

## External balance is improving as well

**According to the forecast prepared by GKI Economic Research Co. in co-operation with Erste Bank external and internal financial balances are substantially improving this year. Inflation has passed its peak, the time of interest rate cuts has arrived. Real income will decrease by 4.5% in 2007 but within this it will stagnate in the fourth quarter.**

The growth of the economy will slow down compared to the last year's rate, but will be much higher than originally expected. Industrial production will grow by approximately 9%. This is due almost exclusively to the exports; domestic sales will almost stagnate. Domestic sales of industry will modestly expand in the group of investment- and intermediary goods, but will decrease in other groups. The output of the construction industry after the last year's decrease and modest growth in the first quarter, declined again in April. 3% growth is expected for the year as a whole. Retail trade turnover decreased by 2.5% in April and by 0.4% in the first four months of the year. The sales of food and other products decreased; only the sales of pharmaceuticals and fuels increased (the latter one is partly due to reduction of illegal import).

Exports are expanding by 18%, imports by 15%. Trade deficit in the first four months decreased from the last years  $\square 0.9$ bn to  $\square 0.5$ bn and in the year as a whole will be about half of the 2006 level. As a result, the total deficit of the Hungarian foreign trade (including services) will be eliminated. Nevertheless, the deficit of the current account will be around  $\square 4.5$ bn. - due mainly to the large profit taking of foreign owned firms. Since the net EU transfers - owing to the delayed disbursements - will be around  $\square 1.5$ bn the external financing requirement will drop to three billion euros, i.e. below 3% of GDP. This decrease was already clearly perceivable in the first quarter (from the  $\square 1.3$ bn in Q1 2006 to  $\square 1$ bn this year).

The inflation rise was only temporary; it started to abate already and from September onward - as the last autumn's large price increases become part of the basis - will drop markedly. The average annual rate of inflation will be 7% but only 4.5-5% % at the end of the year.

Nominal gross earnings will increase faster than planned, by 7.5%. Private sector wages are rising by approximately 8.5%, i.e. faster than the upper limit of the agreement reached in the National Interest Reconciliation Council. In the autumn there will be a slowdown compared to the 10% growth rate of the first four months, because the wage increase generated by the whitening of the employment started already last year. Public sector wages will be increasing by some 6%, with an approximately 8% wage hike in the second half of the year. The difference between dynamics of gross and net wages - which was around 6% in the first quarter - will be diminishing throughout the year. Nevertheless, real wages will drop somewhat faster than projected, by approximately 4.5%. The decrease in real wages will be significantly more modest than planned in the public sector and more pronounced in the private sector. Beginning from September, real wages will no longer be below the level of the corresponding period of 2006. The stricter control of labor relations, the introduction of wage-related contributions based on the double of the minimal wage and the measure connecting health care services with actual payment of health care contributions led to the start of a modest but definite "whitening" of the economy.

In June the central bank started to reduce its base rate, which had been 8% since October 2006. There will be a modest reduction in the summer and a more pronounced one in the autumn - following the drop in the inflation. By the end of the year the base rate may be around 6.5%. The forint is persistently strong, the annual average exchange rate of the euro is expected to be 250 forint.

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

	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>January-April 2007</b>	<b>2007 (forecast)</b>
1. Volume of GDP (%)	104,8	104,1	103,9	102,7*	103,2
2. Industrial production (constant prices %)	107,4	107,3	110,1	109,3	109
3. Investment in the national economy (constant prices %)	107,6	105,3	97,9	97,7*	104
4. Construction (constant prices %)	106,8	116,6	98,4	101,2	103
5. Retail trade (volume index %)	105,8	105,8	104,4	99,6	100,5
6. Exports (current prices in euro %)	115,3	111,4	116,6	118,0	118
7. Imports (current prices in euro %)	113,2	108,3	113,9	115,1	115
8. Trade deficit (□ bn)	3,9	2,9	2,0	0,5	1,0
9. Combined deficit of the current & capital accounts (□ bn)	6,7	5,3	4,5	1,0	3,0
10. Average exchange rate of euro (in forints)	251,7	248,0	264,3	250,3**	250
11. Deficit of the general government (cash flow basis without local governments; billion forints)	1284,1	984,4	2034	753,0**	1550
12. Index of average gross earnings	106,1	108,8	108,1	107,4	107,5
13. Consumer price index	106,8	103,6	103,9	108,6**	107
14. Consumer price index at the end of the period (corresponding month of the previous year=100)	105,5	103,3	106,5	108,5***	104,8
15. Rate of unemployment (at the end of the period %)	6,3	7,3	7,5	7,3***	7,8

\* Q1 2007

\*\* January-May 2007

\*\*\* March-May 2007

Source of actual data: CSO, NBH, MoF