. Since 2004 the exports (in euros) has been growing 2-3 percentage points faster than the imports, in spite of the fact that terms of trade deteriorated in 2005 and 2006 by 2% annually because of the increase in the global energy prices (this year probably will stagnate). Of course, the "combined deficit of the current and capital accounts" or in other words the net external financing requirement will improve even more taking into account the net EU transfers: in 2004 it was equal to 8.1% of GDP, while in 2007 it will be only 4%. The majority of this sum will be financed by the inflow of net foreign direct investment. (The FDI inflow is expected to be more than 4% of GDP, while the outflow around 1%). Consequently the foreign debt will grow only moderately.

**Forecast of GKI Economic Research Co. on Developments in the Hungarian Economy in 2007**

	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007 (forecast)</b>
1. Volume of GDP (%)	105.2	104.2	103.9	103.0
2. Industrial production (constant prices %)	107.4	107.3	110.1	108
3. Investment in the national economy (constant prices %)	107.9	105.6	102*	104
4. Construction (constant prices %)	106.8	116.6	98.4	104
5. Retail trade (volume index %)	105.8	105.8	104.4	101.5
6. Exports (current prices in euro %)	115.3	111.4	115.7	113
7. Imports (current prices in euro %)	113.2	108.3	113.4	110
8. Trade deficit (EUR bn.)	3.9	2.9	2.1	1.0
9. Combined deficit of the current & capital accounts (EUR bn.)	6.7	5.3	5*	4.0
10. Average exchange rate of euro (in forints)	251.7	248.0	264.3	252
11. Deficit of the general government (cash flow basis without local governments; bn. forints)	1284.1	984.4	2034	1550
12. Index of average gross earnings	106.1	108.8	108.1	106
13. Consumer price index	106.8	103.6	103.9	106.5
14. Consumer price index at the end of the period (corresponding month of the previous year=100)	105.5	103.3	106.5	104.5
15. Rate of unemployment (at the end of the period %)	6.3	7.3	7.5	8

\* GKI Co. estimate

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