

## Dismal economic growth

**GKI Co.'s forecast in cooperation with Erste Bank projects a slower economic growth for this year than previously anticipated, while gross wages and inflation are expected to rise more sharply. The latter two will increase government revenues, cutting the deficit despite the slower rate of economic growth.**

The growth rate of the economy slowed down considerably in the second quarter, to as low as 1.4%. Agricultural production dropped markedly due to the unfavorable weather conditions. Following a surge in government-financed construction projects prior to the general elections last year, this year brought a significant decline, resulting in a decrease in the output of the construction sector. Following a marginal growth in the first quarter, the volume of retail sales dropped 3% in the second quarter. At the same time, domestic tourism demand increased, while spending by foreign tourists declined. Industry is the most buoyant sector, which is due almost entirely to the vigorous export activity. In the first half of the year, exports grew by nearly 16%, while domestic sales edged up less than 1%. Domestic sales of consumer goods dropped 4%, but their exports rose 16%. The sales of investment goods, on the other hand, saw an equally rapid rise in both the domestic and foreign markets. Investment activity remained flat in the first half of 2007, but manufacturing investments saw a one-third increase.

Inflation has peaked out and is expected to drop considerably from September onward. At the same time, agricultural producer prices have an opposite effect, which is due to several factors, including the poor domestic crop resulting from unfavorable weather conditions, the increasing use of agricultural products for energy as well as the rapidly growing consumption in Asia. For the year as a whole, inflation is expected to average 7.5%, with a year-end rate of around 5.5%.

Gross nominal wages rose substantially in June. This can be attributed to the fact that the first half of the 13th month bonus payments in the government sector is being gradually distributed from June onward. As a result, gross wages in the government sector increased by over 8% following a period of stagnation over the previous months. As in the prior months, wages in the business sector rose by more than 10% again in June, exceeding the cap set by the National Interest Reconciliation Council agreement. This, however, is partly due to the increasing shift to legal employment and salary structures, which gained momentum last September. Over the next few months, government sector wages will likely grow faster while business sector wages will rise more slowly than in the first half of the year. 2007 as a whole is expected to see an over 4% drop in real wages.

This year unemployment has been less severe so far than in 2006, but it is projected to rise mildly by the end of the year, owing to seasonal factors as well as the expected teacher layoffs.

The reduction in the central bank base rate, which was cut from 8% in June for the first time since October 2006, was put on hold during the summer. A one percentage point rate cut can be expected during the rest of the year, in line with the fall in inflation. As a result, the base rate could drop to 7% or perhaps even lower by the end of the year. The forint weakened in August, but the annual exchange rate is likely to average at 250 forints/euro, which is equal to the average rate of the first seven months of the year. The general government deficit will be about 6% of GDP calculated on the basis of the EU methodology, which is still extremely high but lower than the target set forth in the convergence program. In the first half of the year, exports increased 3 percentage points faster than imports, cutting the trade deficit to less than half.

**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 to June, 2007</b>	<b>2007 (forecast)</b>
1. Volume of GDP (%)	104.8	104.1	103.9	102.1	102.5
2. Industrial production (constant prices, %)	107.4	107.3	110.1	108.3	109
3. Investment in the national economy (constant prices, %)	107.6	105.3	97.9	100.2	102
4. Construction (constant prices, %)	106.8	116.6	98.4	96.0	100
5. Retail trade (volume index, %)	105.8	105.8	104.4	98.5	100
6. Exports (current prices in euro, %)	115.3	111.4	116.6	117.2	118
7. Imports (current prices in euro, %)	113.2	108.3	113.9	113.9	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	249.8**	250
11. Deficit of the general government (cash flow basis without local governments; billion forints)	1284.1	984.4	2034	913.1**	1450
12. Index of average gross earnings	106.1	108.8	108.1	107.9	108.5
13. Consumer price index	106.8	103.6	103.9	108.5**	107.5
14. Consumer price index at the end of the period (corresponding month of the previous year=100)	105.5	103.3	106.5	108.4**	105.5
15. Rate of unemployment (at the end of the period %)	6.3	7.3	7.5	7.0***	7.8

\* Q1 2007

\*\* January to July, 2007.

\*\*\* May to July, 2007.

Sources of actual data: CSO, NBH, MoF