

Significantly improving balance of the economy

According to the forecast prepared by GKI Economic Research Co. in co-operation with Erste Bank the Hungarian economic policy adjustment is taking place in a favorable European business climate but amid growing global economic uncertainty. Restoration of equilibrium in the economy, particularly in general government finance, is slightly faster and more pronounced than originally planned, while economic growth is slower, inflation is higher and overall development activity is tepid.

This year the general government deficit will decline by about 3% of GDP. About half of the improvement is due to rising revenues. The other half is due to spending cuts, with reduced central and local government investments and declined public service expenditures having an approximately equal share. The external balance is also improving significantly. The full trade surplus will approach 2 billion euros, following a modest positive balance last year. At the same time, the deficit in income flows will increase, largely because of the profit earned on foreign capital but also because of the interest expenditures. As a result, the current account deficit will improve from 5.8 billion euros last year to about 5.2 billion euros. As the EU transfers in the capital account are barely increasing from last year's level, the external financing requirement of the Hungarian economy will be 4.5 billion euros, or 4.4% of the GDP

GDP growth will slow even more than expected, to about 2%. Shrinking agricultural production alone will sap GDP growth by 0.5 percentage points, while the drop in public services by more than 1 percentage point. The production of the industry will grow by 8.5%. Domestic tourism is rising dynamically, transit volume is expanding rapidly. Business services are expanding strongly. Output of the construction industry and the retail trade turnover will be down 2%.

Inflation started growing rapidly in the summer of 2006. It peaked in spring 2007 at a higher level than originally forecast, and its decline since the summer of 2007 is also more modest. There are several reasons for that. The roughly 10% weakening of the dollar did not fully compensate for the rising oil, raw material and food prices. Consequently, imported inflation was higher. In the wake of the drought there was a dynamic increase in domestic food prices. In September 2007 inflation dropped substantially, to 6.4%, but further declines will be very modest over the rest of the year (to about 6.2%). Annual average inflation will be about 7.8%. Gross average wages will rise by about 8.5% over the year as the combined effect of an approximately 9.5% increase in the business sector and an approximately 6.3% rise in the government sector, in the wake of the early payment of annual bonuses over the second half of the year. The rise in net earnings will be far less than that. As a result, real wages will decline by about 4.5% statistically, but if the effects of initial gains in reducing tax evasion are also taken into account, the drop will be about 6% in the business and government sectors alike.

The real value of pensions will be unchanged overall (it will decline by some 2% on the basis of the pensioner price index). Household consumption will be down by about 2%, but the volume of purchases will be unchanged, while in-kind consumption will drop heavily. The euro exchange rate will average 250 forints over the entire year. The interest cut process has slowed down and the central bank's base rate will only drop to about 7% by the end of the year.

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

| | 2004 | 2005 | 2006 | Jan.-August 2007 | 2007 (forecast) |
|--|-------------|-------------|-------------|-----------------------------|----------------------------|
| 1. Volume of GDP (%) | 104.8 | 104.1 | 103.9 | 101.9* | 102.0 |
| 2. Industrial production (constant prices. %) | 107.4 | 107.3 | 110.1 | 109.0 | 108.5 |
| 3. Investment in the national economy (constant prices. %) | 107.6 | 105.3 | 97.9 | 101.4* | 102 |
| 4. Construction (constant prices. %) | 106.8 | 116.6 | 98.4 | 92.7 | 95 |
| 5. Retail trade (volume index. %) | 105.8 | 105.8 | 104.4 | 97.8 | 98 |
| 6. Exports (current prices in euro. %) | 115.3 | 111.4 | 116.6 | 118.1 | 118 |
| 7. Imports (current prices in euro. %) | 113.2 | 108.3 | 113.9 | 114.4 | 115 |
| 8. Trade deficit (€ bn) | 3.9 | 2.9 | 2.0 | 0.8 | 1.0 |
| 9. Combined deficit of the current & capital accounts (€ bn) | 6.7 | 5.3 | 5.2 | 2.8* | 4.5 |
| 10. Average exchange rate of euro (in forints) | 251.7 | 248.0 | 264.3 | 250.8** | 250 |
| 11. Deficit of the general government (cash flow basis without local governments; billion forints) | 1284.1 | 984.4 | 2034 | 1147.1** | 1450 |
| 12. Index of average gross earnings | 106.1 | 108.8 | 108.1 | 108.1 | 108.5 |
| 13. Consumer price index | 106.8 | 103.6 | 103.9 | 108.3** | 107.8 |
| 14. Consumer price index at the end of the period (corresponding month of the previous year=100) | 105.5 | 103.3 | 106.5 | 106.4** | 106.2 |
| 15. Rate of unemployment (at the end of the period %) | 6.3 | 7.3 | 7.5 | 7.2*** | 7.5 |

* H1 2007

** January-September 2007

*** Q3 2007

Sources of actual data: CSO, NBH, MoF