MAGYAR NEMZETI BANK

QUARTERLY REPORT ON INFLATION

NOVEMBER 2006

Quarterly Report on Inflation

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Act LVIII of 2001 on the Magyar Nemzeti Bank, which entered into effect on 13 July 2001, defines the primary objective of Hungary's central bank as the achievement and maintenance of price stability. Low inflation allows the economy to function more effectively, contributes to better economic growth over time and helps to moderate cyclical fluctuations in output and employment.

In the inflation targeting system, from August 2005 the Bank seeks to attain price stability by ensuring an inflation near the 3 per cent medium term target. The Monetary Council, the supreme decision-making body of the Magyar Nemzeti Bank, performs a comprehensive review of the expected development of inflation every three months, in order to establish the monetary conditions that are consistent with achieving the inflation target. The Council's decision is the result of careful consideration of a wide range of factors, including an assessment of prospective economic developments, the inflation outlook, money and capital market trends and risks to stability.

In order to provide the public with a clear insight into the operation of monetary policy and enhance transparency, the Bank publishes the information available at the time of making its monetary policy decisions. The Report on Inflation *presents the inflation forecasts prepared by the Economics and Monetary Policy Directorate, as well as the macroeconomic developments underlying these forecast. The* Report *is published biannually, while twice a year partial updates of the forecasts are also prepared. The forecasts of the Economics and Monetary Policy Directorate are based on certain assumptions. Hence, in producing its forecasts, the Economics and Monetary Policy Directorate assumes an unchanged monetary and fiscal policy. In respect of economic variables exogenous to monetary policy, the forecasting rules used in previous issues of the* Report *are applied.*

The analyses in this *Report* were prepared by the Economics and Monetary Policy Directorate's staff under the general direction of Ágnes Csermely, Deputy Director. The project was managed by Mihály András Kovács, Deputy Head of Economic Analysis, with the help of Zoltán Gyenes, Zoltán M. Jakab, Gábor Kátay and Barnabás Virág. The Report was approved for publication by István Hamecz, Director.

Primary contributors to this Report also include, Hedvig Horváth, Éva Kaponya, Gergely Kiss, Péter Koroknai, Zsolt Lovas, Szabolcs Lőrincz, Balázs Párkányi, E. Viktor Szabó, Máté Barnabás Tóth. Other contributors to the analyses and forecasts in this Report include various staff members of the Economics and Monetary Policy Directorate.

The *Report* incorporates valuable input from the Monetary Council's comments and suggestions following its meetings on 6 November 2006 and 20 November 2006. However, the projections and policy considerations reflect the views of the Economics Analysis and Research staff and do not necessarily reflect those of the Monetary Council or the MNB.

Contents

Overview

There was only a slight change in the baseline scenario in spite of tighter monetary conditions

Relative to the August update there is no significant change in our baseline macroeconomic forecast.[1] The inflation and wage figures that we have received in the meantime exceed our previous expectations and have chenged the picture we have outlined on inflation trends in August. Hence, in spite of tighter monetary conditions our baseline projection for inflation remains significantly above the medium-term inflation target over the entire forecast horizon. However, our forecast for core inflation projects a gradual decline in inflation in the second half of the forecast horizon.

The latest data indicate a sharp increase in trend inflation and wage inflation pressure

Since the August update, several macroeconomic data have been published, which differ from the path we previously anticipated.

Trend inflation increased more rapidly last quarter, and the month-on-month core inflation index for September increased substantially, even after eliminating the impact of quasi one-off items. This massive increase in prices is not limited to any one component, as it is evident in all of the main core inflation items.

Another negative surprise arose in connection with the inflation outlook, namely that gross average earnings in the private sector bounced back after the drop during the middle of the year and increased significantly in July and August. Although, the payments of bonuses – which cannot be regarded as a permanent component – played a significant role in the extraordinary growth in average earnings, wage dynamics corrected for these remain higher than we expected. All these point towards increasing wage inflation pressure in the private sector.

In the second quarter of 2006, there was an unprecedented fall in the volume of gross fixed capital formation, despite economic growth at a rate close to its potential, associated with a steady rise in the rate of capacity utilisation. Another reason that would have pointed towards higher investment volume is that the investment intensity of the business sector has previously been known to move in tandem with international economic activity. Current external market conditions can be regarded as favourable: growth in net exports has been a dominating factor on the expenditure side of GDP, induced by favourable trends in external economic activity, and household consumption has increased at a moderate rate.

Slower growth and higher inflation induced by fiscal adjustment measures

Looking forward, we stand by our position that the path of the economy will be dominated by the fiscal adjustment measures; however, uncertainty surrounding the expected path is growing in the wake of information received during the last quarter. In line with the picture we outlined in the August update, we foresee lower aggregate demand for the next two years, which will have a disinflationary effect, while other aspects of the fiscal adjustment measures (increases in taxes and contributions, in indirect taxes and regulated prices) and the weakening in the forint exchange rate since the beginning of the year will appear as a cost shock and will spur higher inflation.

[1] Based on actual data and other information received by 8 November 2006.

For the most part the surprise in the inflation and wage paths are considered one-off, yet it will slow disinflation

In the baseline scenario we continue to presume that economic actors, looking forward to a substantial drop in economic growth and anticipating its impact, will adjust to the cost shock without incurring second round inflationary effects, meaning that inflation expectations will remain co-ordinated. Slower demand, however, can only partially offset the primary impacts.

Although, based on the information available, the factors behind the recent surge in inflation cannot be determined unambiguously, in the baseline scenario we assume that past cost shocks will unwind slowly. Hence, we look upon these as one-off factors, which consequently will increase our inflation forecast only in the short run. In some product markets, however, we expect to see additional inflationary impacts, mainly due to the reduction in the disinflationary effect of more intense competition since Hungary's accession to the EU.

In our forecast we have not made any substantial changes in our view concerning the labour market. The part of the fiscal measures that increase employers' costs is responsible for inflation pressure coming from the direction of unit labour costs, but on account of loose labour market conditions we expect that employees will be unable to pass the real wage lowering impact of changes in tax and contribution liabilities on to employers. At the same time, in light of the latest labour market data we anticipate that wage developments may be stickier and more backward looking. Accordingly, we expect to see gross wages grow in the private sector at a rate somewhat higher than that we anticipated in August, which in turn will increase inflation pressure on the cost side.

Tighter monetary conditions tend to reduce inflation pressure

The impact of factors pointing toward higher inflation is mitigated by the fact that real interest rates have been increasing in recent months and the exchange rate appreciated by close to 4 per cent by October. Market expectations indicate further strengthening in the exchange rate over the long run; this prospect, however, has not been taken into account in our baseline forecast.

Forecast conditions

Our forecast relies on the assumption of a constant policy interest rate, an oil price path based on forward contracts and a HUF/EUR exchange rate fixed at the October average level. In our main scenario, we assume that the fiscal measures are completely implemented as announced. In our opinion, however, the implementation risks surrounding these measures have not diminished significantly, on account of which the sustainability risks surrounding the baseline scenario did not disappear completely.

Lower consumption, slowing investment and foreign trade dynamics, improving external balance

During the next two years, due to lower aggregate demand, economic growth will fall substantially below its potential, and it will be around 2.5 per cent in both 2007 and 2008. The output gap reflects the fiscal measures and, to a lesser extent, the downturn in external economic activity.

Forward looking indicators of economic activity lead us to expect that the growth rate in Europe will slow down in 2007. A drop in domestic absorption will result in significantly lower growth in import volumes, while the dynamics of export growth is expected to slow gradually in 2007 and 2008.

The dynamics of gross fixed capital formation will slow considerably in 2007, primarily due to the reduction in household and government expenditures. At the same time, the growth rate of investment by companies is expected to drop to a lesser extent. Starting from 2008, new EU funds will be available in the government sector and are expected to generate growth in the volume of investments, which in turn will bring about a moderate expansion in investment dynamics at the whole-economy level.

Household consumption is expected to fall in 2007, in the wake of the fiscal measures, while in 2008 it will remain at the level of 2007. In our forecast we have relied on the presumption that households will smooth their consumption; therefore, over the short term consumption will decline less than disposable income.

In response to lower domestic absorption, the external financing requirement may drop to around 4 per cent of GDP in 2007, and below 3 per cent in 2008.

During the first half of 2007 inflation will top out above 8 per cent, then turn back down

Although the inflationary impact of the government's measures is already reflected in the current figures to some extent, in the first half of 2007 we expect the rate of inflation to continue rising sharply, which may be followed by gradual disinflation from the second half of 2007. According to the baseline scenario of our conditional forecast, in 2007 the average annual rate of inflation will reach 7 per cent, and will approximate 4 per cent in 2008. At the same time, in 2008 there is a substantial difference between the dynamics of headline and core inflation. Mostly due to our assumption concerning regulated price developments, the headline price index will hover around 4 per cent throughout the whole year, while the core price index, which better reflects underlying inflation developments, shows further disinflation.

According to the November average of the market's interest rate and exchange rate expectations, the forint might strengthen against the euro to HUF 259 and the central bank base rate decrease close to 7 per cent by the end of 2007; and both could stabilise in 2008. If we use these assumptions in our projection, our annual inflation forecast for 2007 would be lower by 0.3 percentage points, and our forecast for 2008 would be 0.4 percentage points lower. Concerning our forecast of the rate of GDP growth, the change would be 0.1 and 0.2 percentage points lower than the baseline for the next two years.

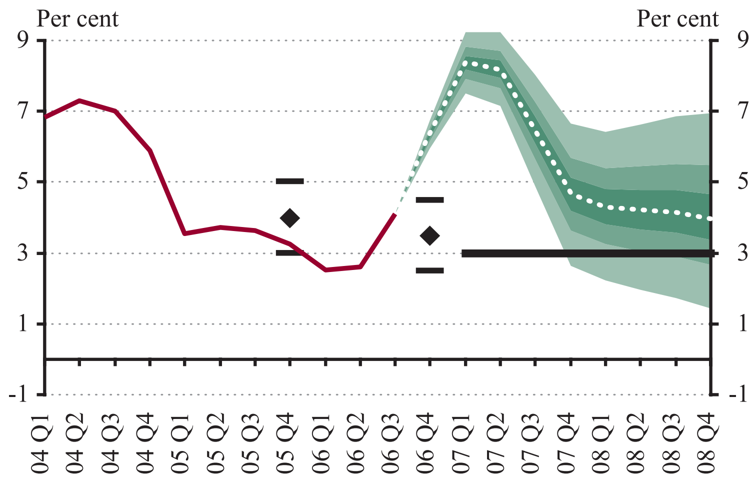
Increasing uncertainty around the baseline scenario, with close to symmetrical risks

The most important assumption contained in the baseline forecast is that medium-term inflation expectations are well anchored. Stronger growth of trend inflation and the observed wage path, however, may also indicate that the co-ordination of inflation expectations have weakened substantially. As our models are not able to reflect any potential problems in the co-ordination of expectations, and because whether or not the problem exists cannot be clearly determined beyond reasonable doubt from the actual data, the impact of any co-ordination related problems is displayed in the distribution of risks surrounding the main scenario. On account of the co-ordination problem, the cost shocks which were previously assumed to be temporary may spill over, the nominal wage path may significantly exceed the baseline, and from the beginning of 2007 higher inflation expectations may be incorporated into wage agreements. The implementation risk of fiscal measures, which are expected to contain consumption and wage dynamics, also indicate uncertainty pointing to higher inflation.

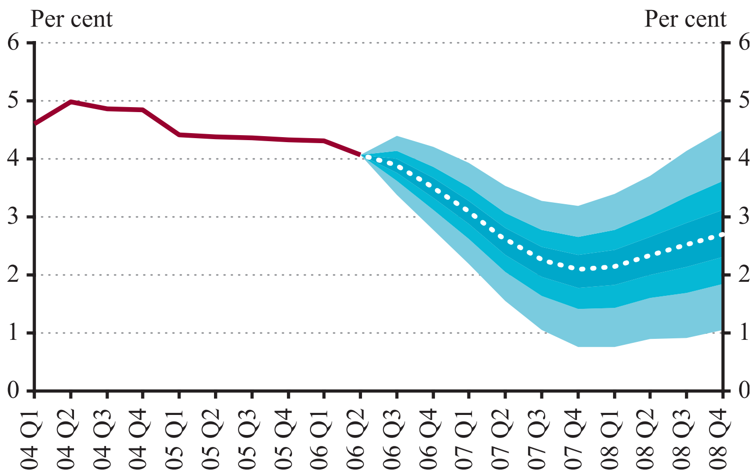
At the same time, uncertainty surrounding the demand reducing impact of fiscal adjustments – if implemented in full – may represent a downside risk factor. Households may be able to smooth their consumption expenditures only to a degree below what is contained in the baseline scenario; therefore, the drop in aggregate demand could be sharper, on account of which the probability of an inflation path below that indicated in the baseline forecast may grow higher. Furthermore, the inflation path may also be lower if the impact of the output gap on inflation exceeds our expectation, or if gas prices are increased at a pace below what we have forecasted. On the whole, the risks surrounding the baseline scenario of the inflation forecast can be deemed symmetrical.

As for the rate of economic growth, the risks also appear symmetrical resulting from two main offsetting uncertainty factors. A more intense drop in consumption may have a downward effect on the rate of economic growth, while the risks of implementation of the fiscal measures are likely to have an upward effect relative to the baseline scenario.

Conditional inflation forecast fan chart



Conditional GDP growth forecast fan chart



Summary table of the baseline scenario

(The forecasts are conditional: the baseline scenario reflecting the most probable scenario that applies only if all the assumptions presented materialise; unless otherwise specified, percentage changes on a year earlier)

	2004	2005	2006	2007	2008
	Actual		Projection		
Inflation (annual average)					
Core inflation[1]	5.9	2.1	2.4	6.1	4.0
Consumer price index	6.7	3.6	3.9	6.9	4.1
Economic growth					
External demand (GDP-based)	2.4	2.0	2.9	2.2	2.3
Impact of fiscal demand[2]	-0.5	0.8	1.5	-4.2	-2.0
Household consumption[3]	3.6	2.1	2.4	-0.9	0.0
Gross fixed capital formation[3]	8.5	6.7	4.2	2.1	4.3
Domestic absorption[3]	4.1	0.8	0.9**	0.0**	1.4
Export[3]	15.8	10.7	15.7	9.8	9.1
Import[3,4]	13.6	6.5	12.1**	7.4**	8.4
GDP[3]	5.2 (4.9)**	4.1 (4.3)**	3.9	2.5	2.4
Current account deficit[4]					
As a percentage of GDP	8.5	6.8	7.1**	5.5**	4.3
EUR billions	6.9	6.0	6.2**	5.2**	4.3
External financing requirement[4]					
As a percentage of GDP	8.2	6.0	6.0**	4.1**	2.6
Labour market					
Whole-economy gross average earnings[5]	5.9	8.9	7.2	5.3	4.7
Whole-economy employment[6]	-0.4	0.0	0.8	-0.2	0.3
Private sector gross average earnings	9.3	6.9	8.3	7.3	7.0
Private sector employment[6]	-0.2	0.3	1.6	0.3	0.5
Private sector unit labour cost	1.8	2.2	5.3	5.6	4.7
Household real income	3.9	3.6***	2.5	-3.8	1.7

[1] For technical reasons, the indicator we project may temporarily differ from the index published by the CSO; over the longer term, however, it follows a similar trend. [2] Calculated using the so-called augmented (SNA) type indicator; a negative value means a narrowing of aggregate demand. [3] Actual and forecasted GDP data do not contain the changes in the CSO's method of GDP calculation, which were published on the 2nd of October. [4] As a result of uncertainty in the measurement of foreign trade statistics, from 2004 actual current account deficit and external financing requirement may be higher than suggested by official figures or our projections based on such figures. [5] Calculated on a cash-flow basis. [6] According to the CSO labour force survey.

** In 2004, the leap-year effect caused an upward distortion in GDP growth of some 0.2 percentage points, and a downward shift in the same amount in 2005. In order for trends in growth to be assessed, these effects must be applied to adjust the original data; corrected values are shown in brackets.*

*** Our projection includes the impact of the Hungarian Army's Gripen purchase, which raises the current account deficit and increases community consumption and imports.*

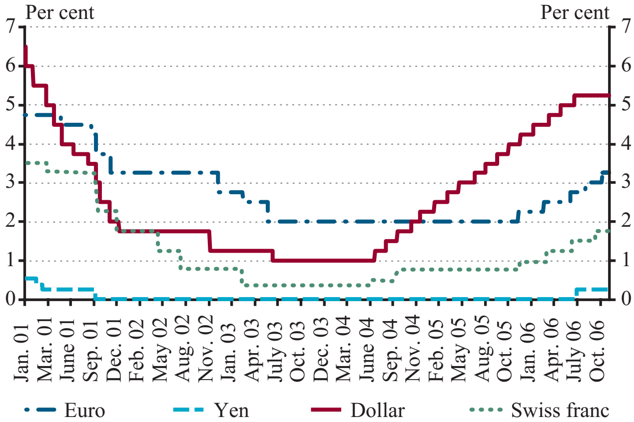
**** An MNB estimate.*

1. Financial markets

Risk appetite on the global financial markets fluctuated significantly in the past half year, in contrast to the previous, relatively stable environment. In May and June, the increasing uncertainty triggered an emerging market sell-off, and investors temporarily decreased their exposure to risk to a great degree. Although risk appetite later approached the high levels seen in the spring as a result of the ensuing recovery, looking forward investor sentiment may continue to be more fragile.

Chart 1-1

Central bank base rates

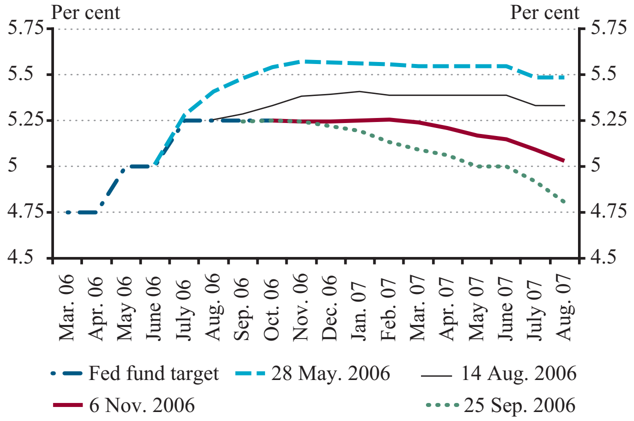


The deterioration of risk appetite is mainly attributable to the end of the accommodating monetary policy and low yield levels which were characteristic of the main markets in the past few years. The change in monetary policy – tightening by the Fed first, followed this year by the ECB and other central banks – gradually raised the level of risk-free interest rates, but investors only slowly adjusted to the changing yield environment. This behaviour was supported by the fact that the US tightening cycle took place in line with expectations, without any major surprises. However, in the middle of this year, as the end of the tightening cycle approached, uncertainty related to the future dollar interest rate path increased. Due to the steady increase in raw material prices over the last few years and the higher-than-expected inflation figures, the inflation risk perceived by the markets increased in May and June, and the expected dollar interest rate path rose. As inflation fears diminished, some market participants were seized by recession fears in August and September, which were mainly related to the anticipated slowdown in the US real estate market. The frequent changes and wide range of expectations further exacerbated market uncertainty.

The first signs of a decline in risk exposure at the global level emerged during the spring of this year, followed by the first wave of major international selling in May and June. The rapid decline in risk exposure affected many

Chart 1-2

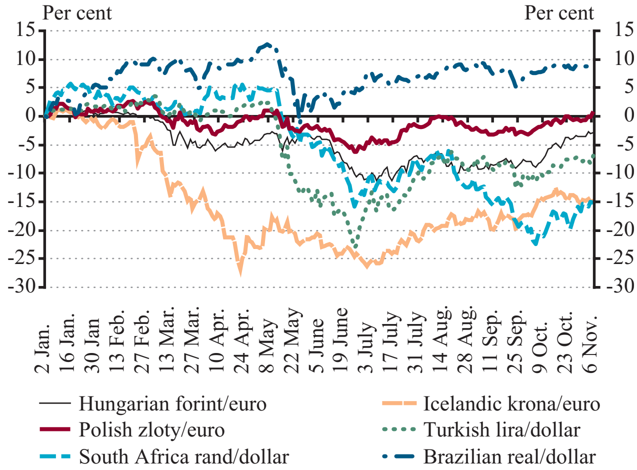
Fed primary rate and estimated levels of the primary rate* at various times



** Calculated from the Fed funds futures list.*

Chart 1-3

Trends in emerging market currencies this year
(cumulative, 2 January 2006 = 0)

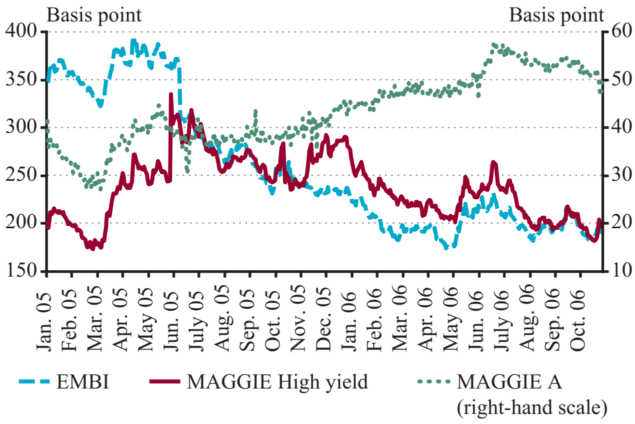


countries and many types of assets, and in countries troubled by external imbalance problems or internal political turmoil this led to substantial weakening of the exchange rates. Whereas investors had previously disregarded fundamentals for the most part, during the sell-off fundamentals were once again given a greater role.

The sell-off however only temporarily reversed the influx of capital into the emerging markets. As inflation fears dwindled, the expected dollar interest rate path and long-term yields also diminished, and the interest rate hikes implemented by the central banks of the countries affected also helped to improve the mood in the emerging markets. According to market expectations, the projected slowdown of the American economy will be moderate and gradual, which could lead to a decrease in the dollar interest rate, however expectations continue to range widely.

Chart 1-4

Bond and credit indices



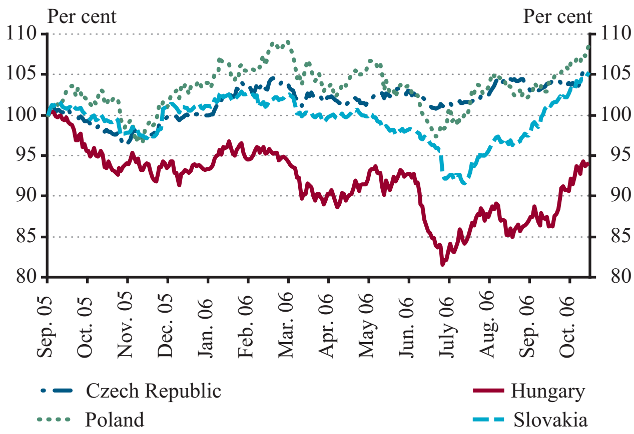
On the whole, the international investment climate has remained favourable. Moreover, the reduction in raw materials prices in August and September had a beneficial effect on the markets with respect to inflation and growth concerns, and this was also reflected in a strong stock market rally. Historically, risk indices remain at very low levels; however, investors still tend to differentiate between countries on the basis of macroeconomic or political risks.

As investors' desire to take risks have diminished, the vulnerability of forint assets have further increased. While during periods of emerging market rallies investors broadly ignored Hungarian country-specific risks (namely the budget deficit and the current account deficit, both of which are extremely high by international standards), the forint suffered a significant setback during the sell-off and its volatility increased. The prices of forint assets clearly moved in conjunction with riskier assets, and were thus particularly sensitive to changes in investor sentiment. Deteriorating sentiment on Hungarian fundamentals was clearly reflected in the major credit rating agencies' downgrades of Hungarian public debt ratings or outlook since the end of 2005. Investors did not find the official target date for the introduction of the euro to be credible, which contributed to this deterioration of sentiment. The announcement of the significantly higher-than-planned budget deficit and public debt figures had further unfavourable market effects. Although political risks in the wake of the elections had a negative impact throughout the entire CE4 region (deadlock in the Czech parliament, resignation of the Polish prime minister, new government coalition in Slovakia), the performance of forint assets still clearly lagged behind that of the neighbouring countries. During this time the forint became the most volatile currency in the region.

Chart 1-5

Developments in CEBI indices* calculated in euro

(1 September 2005 = 100)



* *Total yield of portfolios comprised of standard government papers measured in euro.*

The forint reached a historical low versus the euro and temporarily traded on the weak side of the intervention band. The EUR/HUF 270-280 trading band that eventually evolved was 9 to 10 per cent below the EUR/HUF 245-255 exchange rate level that dominated most of last year's trading. At the same time, Reuters' surveys indicated that analysts predicted the exchange rate to stabilise at EUR/HUF

Table 1-1

Statements by credit rating agencies on Hungarian public debt

Date	Agency	Statement
6 Dec. 2005	Fitch	downgrade (BBB+)
26 Jan. 2006	S&P	negative outlook (A-)
22 Feb. 2006	Moody's	negative outlook (A1)
15 June 2006	S&P	downgrade (BBB+), negative outlook
20 Sept. 2006	Fitch	negative outlook (BBB+)
22 Sept. 2006	Moody's	beginning of review for a downgrade (A1)
4 Oct. 2006	JCR	downgrade (A-)

270 between June and the end of 2006 and at EUR/HUF 262 by the end of 2007 despite significant movements in the spot rate.

Chart 1-6

EUR/HUF exchange rate

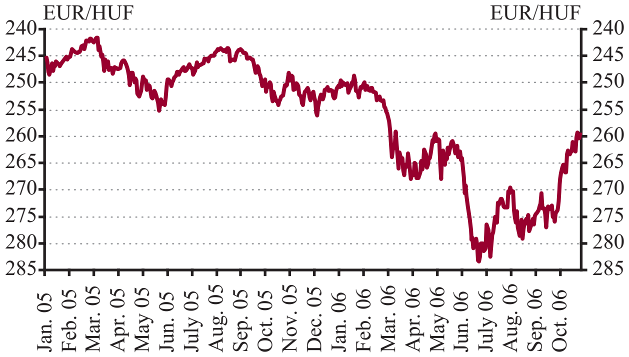
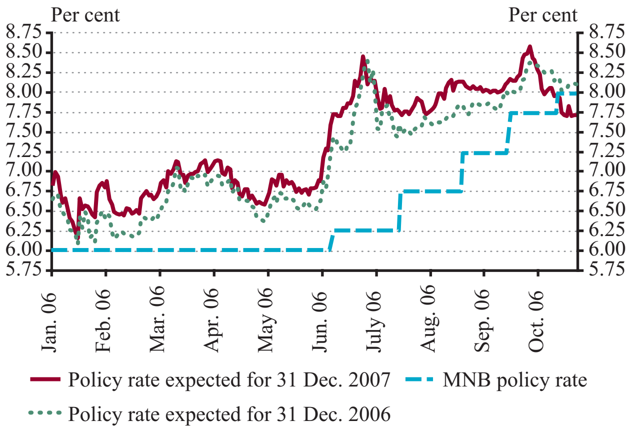


Chart 1-7

The central bank base rate and the base estimated* for the end of 2006 and 2007 from the yield curve

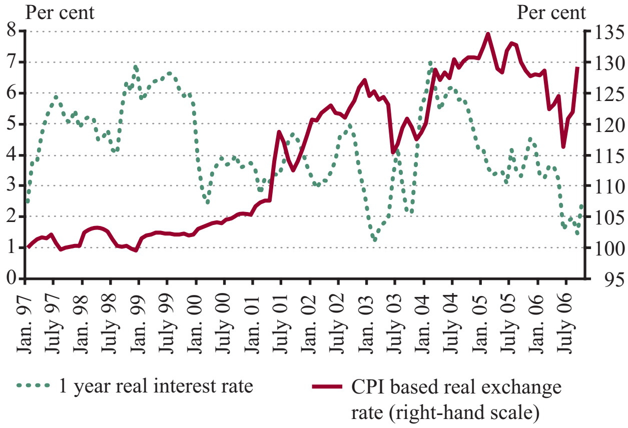


** Two-week forward yield starting at the end of 2006 and 2007 calculated from the zero coupon yield curve of government securities.*

As a result of the substantial weakening of the exchange rate, the expected inflationary effect of the recently announced fiscal adjustment measures, and the premium shock sustained by the emerging markets, market participants priced in substantial interest rate hikes in June. Since June, the MNB has increased the reference interest rate by a total of 200 base points. Although the consensus among analysts and the interest rate path priced in by the market suggested a somewhat less stringent monetary policy, the subsequent, moderate market reactions following the actions taken by the central bank showed that the changes in the base rate did not surprise the market, and that its communication properly guided market expectations. Despite the interest rate hikes, yields on long-term government bonds declined compared to levels at the end of June; hence, the moves helped to stabilize the financial market situation. The one-year ex-ante real interest rate dropped to below 2 per cent in the middle of the year and stayed below the past years' average even after the rise in interest rates. The strengthening of the forint in the autumn contributed to the tightening of monetary conditions, which had relaxed significantly in the second half of last year and the first half of this year. The markets anticipate that there will be room for a decrease in the base rate next year.

Chart 1-8

Monetary conditions*

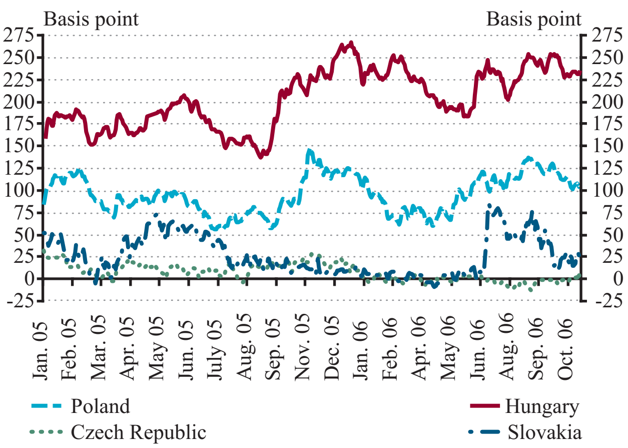


** Real exchange rate, January, 1997 = 100 percent. Higher values represent appreciation. The 1 year forward-looking real interest rate is the monthly average of the 1 year benchmark yields deflated by the 1 year inflation expectations of market analysts surveyed by Reuters.*

In October, the exchange rate recovered from its previous depreciation, borne by the improving environment for international investments, higher central bank interest rates and the market's perception of a decline in risks related to the implementation of measures to reduce the budget deficit.

Chart 1-9

Five-year forward premiums 5 years ahead



The credibility and implementation of the adjustment programme is likely to have a major impact on forint market sentiment in the coming months as well. Despite the improvement in the investment climate, Hungary is still perceived as one of the riskier countries, and accordingly forint assets may still be vulnerable to shocks in risk appetite. Any increase in the risks associated with implementation of the adjustment programme may result in an increase in the expected premium (as seen during the period before the parliament vote of confidence in September, for example) and may result in further downgrading of Hungarian public debt. As indicated by the level of long-term forward premiums, investors remain sceptical about the convergence process in Hungary. On the other hand, however, this means that there may be more room for the reduction of risk premia in the event of a credible improvement in the budget balance.

2. Inflation and its determining factors

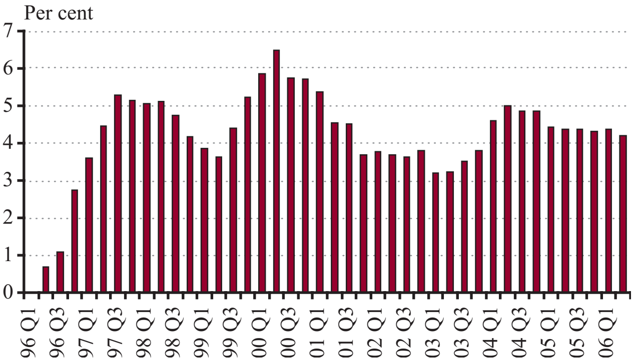
2.1. Economic activity

The first half of 2006 was characterised by strong economic activity (4.2 per cent GDP growth, 4.3 per cent seasonally adjusted), due largely to better-than-expected external demand, while domestic demand is considered weak.[2] A decline in economic growth is forecasted relying upon the indices of business confidence reflecting the future expectations of our business partners, and also due to the fiscal austerity measures introduced in Hungary.

Chart 2-1

GDP growth rate

(annual growth rates)



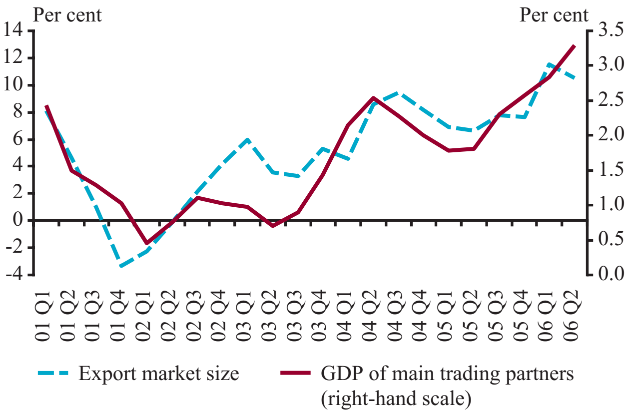
Robust external economic activity – favourable structure, deteriorating expectations

The indicators of external economic activity continue to suggest strong demand on foreign markets. While the demand of our largest commercial partners for exports has not grown further, the growth rate is considered to be close to an all-time high. The robust indices of external business confidence also support this phenomena. The sub-index of the IFO business index on economic activity in Germany, reflecting six-month forward expectations, forecasts unfavourable trends in the business climate, which may be due in part to the demand-decreasing effects of the increase of VAT in Germany scheduled for next January. At the international level, next year's slow-down forecast for the US economy may also be an important factor as far as general expectations are concerned. This slow-down, however, is now expected more likely to be a "soft landing". In summary, the current status of external economic activity may be deemed to be at, or near, its turning point.

Chart 2-2

Forecasts of Hungary's export markets* and the GDP of Hungary's key foreign trade partners

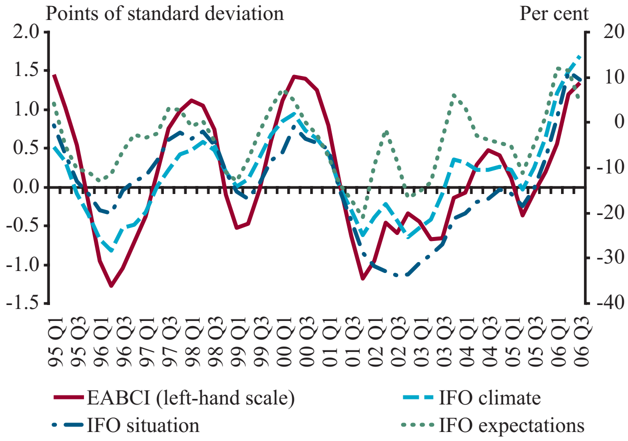
(annual growth rates)



** Size of Hungary's export markets: weighted growth in the volume of import of Hungary's key export markets.*

Chart 2-3

Business climate indices of the euro zone (EABCI) and Germany (IFO)



It is important to note that the economic growth of Hungary's largest trade partner has taken place in an environment that is considered favourable from the standpoint of Hungarian exports. New industrial orders from Germany show signs of strengthening in the product groups (capital goods and intermediate products) which have historically dominated Hungarian export sales to Germany. By contrast, new orders for consumer goods, which constitute a smaller part of Hungarian exports, are decidedly less dynamic. This viewpoint is supported by the factors con-

[2] The Q3 GDP figure was published by the CSO after the editorial deadline for the data for this Report. The new data points to a slowdown in economic activity, which is in line with our expectations.

tributing to the growth of GDP components in the euro area which clearly illustrate that current economic activity is largely driven by investments in fields to which Hungarian exports are directed.

Chart 2-4

New industrial orders in Germany
(annual growth rates)

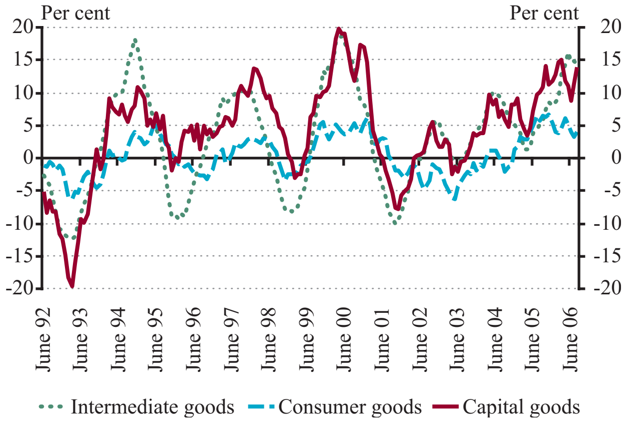
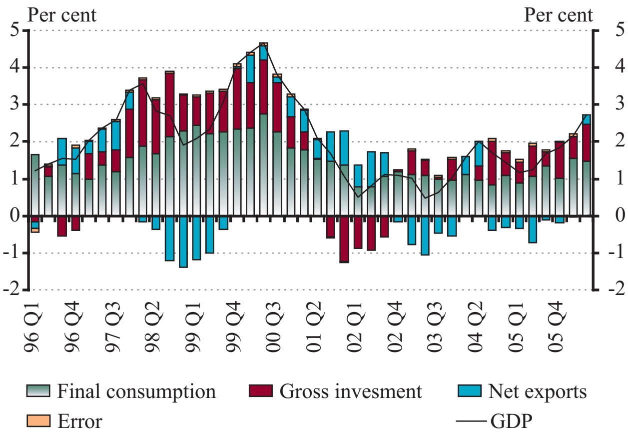


Chart 2-5

GDP growth and contributions by components in the euro zone
(annual growth rates)



Source: Eurostat.

average, and this may be due to the fact that domestic industrial sales are not only linked to the slowing internal demand, but to the more robust external economic activity as well.

Chart 2-6

Production and sales in the manufacturing industry
(annual growth rates)

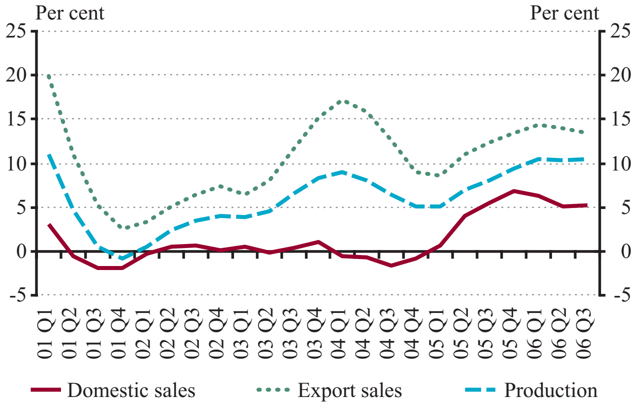
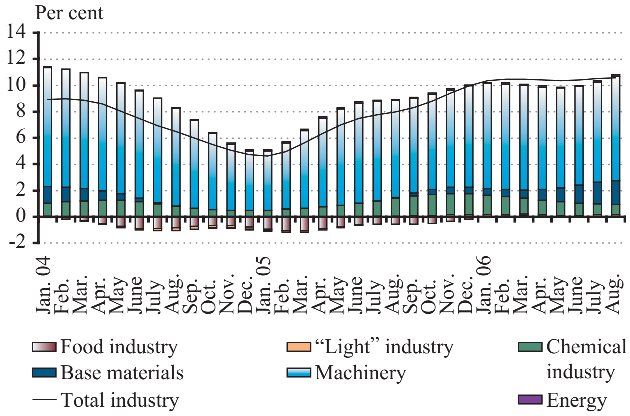


Chart 2-7

Industrial production – growth contributions by different sectors*



* *Annual growth rates of trend series. Contributions of the individual sectors do not necessarily reflect industrial growth as a whole, due to weighting and seasonal adjustments.*

Industrial activity – dynamic growth

Due in part to the favourable external economic activity, industrial production continued to show signs of dynamic growth during the first half of 2006. Manufacturing remained the leading factor in this expansion, and the machine industry managed to retain its previous weight, as it is supported by sales figures. Similarly to previous periods, export sales, which constitute a significant part of manufacturing sales, grew dynamically. The expansion in domestic sales, although it is somewhat less dynamic than previously, is still considered higher than the historical

The dynamics of value added in the first six months were in harmony with gross production processes. In the first quarter, value added in the manufacturing industry rose by 10.8 per cent, an all time high, while the growth rate slowed down to 7.9 per cent in the second quarter. The growth rate of value added in market services dropped to about 4.5 per cent.

During the first half of 2006 there was some improvement in the foreign trade balance as a result of two contrasting impacts. On the one hand, the volume of exports continued to grow at a rate (15 per cent) higher than the volume of imports

(11 per cent), and this factor turned out to be the slightly stronger of the two. This development was due to brisk external demand and to the effects of the real depreciation that first surfaced at the beginning of 2005. All these phenomena are in line with the strong international economic activity mentioned earlier. On the other hand, the terms of trade deteriorated further, due almost entirely to an unfavourable shift in energy prices, similar to the developments that took place in 2005.

Chart 2-8

Volumes of exports and imports of goods

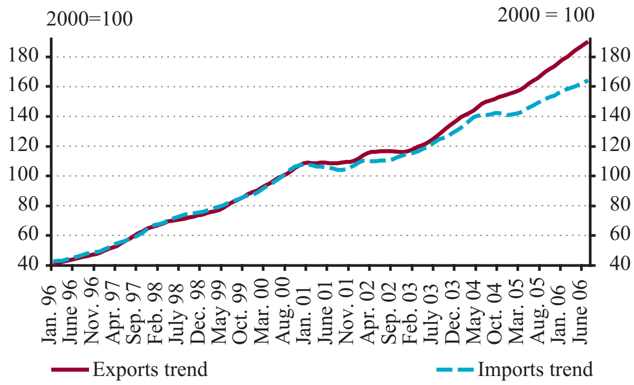
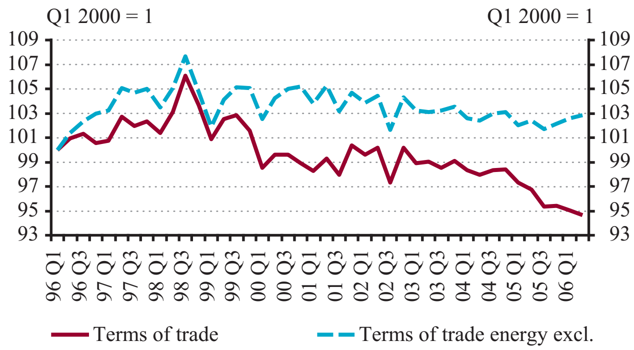


Chart 2-9

Terms of trade



Investments – could there be a correction over the short run?

In 2006 Q2, the volume of investments dropped 3.6 per cent compared to the same period of the previous year. Such a marked decline has not been registered since 1996. This pronounced drop was due largely to the massive reduction (6.8 per cent) in new construction, which occurred as a result of the decline in non-commercial real estate transactions, and also due to the status of state-financed highway construction projects.

Purchases of machinery, equipment and vehicles are still on the rise, although at a slower pace, which raises the question as to the degree of harmony with strong industrial performance. The rate of capacity utilisation in the corporate sector remained at an all-time high, mirroring a steady rate of investment for the present with potential for growth in the future. It is possible, though, that companies are likely to view this new found prosperity as only temporary, or they may tend to view the cycle as already having peaked. This presumption is underlined by the fall in business confidence indices, indicating future expectations in the external markets, and also by the impact of the government's proposed austerity measures.

Chart 2-10

Gross fixed capital formation
(annual growth rates)

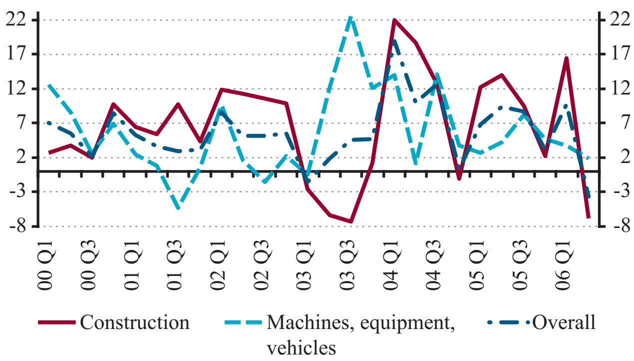
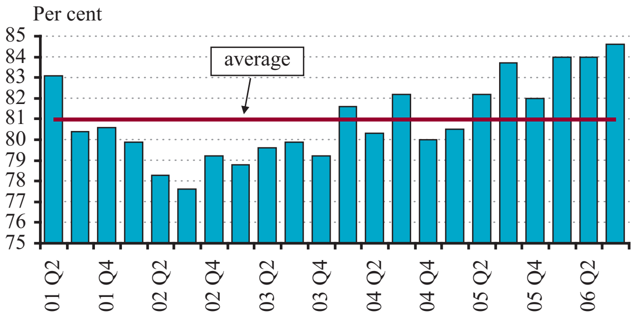


Chart 2-11

Rate of capacity utilisation* in the manufacturing industry



* *Source: Eurostat.*

Decreases in household consumption and in home purchases

A decline in both household consumption expenditure and retail sales was registered in the second quarter. This means that consumption during the past year and a half has grown more slowly than income. Hence, the rate of growth in consumption retreated to the level of 2001. This particular phenomena may be attributed to reductions in income forecasts and to increasing uncertainty regarding income prospects.

During the first six months the gap between the rate of growth in the volume of retail sales and in household consumption expenditure has narrowed – as we expected.

The reason for this was that while there was a drop in sales of industrial products, mainly in the retail sector, the increase in services – which are represented only in the consumption expenditure figures – remained steady.

The retail sales figures for July and August suggest a mild acceleration of the increase compared with the slowdown of earlier months. This might be in close connection with the higher-than-expected wage figures for the period. As the latter might be considered as partly temporary, we expect a gradual slowdown in retail sales figures for next months, simultaneously with a slowdown in wage inflation and a pick-up in inflation.

Chart 2-12

Household consumption expenditure and retail sales
(annualised quarterly growth rate)

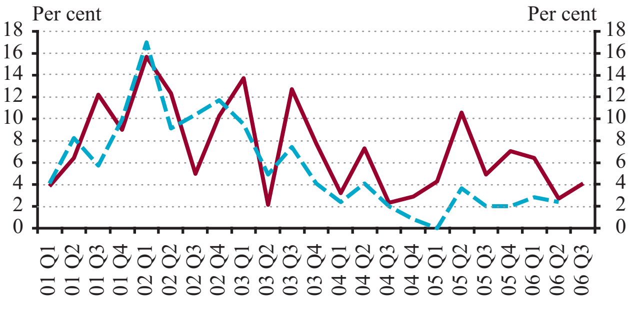
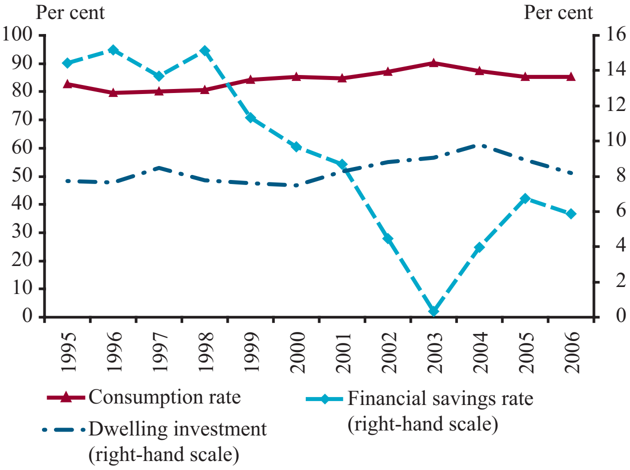


Chart 2-13

Consumption and savings ratios*

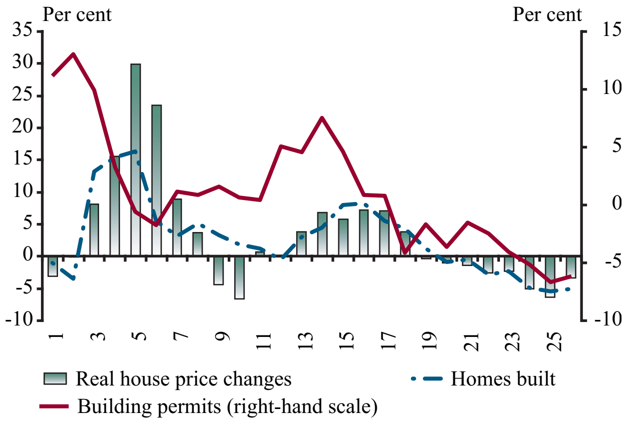


* *Information concerning consumption and home purchase figures was supplied by the CSO (up to 2004), and by the MNB for financial savings. Due to the differences in methodology between the two statistics, the amounts of the ratios will not necessarily be 100. All figures up to 2004 contain actual data, and they are estimated for 2005 and 2006.*

In the second quarter, home purchases continued to decline, albeit at a slower pace. Real prices in the real estate market dropped even further, although to a lesser degree in comparison to the previous quarters. There is steady oversupply in the real estate market, which is still the reason for the decline in home purchases. Insufficient demand is due, in part, to the massive real estate purchases of recent years, and also to the reductions in income forecasts and to increasing uncertainty regarding income prospects.

Chart 2-14

Real home prices, number of building permits issued and the number of homes constructed



Annual growth rates for real home prices, and annualised quarterly growth rates for the other time series.

Economic growth – favourable dynamics, deteriorating prospects

Economic growth remained strong in the first quarter. As revealed by seasonally adjusted data, GDP increased by 4.4 per cent in the first quarter and by 4.2 per cent in the second quarter by comparison to the same periods of the previous year. The short-base index, however, indicates a minor deceleration in the first quarter and acceleration in the second quarter, and hence the growth rate is fluctuating around its potential rate.

From the perspective of the expenditure side, the largest – and increasing – contribution to growth was made by net exports[3], while the consumption component remains below the historical average, despite being higher than last year. The contribution of investments to growth dropped considerably in the first two quarters of 2006.

[3] As previously indicated, accounting problems may have surfaced in statistics as a side-effect of Hungary's accession to the EU, and this could put the growth of net export sales in a light more favourable than it actually is. However, we should point out that this effect will be lower this year than it was in the previous two years.

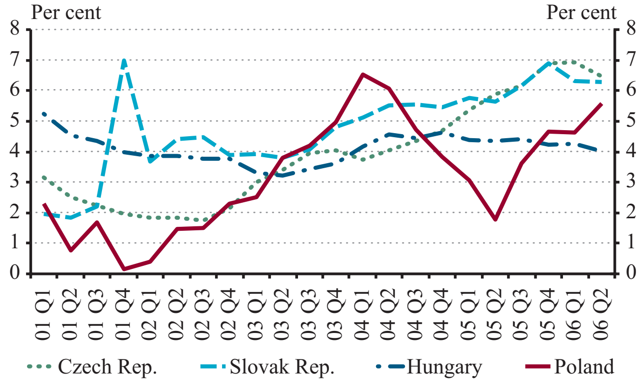
From the production side, the growth rate of manufacturing production in the second quarter continued to surpass that of GDP. Growth in market services was close to the GDP dynamics. The value added figures for the agriculture and construction sectors, however, showed a decline in the second quarter.

Economic activity of the Central-Eastern-European region is characterised by accelerating GDP growth in Poland, where as GDP in the Czech Republic and Slovakia came to a standstill at high levels. In this light, growth in Hungary appears to be the most stable, as well as the lowest after the fourth quarter of 2005.[4]

Chart 2-15

GDP growth in the region

(annual growth rates)



[4] With regard to the previous footnote, it should be mentioned that the aforementioned accounting problems arising in relation to Hungary's accession to the EU may emerge in different ways, to a different extent in the statistics published by the countries of the region. As we do not have any further information regarding this matter, caution should be exercised in comparing GDP figures.

2.2. Labour market

In the second and third quarters of 2006 the number and the ratio of active workers continued to increase, but to a lesser degree than previously. As a result of this and the stagnating level of employment, which experienced a slow start early this year, unemployment has increased. Recently, the unemployment rate has taken wild turns and currently stands at 7.5 per cent, coinciding with an activity ratio of 55 per cent.

Wage pressure stemming from the increase in the minimum wage at the beginning of the year and from massive payments of bonuses was followed by a larger-than-expected negative adjustment, and even though there was some decline in the summer months, wage inflation appears to be back on a rising trend as indicated by July and August figures. Non-regular or premium payments had again a decisive role in it, as partly due to government tax hikes expected for September, payments were brought forward in several industries of the private sector. Increasing tendency was also evident in the regular payments. In the private sector, the annualised growth rate of gross average wages in the month of August was 11.6 per cent, while that of regular payments of wages indicates 8.2 per cent.

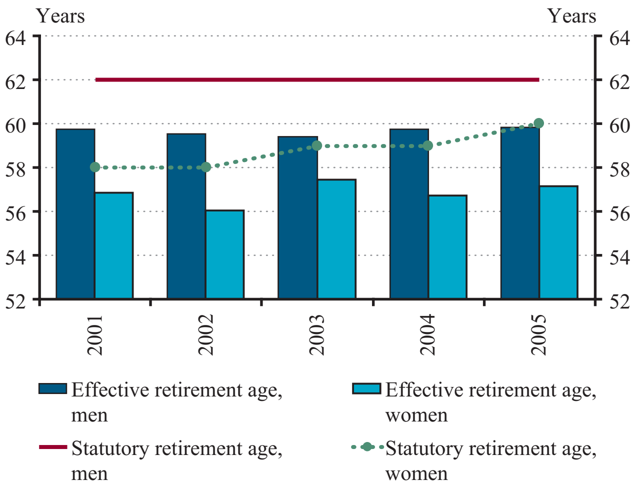
Activity grows at a rate faster than supported by demographic data

Since 2001, the number of active workers on the labour market increased by a rate in excess of what is supported by demographic forecasts. What this indicates is that the economy has substantial reserves in terms of labour force, or from a different perspective, that it is not impossible to curtail the rate of inactivity that is considered exceptionally high by international standards. As to where this surplus in growth originates from is difficult if not impossible to explain relying on anecdotal information (such as the abolishment of mandatory military service). One feasible explanation may lie in the rapid increase of wages during the early part of the decade, which had a beneficial effect in encouraging previously inactive people to enter the labour market, just as – closely related to the prior – changes in the willingness of women to enter the labour market in light of the fact that the growth in activity is dominated by the activity of women, more specifically by women between 55 to 59 years of age. Fixing the rate of activity of this latter age group at its lowest level in 1997, the entire growth in the rate of activity of the total working population disappears.

Increasing the statutory retirement age may offer a palpable explanation for this phenomena, that in all likelihood had the most powerful effect on this particular age group. However, this factor was taken into account by Hablicsek (2005)[5] as a demographic process, whereas, in terms of the effective retirement age, meaning the average age when people in fact retire, there is no proof that the actual retirement age has increased in tandem with the statutory increase (Chart 2-16).

Chart 2-16

Statutory and effective retirement age, 2001–2005
(ages indicated in years)



In conclusion of the above, apart from the demographic indices of society, the increase in the retirement age also fails to provide any feasible explanation for growth in labour force activity; still, the preferences of women in connection with employment may offer a plausible cause that has yet to be verified. Nevertheless, it appears undeniable that increasing activity leads to a looser labour market from the perspective of supply.

Moderate labour demand

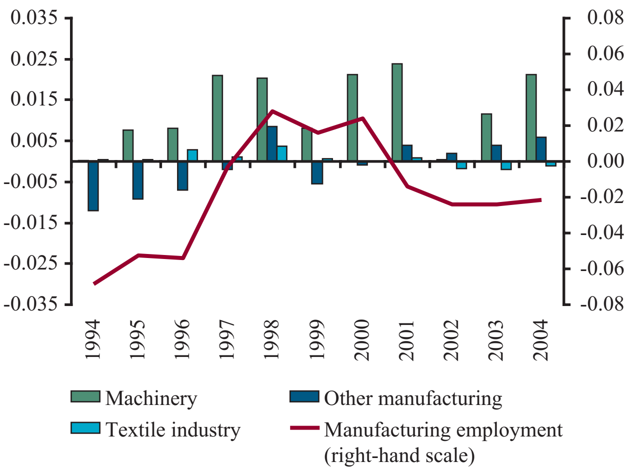
In spite of the fact that wage costs in the last two years have increased in line with productivity throughout the

[5] Hablicsek L.: Projection of demographic scenarios and economic activity for long-term retirement models, Aktív Társadalom Alapítvány (Active Society Foundation), June 2005.

entire private sector (Chart 2-19), the labour demand for market services and in the manufacturing industry differs significantly. While the rate of employment in the prior is still on the rise, the latter shows a tendency that is just the opposite. Structural changes, which are especially typical for transition countries, may well be the reason for this occurrence, and the fact that the cost of labour is increasing faster than the cost of capital provides an additional reason why labour continues to be substituted by capital throughout the manufacturing industry, as we have previously indicated. This resulted in a structural shift from labour intensive sectors to sectors which are more capital intensive, and in consequence the labour demand in the manufacturing industry has dropped, and the labour demand in the private sector is at a standstill. The decomposition of this process at the corporate level may offer additional information of interest (Chart 2-17).

Chart 2-17

Value added of labour to GDP growth and changes in the size of workforce in the manufacturing industry, 1994-2004[6]

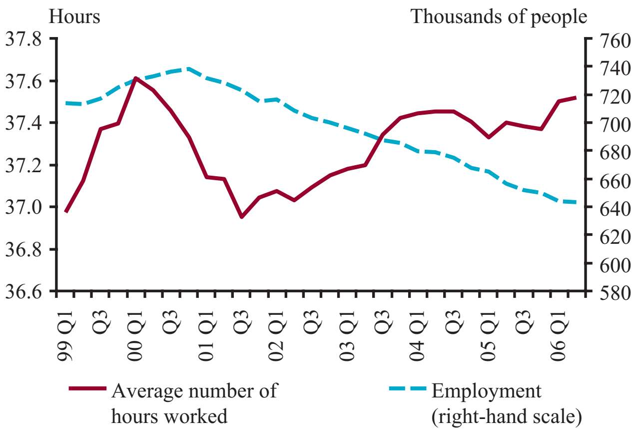


According to these figures, in 2002 there was only a temporary setback in the value added of labour to growth, and it rebounded in 2003 and 2004 in spite of the overall reduction of employment in the manufacturing industry. What actually happened was that the capital intensive companies (e.g. in the machine industry, information technology and communication sectors), which carry a larger weight in growth, increased their workforce, while other sectors with less and decreasing value added, which employ the majority of the workforce in the manufacturing industry (such as the textile industry) had to lay off many workers.[7]

On the other hand, Chart 2-18 also indicates a kind of structural shift, according to which during the last five years in the manufacturing industry there has been an increase in the average hours worked, which in addition shows cyclical behaviour, while the size of workforce was drastically reduced. This may be due to two fundamental reasons. One is the structural labour shortage, which might mean that it is impossible to hire people with the proper skills. The other being the cyclical shortage of labour. This might be compensated by increasing the capacity utilisation of the existing workforce, instead of hiring new employees because of the high adjustment costs involved. Though extra work payments might also be costly it is still possible that it is cheaper than cyclical employment.

Chart 2-18

Average hours worked and employment in the manufacturing industry, 1999-2006



Both capital-labour substitution and the intensifying capacity utilisation of labour indicate moderate demand, in other words a looser labour market from the perspective of demand.

Consequence: increasing unemployment

As far as demand and supply is concerned, the labour market appears to be on a looser path; notably, as indicated by current activity, supply in the labour market is increasing, while according to the number of people currently employed, demand is stagnating. This tendency will without a doubt result in increasing unemployment, and it raises a question as to whether those constituting the recent growth in activity (e.g. women in the 55-59 age group) appear in the labour market with or without a job, that is to say, as employed or unemployed.

[6] Data from 2001 should be analysed with caution, due to changes in accounting regulations although the authors have attempted to adjust for these changes (source: G. Kátay–Z. Wolf: Driving Factors of Growth in Hungary – Decomposition Exercise, manuscript, 2006).
[7] G. Kátay–Z. Wolf: Driving Factors of Growth in Hungary – Decomposition Exercise, manuscript, 2006.

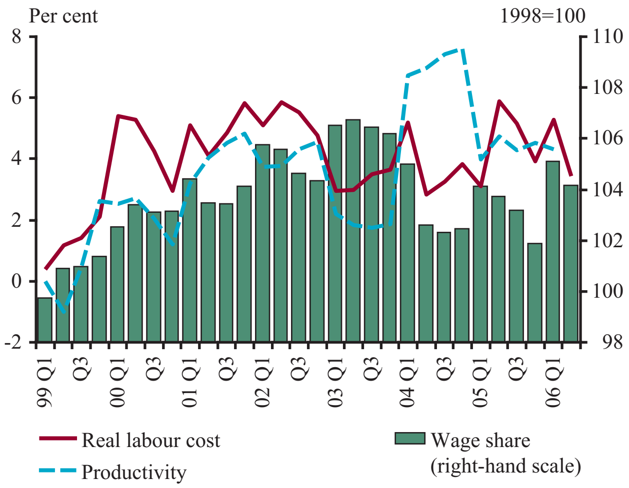
Looking at the age groups of the unemployed, the former looks more feasible. In contrast with activity, young persons are the driving factor behind increasing unemployment. The majority of jobless people are between 20 to 24 years of age, while the highest unemployment rate, far surpassing any other age group, emerges among the 15 to 19 age group (40.6 per cent), who are exactly the young low skilled individuals.[8]

Creeping wage inflation in spite of a looser labour market

Before 2004, wages were increased at a rate higher than the rate of productivity. In 2004 this trend reversed, primarily after shocks from regulatory measures. Moreover, this trend was supported by rising economic prosperity on the international stage, as well as by the diminishing wage pressure stemming from the capital-labour substitution as mentioned above. However, data from 2005 show signs of a slowdown in the latter, wages remained to increase consistently with productivity (Chart 2-19).

Chart 2-19

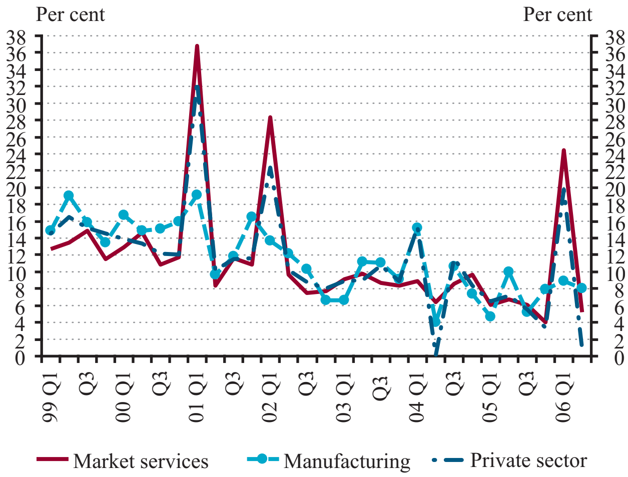
Unit labour cost, real labour costs and productivity in the private sector, 1999-2006
(annualised growth rate and level)



Over the last several years, wage inflation in the manufacturing and service industry more or less evened out. Nevertheless, the first half of 2006 indicates that the processes occurring in these two sectors are quite different. In our view, this may be due to the following basic reasons: One is that, based on the statistics, the increase in the minimum wage is more evident in market services, in all likelihood because there are more employees registered at the minimum wage in this sector. On the other hand, the bonus payments, which we will discuss in detail in the next section, had a more significant impact in this sector. Furthermore, the conditions for workforce demand are different in these two sectors: In the manufacturing industry, productivity has increased more rapidly, resulting in a relatively looser labour market, albeit to the best of our knowledge most of this growth in productivity is cyclical in nature. By contrast, in the market services sector labour demand is on the rise while productivity remains low.

Chart 2-20

Increase of gross average wages in the manufacturing industry, in the market services sector and in the whole private sector
(annualised quarterly growth rate, per cent)



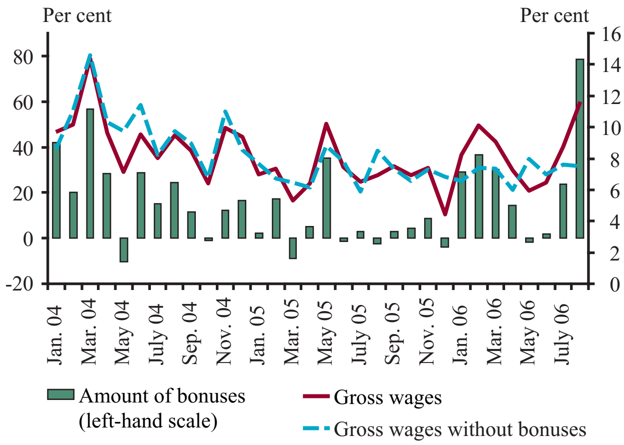
The volume of non-regular (bonus) payments (Chart 2-21), which constitutes a significant factor in both sectors, though to different degrees, is of particular importance from the standpoint of the period under review. The minimum wage increase prescribed for the beginning of this year – in accordance with our predictions and due to the faster-than-expected negative adjustment – did not have a prolonged effect in the private sector, however, wage inflation pressure did make its presence felt. In addition, the surprising intensity of bonus payments exceeded all expectations, based upon previous years figures, and made a massive contribution to this in the manufacturing industry, and even more so in the services sectors. The reason for this may be sought in the rearrangement of profit and productivity surplus from last year, and, with respect to July and August, in making payments prematurely in order to avoid the payment of higher employers' and employee's contributions as announced. In the chart, the increase in regular gross average earnings can also be detected.

A looser labour market carries the potential to ease wage inflation in its own right. However, the latest – unexpected-

[8] This group is followed by the 20 to 24 age group; however, their unemployment rate is less than half of the youngest (18.1 per cent).

Chart 2-21

Gross average earnings in the private sector with and without bonuses
(monthly data annual growth rates, per cent)



ly high – inflation figures may have the opposite effect. On this basis, we will outline two different scenarios, both of which may be consistent with existing payroll data, and we cannot be certain as to which one of the two will eventually materialise. In the first scenario, payments of bonuses will be substantially reduced during the remainder of the year, and market participants will handle the outstanding inflation figures as a simple shock, and will ignore them in terms of their future expectations. As a consequence, the temporarily surge in wage inflation (with and without bonuses) will slow down, and the economy will experience diminished wage inflation induced by the looser labour market. However, according to the other scenario, market agents increase their inflation expectations, yet they are only able to adjust to this higher nominal wage path due to the wage contracts fixed at the beginning of the year through non-regular payments. In this case, massive bonus payments are projected for the remainder of the year, and wage inflation reflecting these bonuses will prevail, since from the beginning of 2007 higher inflation expectations may be incorporated into contracts for regular wages.

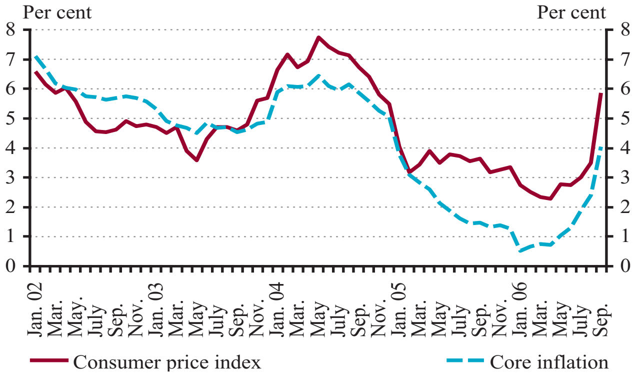
2.3. Inflation trends

Changes in consumer prices are greater than projected in the August update, showing a rising tendency. In the third quarter of 2006, the annual index of consumer prices stood at 4.1 per cent, while the rate of core inflation was 2.8 per cent, representing a 1.5 and 1.8 per cent increase, respectively, compared with the previous quarter.[9]

The reason behind this substantial increase may be attributed to several factors, such as the net 15 per cent hike in regulated energy prices, the increase of the 15 per cent VAT rate to 20 per cent, the exchange rates weakening since the beginning of the year, and a lesser impact of foreign competition to mitigate inflation. All of these factors are responsible for the significant increase in inflation during the quarter, however, it is not yet clear as to which of these factors will fade out and which ones will remain, and to what extent.[10] Regarding this question, inflation expectations will play a key role, which, according to surveys, stagnate at historically high levels. Due to strong co-movement of these surveys with actual data, it cannot be determined unambiguously whether they contain relevant information on longer term inflation processes.

Chart 2-22

Consumer price index and core inflation
(yearly changes)

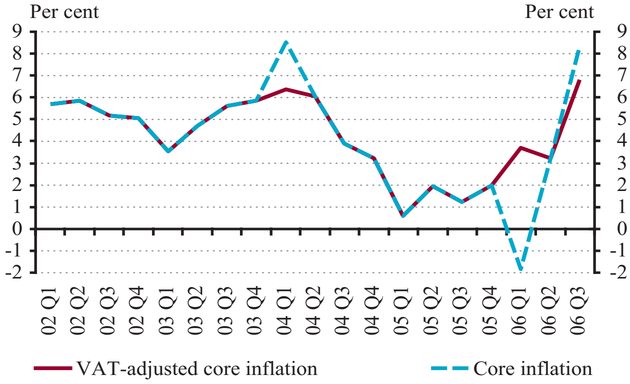


Rising trend in core inflation

The principle reason for the substantial leap in inflation in the third quarter appears to be the hike in indirect taxes. As for the core inflation factors, the increase of VAT applies almost to all processed foods and about one-third of market services. In order to clearly conceive the basic tendencies of core inflation it would be necessary to separate the impacts of the aforementioned measures from the actual data.[11] According to our calculations, the annualised monthly index reflecting the underlying trends of core inflation was 13 per cent in September (7-10 per cent without one-off effects), fluctuating between 5 to 10 per cent for the entire quarter. Although the rate was rising during this period, long-term conclusions should not be drawn from this process, because of the impacts referred to in the introduction.

Chart 2-23

Overall core inflation adjusted for tax effect*
(annualised quarterly changes)



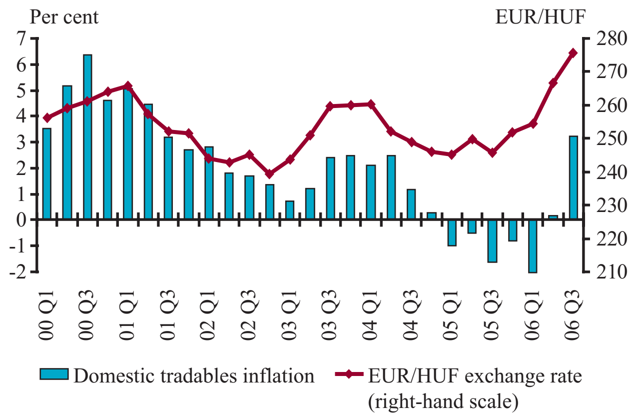
** Adjusted by MNB.*

The effect of weaker exchange rates in the inflation of industrial products

In the prices of industrial products a general rise was observed. The higher prices of non-durables is of particu-

Chart 2-24

Inflation of industrial products and the exchange rate
(annualised quarterly changes)



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[9] After finalising the report, the October CPI data was released. The figures basically were in line with our expectations, and hence supported the analysis in the report.

[10] A more detailed assessment of the above can be found in Box 2-1.

[11] The technical details of the estimation procedure are contained in Box 2-1.

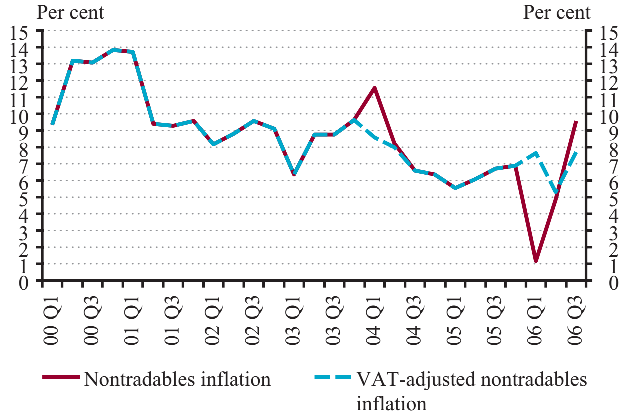
lar interest since the full spectrum of industrial goods tend to move in tandem with its' long-term trends. The weaker exchange rates since March of 2006 could have a significant impact yet it is uncertain as to whether it can be the cause of increasing inflation dynamics in itself.

Higher inflation in market services

The annualised quarterly index for market services remained between 6 to 7 per cent for quite some time, and it appears to shift in the direction of a rising trend according to current data. The price development of this market is presumed to be primarily dominated by wage dynamics, with numerous other factors also involved, such as demand and inflation expectations. According to the information available, the changes of the unit labour costs in the service sector and demand cannot justify in themselves the rising trend in the inflation of services. Thus increasing inflation expectations may have played a key role in acceleration of inflation in this product group.

Chart 2-25

Inflation of market services
(annualised qurterly changes)

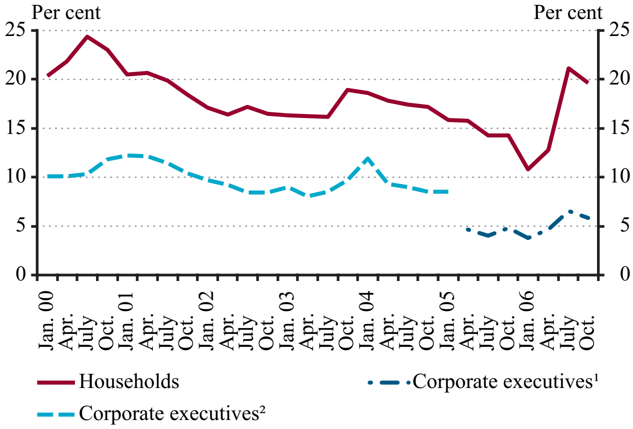


Inflation expectations remain elevated

There was no major adjustment in inflation expectation of market participants after salient rise in the previous quarter. It is important to note that, while household's expectations remain remarkably elevated around 20 per cent, corporate expectations are more moderate at 5-6 per cent. Turning to developments in wage inflation, corporate leaders expect stagnation while in perceived wage inflation a further increase was observed. The qualitative index of GKI confirms the same processes.

Chart 2-26

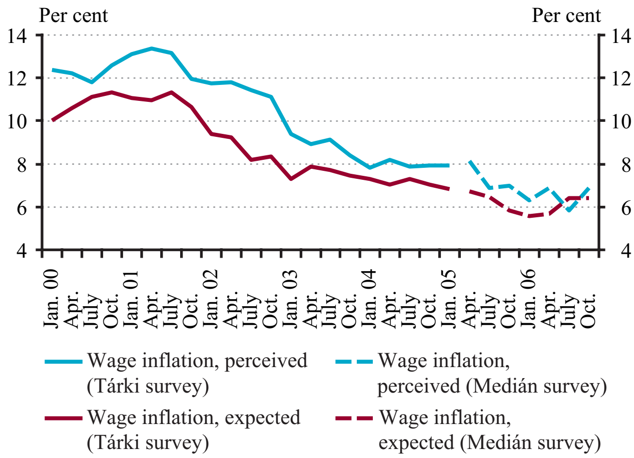
Inflation expectations by corporate executives and households (for the next 12 months)
(Tárki and Medián corporate survey)



[1] *Median survey.* [2] *Tárki survey.*

Chart 2-27

Wage expectations and perceptions of corporate executives
(Tárki and Medián corporate survey)



Prices of agricultural products continue to rise

The prices of agricultural products continued to rise during the third quarter, and this had an impact on prices of processed and unprocessed foods alike. This quarter prices went up for the entire food industry by 10.1 per cent on the average, more specifically, 17.7 per cent for unprocessed foods and 6.4 per cent for processed foods. The price increase is considered general in all product cat-

Chart 2-28

Unprocessed food price inflation

(in levels, seasonally adjusted)

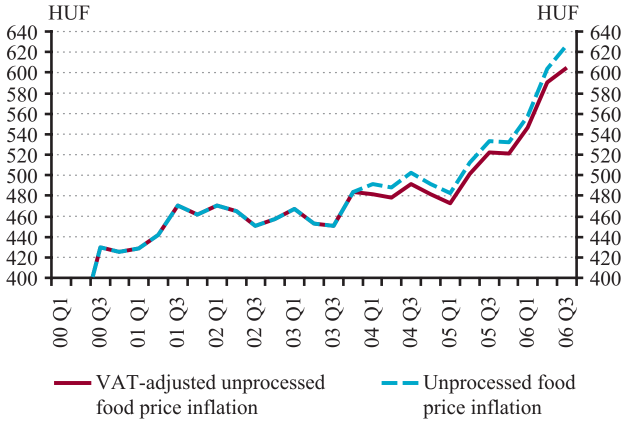
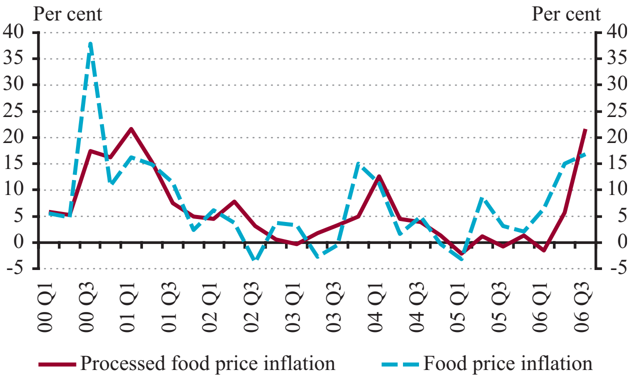


Chart 2-29

Processed food price inflation

(annualized quarterly changes)



egories. In case of processed foods, the reason may lay in the weakening of the temporary disinflationary effect of stronger competition induced after Hungary's accession to the European Union, and the increase of indirect taxes.[12] The growing prices of basic agricultural products may be identified as the driving factor for unprocessed foods.

Mixed effects in energy prices

There was a 15.4 per cent increase in the regulated energy prices effective as of the first of August, which had an impact in consumer price statistics in the month of September. This measure resulted in a massive rise in the market prices of energies, ranging between 4.5 to 16.5 per cent. Changes in fuel prices reflected changes in the international market. During the first two-thirds of this period prices went up by around 5 per cent, only to drop back at the same rate towards the end of August. This effect is significant in itself, and taking into account the base effect, it reduced the consumer price index for September by close to 0.5 per cent.

Box 2-1: Which factors rendered the measurement of underlying inflationary trends difficult during the previous quarter?

During the last quarter we were witnessed two major factors with a tangible impact on prices, which tend to pose substantial difficulties for the measurement of underlying inflationary trends. The increase in indirect taxes in September had a direct impact, while the lesser impact of foreign competition to mitigate inflation indirectly influenced the basic processes in price changes. In order to be able to assess the basic tendency, the one-off shock must be filtered out for the prior, and the ongoing processes have to be evaluated for the latter.

Effect of the increase of indirect taxes

In the following we will analyse only core inflation items. To begin the analysis we have separated alcohol and tobacco products from the range of goods under review. We have estimated the technical impact generated by the increase of VAT as 1 per cent relying on the information conveyed in the August report. In the forthcoming we took a relatively conservative approach, according to which an increase of indirect taxes by 5 percentage points was adopted during a period of one month and fully applied in consumer prices. Furthermore, we have taken into consideration other impacts, that have the potential to adjust the indices of underlying processes downward. Firstly, the VAT increase may generate additional increases in the prices of products to

[12] For more details see Box 2-1.

which the VAT increase does not directly pertain[13], and secondly it induced a hike in prices in excess of what is justified by the changes in the relevant regulations. One explanation for this effect may be offered by the substitution effect between products and the premature implementation of prices increases. Relying on our previous estimates, the result of these two impacts will be around 0.2 per cent, however, the present environment may have possibly resulted in higher increases.[14] All things considered, the annualised monthly rate of inflation, intended to reflect the basic inflationary trends, was around 7-10 per cent in September, and fluctuated between 5 to 10 per cent during the quarter, with a rising tendency. Based on the analysis supported by the principles set forth above, it appears that while the pass-through in market services was complete, for processed foods it was not complete but still higher than our estimate of approximately 40 per cent. It should be emphasised that, the presumption of complete pass-through does not reflect the empirical experiences of 2004, nor our expectations which were adopted on this basis as indicated in the August report, according to which during the first month following the VAT increase only about two-thirds of the increase will actually be applied in consumer prices. In spite of the fact that the indicators are relatively high, real conclusions may be drawn concerning the basic inflationary trends and long-term tendencies based on the data of the following months.

What happened in the market of food in the past two years?

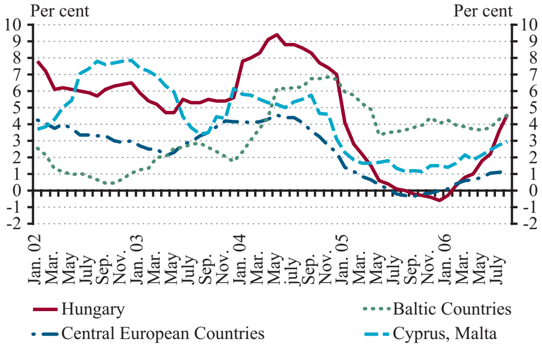
In the price level of processed food unexpected rise was observed in the third quarter of 2006. As an explanation, examining tendencies in food markets of new European Union countries, regional trends can be identified. Significant drop in price level after the EU- accession turned into pronounced increases at the beginning of the year. This tendency is even more relevant for Hungary. Extreme effects can be observed both in the case of the initially increased competition and the following adjustment process. This process can most likely be attributed to interaction of changes in market structure and costs.

After Hungary's accession to the European Union, competition became more intense. This was felt through two channels: one was that more participants entered the market, and the other was the expansion in the selection of goods. The latter comprised mostly of the lower priced products of other recently joined countries, that also paved the way for price increases at a lower rate. The aforementioned two impacts resulted in lower price levels. This process was apparent mostly in the prices of processed foods that, practically speaking, were almost unchanged for an extended period. However, based on the facts of the last six months a regional phenomenon appears to be emerging, namely that the short-term disinflationary effect of stronger competition is gradually fading. Higher prices of raw materials (unprocessed food, oil prices and exchange rate pass-through) may decrease profit margins at stable consumer prices. According to upward tending data, in all likelihood companies are no longer willing to reduce their profit margins to compensate on the cost side for the pressure to price increases (nor do they have the capacity to improve efficiency).

Regarding future developments, it is of high importance to identify whether the hike in foods inflation to this extent is the beginning of a persistent, long term process or a temporary effect only. Possible explanations imply the following. If the changed market structure – enabling higher increases in profit margins and prices – resulted in immediate adjustment, the process unambiguously points towards higher long term inflation. On the contrary, it is also possible that cost factors passed through to prices more dynamically than expected. In this case we are facing a correction implied by higher costs which, in the longer run, does neither influence the dynamics of inflation, nor the development of profit margins. A third explanation could be that the elevated inflation expectation led to higher price increases. This would make it impossible to determine the direction of changes in inflation and profit margins. It cannot be ruled out that the rise in inflation expectations is temporary only and expectations will return to previous moderate levels. Data released in the following months will help to decide which explanation will prove to be relevant for this process.

Chart 2-30

Harmonized indices of processed food prices
(monthly data, annual rate of change)



[13] For more information refer to "Quarterly Report on Inflation" (August 2006) update, Chapter 3.3: http://english.mnb.hu/Engine.aspx?page=mnben_infrep_en&ContentID=8817.

[14] All shocks during this period made the price increase a more likely eventuality; hence, it seems reasonable to presume that the market participants increased their prices at a higher rate than in 2004.

3. Outlook for inflation and the real economy

According to our November forecast, during the next two years economic growth is expected to slow down considerably and starting from middle next year inflation is expected to drop.[15] The economic path will be dominated, on the one hand, by cost increasing effects of government measures and the exchange rate and by the income-decreasing, demand-lowering effects of fiscal tightening, on the other. In the short run, rising inflation will be dominant, caused by costs increases (higher taxes and contributions) and by the weakening of the currency since the beginning of the year. Later, demand effects will gradually strengthen, and the economy will slow down, which will have a disinflationary effect in the second half of our forecast horizon, though it can only partly counterbalance the inflationary pressure of the cost shocks. In certain goods markets the fading effects of the price-constraining competition following EU accession will mean an additional inflationary factor.

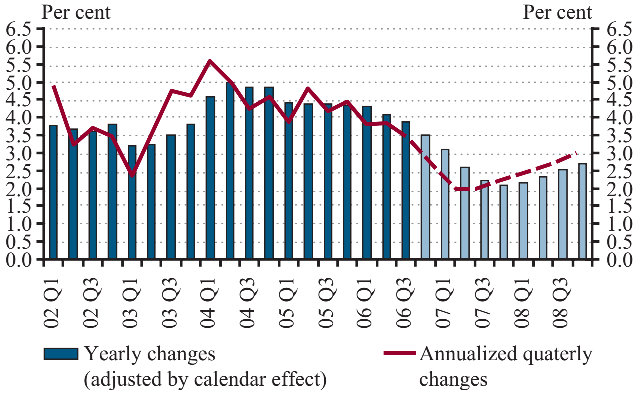
According to the baseline scenario, inflation will continue to rise until the second quarter of 2007, then it will gradually decline. However, on the entire forecast horizon the rate of inflation is expected to exceed the medium-term target. The symmetrical risk distribution around the forecast's baseline scenario is in essence a reflection of the uncertainty stemming from inflation expectations that are presumed to increase in recent months. The baseline scenario was based on the assumption of well-anchored expectations.

Growth rate is expected to substantially fall behind its full potential in 2007-08

The outlook for economic activity – in line with what is contained in the August Report – indicates that economic growth is expected to slow down significantly from the 4 to 5 per cent rate that we have seen during the past few years. In the next two years, the growth rate of the Hungarian economy will be considerably less than its full potential: after more than a decade, the output gap will remain negative for some time. According to our forecast, in 2007 and 2008 economic growth is projected in the neighbourhood of 2.5 per cent, while this year the growth rate will be around its potential thanks to the robust growth achieved during the first six months. According to our calculations the considerable slowdown will already begin in the second half of this year, and the lower turning point of the cycle is expected to materialise in the middle of next year. However, it will not bring about a notable turn for the better, as in 2008 only moderate improvement can be expected, hence the negative output gap will prevail over the longer run.

Chart 3-1

Annual and quarterly growth rate of the gross domestic product



A slowdown in external economic activity is projected

In recent years the Hungarian economy relied predominantly on brisk economic activity in Europe. In European growth, investments play an important role, and this has made its beneficial impact on the Hungarian economy felt through the dynamic growth of industrial production and export sales.

Following the dynamic growth this year, the growth rate in Europe is expected to slow down as of 2007, and most long-term projections and forecasts have taken an unfavourable turn during the past few months. Economic activity within the euro area, and in particular in Germany, is characterised by two trends: according to the latest indicators of economic activity (IFO and EABCI indices) business confidence is extremely high at the present, however, on the half-year horizon economic activity is expected to decelerate considerably.

Looking forward, in parallel with the changes in external economic activity, the growth rate of exports is expected to slow down following the outstanding rate in 2006. The moderate growth in domestic demand and the slowdown in exports will also moderate import growth rates.

Diminishing investments

The data from recent quarters on corporate investments and capacity utilisation indicate that the domestic business

[15] Our forecast is based on data and information available by November 8.

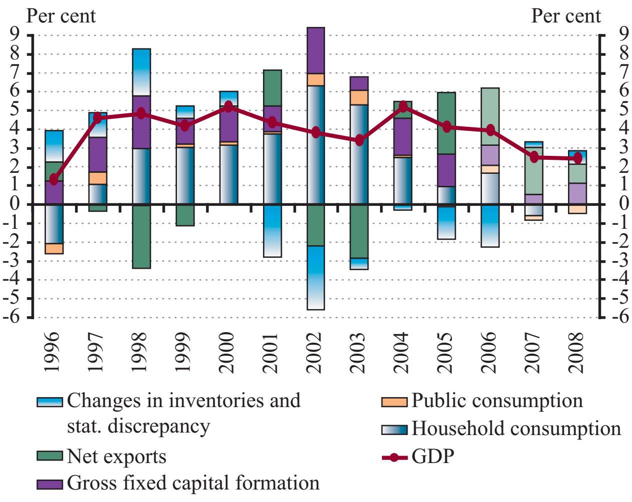
sector did not look upon the strong economic activity around Europe as lasting, and investment activity remained moderate despite an all-time high rate of capacity utilisation. Accordingly, the effect of slower external economic activity will be mitigated in gross fixed capital formation: the dynamics of investments by the business sector will be reduced somewhat, but we expect the growth rate to stabilise around 4 per cent in the following two years. Profit expectations deteriorating due to increasing tax burdens also point toward slower investment dynamics.

The substantial decline in construction during the second quarter of 2006 clearly demonstrates that housing and government investments are expected to slow down considerably. In our view, the reduction of income in the households will manifest itself in declining housing investment this year, which will continue over the next two years as well, with the largest drop forecasted for next year. The unfavourable outlook is underpinned by the drop in the number of building permits issued and in the number of new homes completed this year. All in all, the volume of housing investment is expected to drop by close to 20 per cent in 2008 compared to the all-time high in 2004.

As far as government investments are concerned, the largest slowdown is expected in this sector after the strong growth in 2005, which may be made even worse over the short term by the delays of highway constructions which were originally planned to be completed this year. At the same time, according to our forecast, the increasing availability of EU funds is expected to boost growth in the government sector from 2008.

Chart 3-2

GDP growth and contributions by the various components



** Data for the years before 2000 are based on former FISIM accounting.*

As a result of the strongly different investment behaviour of the three sectors, this year and the next investment dynamics are expected to lag behind the rate of economic growth, whereas in 2008 investments may expand at a rate somewhat higher than GDP.

Substantial loss of income and declining consumption

In projecting the behaviour of the household sector, decreases in real income will provide the starting point. There are a number of reasons behind the reduction in disposable income over the short term. One is the government measures for increasing taxes and contributions, and the other is that gross real wages and other revenues of households will also decline; while the real value of financial transfers remains constant. In consequence of the changes in the legal environment, next year net wages will drop by about 3 per cent in relation to gross wages by comparison to the first half of 2006. As far as gross real wages are concerned, a two per cent decline is forecasted for 2007, after the steady growth of last years, on the average for the entire economy. However, in 2008 income will be back on the rise, if ever so mildly, due to the fade away of tax effects and a slowdown in inflation.

In the August Report we addressed in detail the expected consumption behaviour of households, and we highlighted key economics considerations.[16] At times of decreases in income, the path of consumption is primarily determined by whether changes in income expectations are expected to prevail, by liquidity constraints, and by precaution motives in the wake of uncertainty. Taking these factors into consideration, our view on the expected smoothing of consumption has not changed materially during the past months. In our forecast we stand by our previous position, namely that the consumption of households will fluctuate less than incomes. Accordingly, next year the rate of decline in consumption will remain behind the rate of decrease of incomes, and in 2008 consumption will stagnate, while incomes will take a turn for the better.

Higher consumption smoothing can occur than our baseline scenario, if the households view the decrease in disposal income that is expected for next year as being temporary, after the steady rise in income in recent years. Additionally, the easing of liquidity constraints, rapid expansion of loan products as recently experienced in the

[16] For more details see Box 2-1 in the August Report.

Chart 3-3

Consumption/income ratio
(baseline)

financial sector, and simplifying loan applications could also constitute additional reasons.

However, more moderate smoothing is indicated by the fact that the low rate of financial savings tend to enhance precautionary motives. Another reason for more moderate smoothing is that the consumption/income ratio is already high by international comparison.

In light of the mutual risks we should point out that in the outlook for real economy the degree of smoothing of consumption continues to constitute the most significant uncertainty. In consideration of the fact that consumption has a decisive weight in GDP, if consumption deviates from the main scenario it may have a substantial impact on economic growth as well.

Increasing risks in wage developments

The starting point of our wage projection is that wage dynamics will take a different path in the general government and in the private sector during the next two years. Relying on the presumption that the government wage bill will be frozen for a two-year period as planned by the government, we forecast a minimal increase, in the private sector we based our calculations on labour market trends and developments in the real economy.

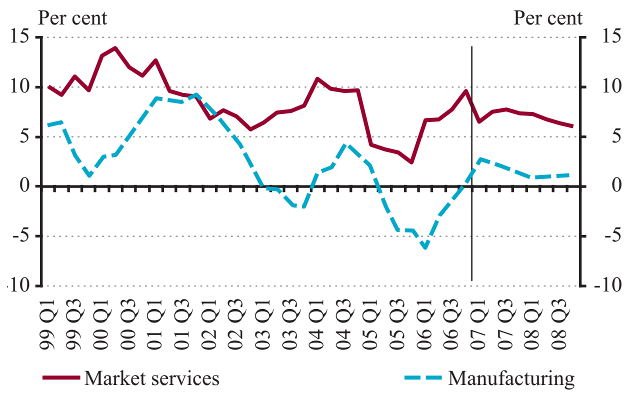
Estimated developments in labour supply and demand will sustain the current loose labour market conditions. Demographic reasons and stricter pension regulations equally contribute to the increase of the rate of activity and supply in the labour market. Increasing demand on the labour market, however, appears to be very limited in the next two years, due to slowing economic growth and increasing tax burdens.

In spite of a loose labour market, according to the latest information available the nominal wage path projected for the next two years has risen in the private sector. In contrast with previous expectations, there was no decline in wage dynamics in the last months, as explained in detail in section 2. Nonetheless, with regard to the very high figures for the last month, it should be noted that they most likely contain the impact generated by the sudden surge in bonus payments, which presumably reflects payments brought forward in light of tax and contribution increases. The increase in employers' contributions also contributes to higher labour costs, thus in 2007, despite the mild decrease in average wage dynamics, the growth rate of nominal labour costs in the private sector will remain constant.

Differing sectoral developments are behind the aggregate picture characterised by higher wages. In the manufacturing industry, the higher nominal wages do not bring about any inflation pressure. Since production has grown rapidly, unit labour costs will be lower this year, and will grow at only a modest rate in 2008. In the case of market services, however, the situation is different: unit labour costs will keep growing at high rates, and hence they will lead to significant inflation pressure. The primary reason for this, is that no sizeable adjustment is expected in wages, nor in the size of workforce – attributed to rigid labour market positions – despite the forecast for a moderate increase of value added in the sector.

Chart 3-4

Unit labour costs in the manufacturing industry and in the market service sector
(annualised quarterly growth)



In forecasting the wage path the role of nominal wage expectations must also be taken into consideration. This factor is currently of special importance due to the substantial increases in price levels, in the wake of one-off price shocks. In the baseline scenario, we stand by our previous position, namely that labour market participants will – following the practices of previous years – "overlook" the one-off inflationary shocks caused by the increase in indirect taxes. In 2008, however, nominal wages will be adjusted to decreasing inflation only to a lesser extent due to backward-looking wage setting.

Table 3-1

Wage projection

	2005	2006	2007	2008
Private sector				
Average wage	6.9	8.3	7.3	7.0
Unit labour costs	2.2	5.3	5.6	4.7
General government*				
Average wage	12.8	5.4	1.5	0.4
National economy*				
Average wage	8.9	7.2	5.3	4.7

** Cash-based approach.*

The wage dynamics of previous months and inflationary developments indicate rising trends in risks concerning next year's wages. The risks stemming from changes in expectations – pointing toward higher nominal wages – are captured as inflation uncertainty, rather than generating changes in the baseline scenario.

All in all, in the baseline scenario there will be a slight decrease in wage growth in the private sector in 2007-2008, however, the process will commence at a level above 8 per cent, somewhat higher than previously estimated. Simultaneously, we foresee some increase in the upward risks stemming from wage expectations, displayed in uncertainty around the baseline path.

Inflation gradually decreasing from the high above 8 per cent

In the period ending in 2008, apart from the estimated developments in the real economy, the impact generated by government measures will also substantially influence the inflation path. In the short run, inflation is expected to further increase rapidly, followed by a gradual slowing process in the second half of 2007; nevertheless, the forecast indicates a CPI around 4 per cent at the end of the forecast period. According to our forecast, the yearly average inflation will be approximately 7 per cent in 2007, and 4 per cent in 2008. At the same time, core inflation shows a continuously decreasing trend from mid-2007 until the end of our forecast horizon, core inflation will be below 4 per cent in the second half of 2008. The difference in the forecasted path of CPI and core inflation is explained by our assumptions on regulated prices.

In September the effect of government measures – indirect tax increases (discounted VAT rate, excise duty) and the increases in regulated prices – appear in the price index. As the starting point of the forecast, it is important to note that increase in inflation in the third quarter surpassed what was expected in connection with one-off items. The higher rate of actual inflation tends to have an unfavourable impact on the inflation outlook, mostly at the short end of the forecast horizon. At the same time, long-term expectations are fixed in the baseline scenario, and thus higher initial price level does not lead to lasting inflationary pressure.

In addition to the unfavourable initial situation, high unit labour costs also contribute to higher inflation, especially in the case of service sector prices. From the standpoint of the inflation outlook, the major assumptions used for our forecast took a clearly turn for the better in recent months.

Table 3-2

Inflation forecast

	06 Q1	06 Q2	06 Q3	06 Q4	07 Q1	07 Q2	07 Q3	07 Q4	08 Q1	08 Q2	08 Q3	08 Q4
Core inflation	0.8	1.1	2.9	5.0	6.8	7.1	6.1	4.5	4.4	4.1	3.8	3.6
Consumer price index	2.5	2.6	4.1	6.3	8.4	8.2	6.5	4.7	4.3	4.2	4.1	4.0
Annual average core inflation	2.4				6.1				4.0			
Annual average price index	3.9				6.9				4.1			

Box 3-1: Assumptions

In accordance with the past practices which we have been following for quite some time, we prepared a conditional macroeconomic forecast. Accordingly, we used a fixed path for the following variables: the EUR/HUF and EUR/USD exchange rate, the MNB base rate and long-term yields, and the forward price of Brent crude oil. In calculating the budget deficit we relied on interest payments as shown in the market yield curve. As regards the measures taken by the government, we took into account the first version of the budget act draft and official announcements.

As regards regulated prices it should by noted that in those cases (e.g. household gas prices, district heat and interurban public transport) where no final government decision has been made, our assumption relating to the extent and timing of the price increases has not changed.

By comparison to previous quarter's report, some key variables have changed significantly. Changes in basic components – primarily the reduction of oil prices and appreciation of the exchange rate by almost 4 per cent – point to significantly lower inflation. However, these favourable impacts will not apply evenly over the forecast horizon for more than two years. The stronger exchange rate is expected to be a significant disinflationary factor in 2007 and 2008, while lower oil prices will have a mitigating effect on inflation this year, and the next to a lesser degree. The reduction of spot oil prices changed the forward oil price path, including its slope, and – viewed as a technical impact – will slightly increase inflation in 2008.

Apart from the impact of the main assumptions, the estimated path of regulated prices also points toward slightly lower inflation: the changes in telecommunications regulations scheduled to take effect in 2007, and the restructuring of the system of subsidising medicine prices has the potential to reduce inflation in 2007 by close to 0.3 percentage points on the whole, in comparison to our previous forecast.

Table 3-3

Changes in major assumptions relative to the August Report*

	Augusztus 2006			Current		
	2006	2007	2008	2006	2007	2008
Central bank base rate (%)**	6.75	6.75	6.75	8.0	8.0	8.0
EUR/HUF exchange rate	269	277.6	277.6	265.9	267.3	267.3
USD/EUR exchange rate (cent)	124.9	126.9	126.9	124.9	126.2	126.2
Brent oil price (USD/barrel)	70.3	76.3	74.6	65.1	64.8	67.2
Brent oil price (HUF/barrel)	*15,144*	*16,696*	*16,329*	*13,860*	*13,722*	*14,228*

** Yearly averages, based on the October exchange rate and futures oil prices.*
*** End-of-year value.*

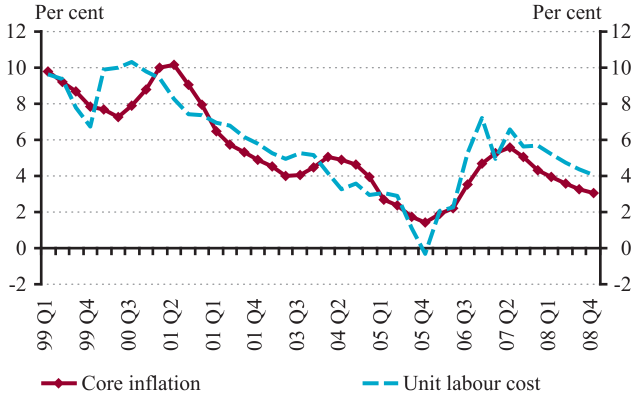
A further significant increase in inflation is expected in the next two quarters, with inflation possibly peaking at over 8.5 per cent next spring. In the first quarter of 2007, inflation rate will be almost 6 percentage points higher than in the same period of 2006. From the second quarter a gradual decline may occur. Inflation may decrease to nearly 4 per cent by early 2008, with then the year-on-year figure remaining around this level for a longer period. At the same time, core inflation shows a continuous decline in 2008, and by the and of the year quarter on quarter core inflation rates might come close to 3 percent. The difference between core inflation and CPI are essentially caused by our assumptions for administered prices.

The impact of government measures has a smaller effect on the longer-term inflationary outlook, and the importance of economic relationships, based on market mechanisms, is gradually increasing. One of the most relevant relationships is between unit labour costs and core inflation. Chart 3-5 illustrates well, that trend inflation, adjusted for volatile elements and price level effects of indirect price changes, moves together with unit labour costs in the private sector. This close relationship also suggests that, after a steep rise, trend inflation is expected to decrease continuously from mid-2007 through to the end of our forecast horizon. It is worth noting that unit labour costs are permanently higher than trend inflation on our forecast horizon, indicating lower profit margins, which is in line with weaker domestic demand.

In our view, the slowdown in economic activity and the reduction of demand will have a disinflationary effect simi-

Chart 3-5

Trend inflation* and unit labour costs



** Core inflation adjusted for indirect tax changes.*

On the whole, we are of the opinion that the potential increase in expectations and stagnation at a high level constitutes the largest upward inflation risk over the next two years. The implementation risk of fiscal measures not yet adopted – first and foremost the proposed two-year wage bill freeze – is expected to surface in 2008 as an additional inflationary factor. Nevertheless, if the disinflationary effect of the negative output gap proves to be stronger, it will likely result in lower inflation in both years compared to the base-lar to the previous quarter. In connection with these long-term effects, we believe that consumption smoothing and the negative output gap forecast for 2007-2008 will have greater impact in inflation in 2008.

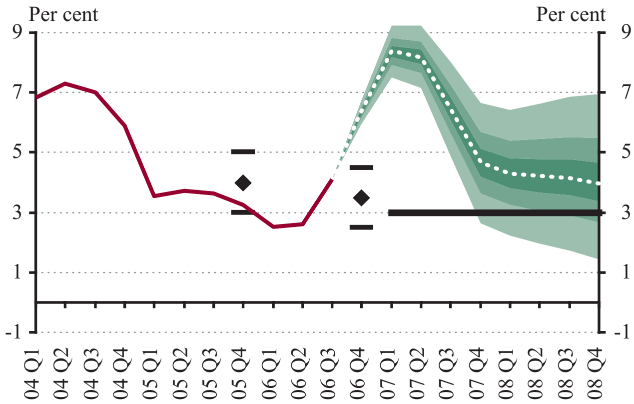
Symmetrical inflation and growth risks

As for the main scenario described above, we were able to quantify the impact of five uncertainty factors, which have the potential to influence inflation or growth during the 2007-2008 period. Hence, we have examined the impacts stemming from inflation expectations, the smoothing of consumption, the disinflationary effect of aggregate demand, the implementation of government measures, and from the uncertainty surrounding the rate and timing of increases in gas prices.

Of the most common uncertainty factors, inflation expectations and their impact on wage agreements and price setting are the most important. Based on the macroeconomic figures of past months, inflation expectations are now more likely to increase in connection with massive, one-off price increases, and consequently the nominal path of the economy may take, and remain on a different path from that presented previously. In contrast with our previous assumptions, risks stemming from expectations may emerge in the near future and, consequently, they may substantially influence the 2007 inflation path. As mentioned earlier, in accordance with our adopted modelling and forecasting practice, these risks will materialize in risk distribution rather than in the baseline scenario.

Chart 3-6

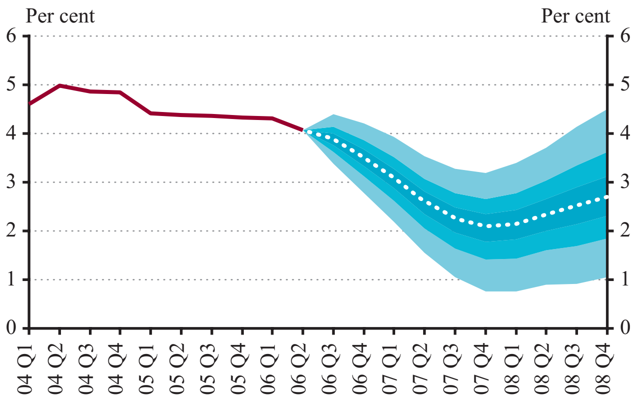
Inflation forecast fan chart*



** The fan chart represents the uncertainty around the central projection. Overall, the coloured area represents a 90 per cent probability. The central, darkest area containing the central projection for the consumer price index illustrated by the white dotted line (as the mode of distribution) refers to 30 per cent of the probability. The year-end points and the continuous, horizontal line from 2007 show the value of the announced inflation targets.*

Chart 3-7

GDP growth fan chart*



** The fan chart represents the uncertainty around the central projection. Overall, the coloured area represents a 90 per cent probability. The central, darkest area containing the central projection for GDP illustrated by the white dotted line (as the mode of distribution) refers to 30 per cent of the probability.*

line scenario. Lower inflation may also be seen if consumption smoothing turns out to be lower, i.e. if household consumption falls more strongly than we expect, or if the price of natural gas and district heating is increased at a rate below projections, to reach the level of world market prices at a later date.

In light of the above, we envisage close to symmetrical inflation risks for 2007-2008 around the baseline. Accordingly, relying on the baseline scenario above the inflation target, if our main assumptions are realised, substantial risks remain that the inflation rate will be above price stability in 2008.

In connection with the GDP forecast, we envisage slightly downside risks for next year, mainly due to lower consumption. In essence, risks will remain symmetrical in 2008, when the impact of lower consumption may be offset by looser fiscal policy (higher wage increase in the government sector).

4. Background information

4.1. Background information on the projections

Compared to the August Inflation Report, we expect that the rate of price increase will be slightly higher this year, and project a slightly lower rate for both next year and 2008. Accordingly, we raise our forecast for average annual inflation by 0.1 percentage point for 2006, and reduce it by 0.1 percentage point for 2007 and 2008.

Our view on inflation developments – in terms of the relevant magnitudes – has not changed, meaning that the slight deterioration in the inflation outlook results from the improvement in certain assumptions employed in our projection in conjunction with less favourable actual data. This duality applies to our entire forecast horizon: the first part is dominated by a higher-than-expected rise in inflation in tandem with lower oil price-path over the short term, while over the medium term cost inflationary pressure and a stronger forint exchange rate generates an opposite effect.

The moderate inflationary environment characteristic of the early part of 2006 ended in the summer, as reflected by the gradual rise in core inflation data from June on. Although the impact of the change in the VAT rate is still uncertain for September, trend inflation is significantly higher than anticipated and this indicates an inflationary environment that will undoubtedly be higher over the short term. Furthermore, the unexpectedly high data seen in recent months also point to higher inflation expectations. At the same time, to some extent the increase in core inflation may be due to the fact that the change in the VAT rate presented an opportunity for sellers to compensate for cost pressure that is presumed to have increased recently, and to implement price increases sooner than planned.

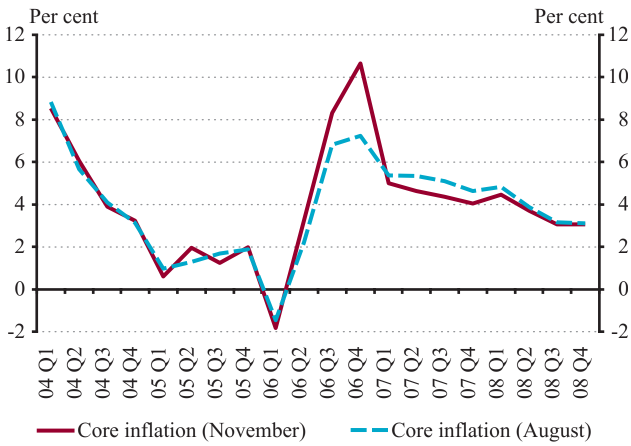
Similar to inflation data, wage figures for July and August also turned out to be higher than expected. These data are also difficult to assess due to the changes implemented in September, such as the regulations concerning employee's contribution. At the same time, the decline in productivity in the service sector also induced rising wage costs. Even though in our baseline projection we assumed that – due to the credibility of the inflation targeting policy – the recent unfavourable data would not affect inflation expectations, in light of the latest wage figures our previous forecast for private sector wages had to be increased slightly for each year. All in all, relative to our August projection, the effect of wage costs on prices may result in higher inflation in 2007 and 2008.

Since in our baseline scenario we assumed anchored inflation expectations, after some interim period the rate

Chart 4-1

Changes in our projection of core inflation*

(annualized quarterly changes)



** Without direct VAT effects.*

Table 4-1

Changes in major assumptions relative to the August Report*

	August 2006			Current		
	2006	2007	2008	2006	2007	2008
Central bank base rate (%)**	6.75	6.75	6.75	8.00	8.00	8.00
EUR/HUF exchange rate	269	277.6	277.6	265.9	267.3	267.3
EUR/USD exchange rate (US cent)	124.9	126.9	126.9	124.9	126.2	126.2
Brent oil price (USD/barrel)	70.3	76.3	74.6	65.1	64.8	67.2
Brent oil price (HUF/barrel)	*15,144*	*16,696*	*16,329*	*13,860*	*13,722*	*14,228*

** Annual averages on the basis of the average exchange rate in effect in October 2006 and the forward oil price path.*
*** Year-end figures.*

of increase in prices may return to the level we previously projected, despite the unfavourable new data (see chart 4-1). Therefore, any coordination failure risks concerning inflation expectations are accounted for in the fan chart.

As for the assumptions used in the forecast, the oil price path and the exchange rate – fixed at close to 4 per cent stronger than before – both result in a slower increase in prices. One difference between the two is that while the cheaper oil has a mitigating effect on inflation in 2006 and 2007, the stronger forint only has an impact on inflation in 2007 and 2008.

As there was no new information on regulated prices, we essentially used our assumptions from the August *Inflation Report*.[17] Next year, as far as regulated prices are concerned, the reduction in carrier prices in the telecommunications sector and the new elements of pharmaceutical subsidies will provide a further decline in inflation relative to August.

However, a significant change in our assumptions regarding government sector wages was made compared to the previous *Report*. Namely, we assumed the freezing of the total wage bills instead of the average wage. This resulted in a one-and-a-half per cent increase in public sector wages, in 2007. Higher than previously assumed public sector wages had a primary impact on household income in 2007, and thus it increased consumption and GDP figures slightly, but its effect on the inflation rate turned out to be negligible.

As far as developments in the real economy are concerned, in addition to household consumption, we have reconsidered our outlook for gross fixed capital formation as well. Based on the latest figures, we revised downward our projection for short-run corporate investment, whilst over the medium term we maintained a moderate increase similar to our previous forecast. Due to the favourable recent data, while using practically the same path for external demand as in our previous Report, the contribution of net exports to growth increases in 2007, but decreases in 2008. Based on these two impacts, our projection of GDP growth for 2007 was as much as 0.1 percentage point higher, whereas in 2008 both impacts will slightly slow down the economy, leading to a 0.1 percentage point lower projected rate of growth.[18]

Impacts of an alternative interest and exchange rate path

We analysed the effects that adopting the average expected exchange rate and interest rate of the November Reuters survey as our underlying assumption would have had on our baseline projection. According to the survey, analysts anticipate the forint to appreciate by nearly 3.5 per cent (a forint-euro of around 259) by the end of 2007, relative to the assumption in our baseline scenario. At the same time, they also expect the central bank base rate to be lowered by approximately 80 basis points. Applying these assumptions our inflation forecast would be 0.3 percentage points lower for 2007 and 0.4 percentage points lower in 2008. The impact of GDP growth would be smaller, it would decrease by 0.1 percentage point in 2007 and by 0.15 percentage points in 2008.

Table 4-2

Key factors affecting our inflation forecast

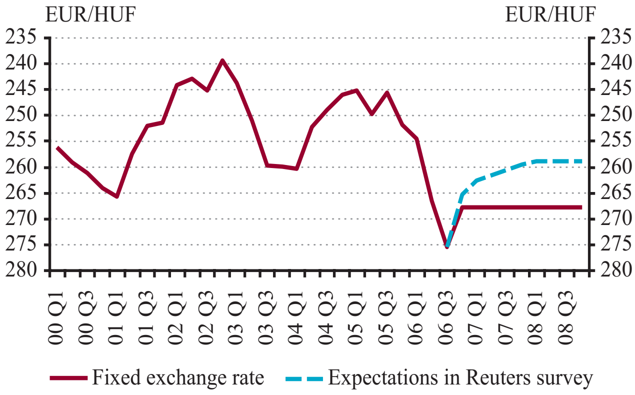
	Result in higher inflation	Result in lower inflation
Short term	• Higher impact of VAT increase in September • Additional price increases parallel with the VAT increase	• Decline in the forward oil price path
Long term	• Higher wage path • Increase of the slope of forward oil price path	• Appreciated forint exchange rate assumption • Dropping household income levels • Regulated prices

[17] To the best of our knowledge, up to the date when data collection for the Report was closed, no final decision had been made concerning the increase of energy and transportation prices for next year.

[18] Regarding the projection of the real economy it is important to note that according to the revision of GDP data, as published by the CSO on 2 October 2006, we calculated all deficit and balance figures using the revised annual data, whereas quarterly figures are based on the former methodology, as no revised quarterly data is available at this time.

Chart 4-2

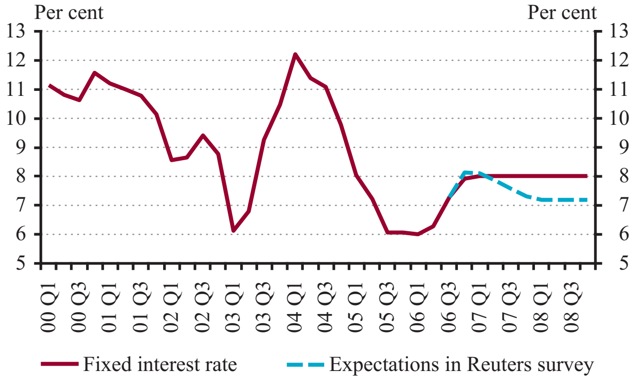
Exchange rate assumptions based on Reuters survey prepared in November and the fixed rate projection*



** Inverted scale.*

Chart 4-3

Central bank base rate assumptions based on Reuters survey prepared in November and the fixed rate projection



The MNB's main scenario versus other projections

With regards to inflation, most of the analysts and institutions forecast a somewhat slower pace; nevertheless, our baseline projection lies within the range of the analysts for both years. Our projection for GDP growth, however, is entirely in line with other forecasts, and the same is true for expected budget and current account deficits.

Table 4-3

Changes in central projections relative to August
(average percentage changes on a year earlier, unless otherwise indicated)

	2005	2006		2007		2008	
	Actual	Projection					
		August	Current	August	Current	August	Current
Inflation (annual average)							
Core inflation[1]	2.2	2.0	**2.4**	5.6	**6.1**	4.4	**4.0**
Consumer price index	3.6	3.8	**3.9**	7.0	**6.9**	4.2	**4.1**
Economic growth							
External demand (GDP-based)	2.0	2.2	**2.9**	2.1	**2.2**	2.3	**2.3**
Impact of fiscal demand[2]	0.8	1.8	**1.5**	-4.1	**-4.2**	-1.7	**-2.0**
Household consumption[3]	2.1	2.5	**2.4**	-1.0	**-0.9**	-0.3	**0.0**
Memo: Household consumption expenditure[3]	*1.8*	*2.6*	***2.4***	*-0.9*	***-0.7***	*0.0*	***0.3***
Fixed capital formation[3]	6.6	6.3	**4.2**	2.0	**2.1**	4.3	**4.3**
Domestic absorption[3]	0.8	1.5**	**0.9****	-0.2**	**0.0****	1.1	**1.4**
Export[3]	10.8	13.7	**15.7**	9.5	**9.8**	9.4	**9.1**
Import[3,4]	6.5	10.8**	**12.1****	6.9**	**7.4****	8.3	**8.4**
GDP[3]	4.1 (4.3)*	3.9	**3.9**	2.4	**2.4**	2.5	**2.4**
Current account deficit[4]							
As a percentage of GDP	6.8	8.1**	**7.1****	5.9**	**5.5****	4.7	**4.3**
EUR billions	6.0	7.0**	**6.2****	5.3**	**5.2****	4.5	**4.3**
External financing requirement[4]							
As a percentage of GDP	6.0	6.9**	**6.0****	4.5**	**4.1****	3.0	**2.6**
Labour market							
Whole-economy gross average earnings[5]	8.9	6.8	**7.2**	4.4	**5.3**	4.5	**4.7**
Whole-economy employment[6]	0.0	0.4	**0.8**	-0.4	**-0.2**	0.5	**0.3**
Private sector gross average earnings	6.9	7.9	**8.3**	6.7	**7.3**	6.7	**7.0**
Private sector employment[6]	0.3	1.0	**1.6**	0.1	**0.3**	0.6	**0.5**
Private sector unit labour cost	2.2	4.3	**5.3**	4.3	**5.6**	3.9	**4.7**
Household real income	3.6***	4.3	**2.5**	-4.3	**-3.8**	2.0	**1.7**

[1] For technical reasons, the indicator that we project may temporarily differ from the index published by the CSO; over the longer term, however, it follows a similar trend. [2] Calculated from the so-called augmented (SNA) type indicator; a negative value means a narrowing of aggregate demand. [3] Actual data does not contain the impact of the CSO national balance revision received on 2nd of October [4] As a result of uncertainty in the measurement of foreign trade statistics, from 2004 actual current account deficit and external financing requirement may be higher than suggested by official figures or our projections based on such figures. [5] Calculated on a cash-flow basis. [6] According to the CSO labour force survey.
** Adjusted for calendar effect. ** Our projection includes the impact of the Hungarian Army's Gripen purchase, which raises the current account deficit and increases public consumption and imports. *** An MNB estimate.*

Table 4-4

MNB's main scenario versus other projections

	2006	2007
Consumer price index (annual average growth rate, %)		
MNB	3.9	6.9
Consensus Economics (September 2006)[1]	3.4–3.7–4.0	5.5–6.4–7.0
OECD (May 2006)	2.1	2.9
European Commission (Autumn 2006)	3.9	6.8
IMF (September 2006)	3.5	5.8
Reuters-survey (November 2006)[1]	3.7–3.9–4.0	5.8–6.5–7.3
World Bank (September 2006)	3.7	6.5
GDP (annual growth, %)		
MNB	3.9	2.5
Consensus Economics (September 2006)[1]	3.6–3.8–4.0	1.8–2.4–3.0
OECD (May 2006)	4.6	4.4
European Commission (Autumn 2006)	4.0	2.4
IMF (September 2006)	4.5	3.5
Reuters-survey (November 2006)[1]	3.6–3.9–4.3	1.8–2.4–3.1
World Bank (September 2006)	3.8	2.5
Current account deficit (EUR billion)		
MNB	6.2*	5.3*
Consensus Economics (September 2006)[1,2]	5.8–6.6–7.2	5.1–6.1–7.8
Reuters-survey (November 2006)[1]	5.8–6.5–7.8	5.2–6.5–6.6
Current account deficit (as a percentage of GDP)		
MNB	7.2*	5.8*
OECD (May 2006)	7.7	7.3
European Commission (Autumn 2006)	7.3	5.1
IMF (September 2006)	9.1	8.0
World Bank (September 2006)	8.0	6.7
Budget deficit (ESA-95 method, as a percentage of GDP)		
MNB	9.5–10.4**	6.1–7.7**
Consensus Economics (September 2006)[1]	8.6–10.0–11.0	5.7–6.8–7.5
European Commission (Autumn 2006)	10.1	7.4
Reuters-survey (November 2006)[1]	9.5–10.0–10.2	5.9–6.6–7.4
World Bank (September 2006)	8.6	5.1
Forecasts of the size of Hungary's export markets		
MNB	9.1	4.0
OECD (May 2006)[3]	7.9	6.9
European Commission (Autumn 2006)[3]	9.1	6.3
IMF (September 2006)[3]	8.1	5.7
Forecasts of GDP growth rate of Hungary's trade partners		
MNB	2.9	2.2
OECD (May 2006)[3]	2.6	2.5
European Commission (Autumn 2006)[3]	3.1	2.4
IMF (September 2006)[3]	2.8	2.3

*MNB projections are so-called 'conditional' projections. Therefore, they cannot always be directly compared to other projections. [1] In addition to the averages of polled analysts' responses (the values in the middle), the smallest and largest values are also indicated for the Reuters and Consensus Economics surveys in order to illustrate dispersion. [2] The survey specifies current account projections in US dollars, therefore they are converted at the EUR/USD exchange rate assumed in the current Report. [3] Values calculated by the MNB; the projections of the named institutions regarding individual countries are considered with the weights used for calculating the MNB's own external demand indicators. This way, the forecast may differ from the numbers published by the aforesaid institutions. * Our projection takes account of the negative effect on the current account resulting from the Gripen fighter procurement. ** Risk domain related to the ESA deficit, which contains risks relating to the measures announced under the New Equilibrium program. Source: Consensus Economics Inc. (London) Eastern Europe Consensus Forecasts (September 2006); European Commission Economic Forecasts, Autumn 2006; IMF World Economic Outlook (September 2006); Reuters survey, November 2006, World Bank EU-8 Quarterly Economic Report (September 2006); OECD Economic Outlook (May 2006).*

4.2. Developments in general government deficit indicators

In drawing up the budget projection we relied on the draft bill for the 2007 budget act, on the updated convergence program submitted in September and on Government announcements. For the purposes of the projection budget items are identified in the following three groups based on the information available:

1. we will forecast the impacts of the measures – regardless of whether they were known before or adopted recently – that were enacted into law and primarily intended to increase revenues, based on our own calculations consistent with MNB's macroeconomic projection. This category covers tax and contribution increases for the most part.

2. in connection with any measures that were already announced, but not yet enacted into law, we accepted the Government's forecasts if there was any available. In other words, in the absence of detailed information we assumed that the Government will to realise its measures in a way that their impact on deficit will be identical with the Government's latest forecast. This category includes, among others, the doctor's consultation fee or the expenditures of budgetary units.

3. the items carrying the largest degree of uncertainty are the ones which have already been announced but not yet enacted into law, and no official forecast is available with respect to their budgetary impact.[19] These items are impact of restructuring the natural gas compensation scheme or the system of subsidising medicine prices, and the impact of reforms in the healthcare system. In these cases we applied our own assumptions regarding certain input variables and the foreseeable budgetary impacts.

The deficit targets set out in the convergence program as submitted in September may be achieved if the Government manages to implement all measures it contains. Implementation, however, is burdened with risks prone to increase in time. According to our baseline projection the ESA deficit for 2006 is estimated to be around 9.9 per cent of the GDP, while the ESA deficit for 2007 is expected to be around 6.5 to 7.7 per cent of the GDP. We have defined the range for 2007 under the assumption that if budgetary developments will be favourable next year, and if deficit drops below 6.5 per cent of the GDP, the Government will spend the so called contingency reserves set aside in the budget (for further information see below).

Table 4-5

Fiscal deficit indicators in our baseline scenario
(as a percentage of GDP)

	Forecast		
	2006	2007	2008
1) GFS balance	-9.5	-6.5	-4.0*
2) ESA balance adjustments	-0.4	0.0	-0.2
3) ESA balance (1+2)	-9.9	-6.5	-4.2
4) ESA-balance with risks **	(-9.5)-(-10.4)	(-6.1)-(-7.7)	(-3.4)-(-5.3)
5) Quasi fiscal expenditures and other adjustments	-1.2	-0.4	-0.7
6) Augmented (SNA) balance (1+5)***	-10.7	-6.9	-4.9
7) Augmented (SNA) primary balance	-6.8	-2.7	-0.7
9) Impact of fiscal demand	+1.5	-4.2	-2.0

** As we have no budget bill 2008 for this year we estimated the level of various deficit indicators on the basis of completion of the measures outlined in the convergence programme.*

*** Range of risks related to the ESA deficit, which contains our risk assessment relating to the convergence program. The range of risks related to the ESA deficit for 2007 was defined in consideration of the allocation of contingency reserves to the extent required according to the budgetary trends.*

**** The cash-based deficit of the general government minus extraordinary revenues and expenditures, and including quasi fiscal operations settled outside the general government (MNB estimate).*

[19] The cut-off date of our projection was the 8-th of November. Note that our results are not changed by the Constitutional Court's decision on the tax of companies' petty cash, since this was excluded from our baseline projection as a measure with high risks.

The deficit for 2008 is expected under the baseline scenario to settle around the 4.3 per cent deficit level as it is targeted in the convergence program, however, the major part of the distribution of risks will exceed the deficit target. Compared to the baseline projection contained in the August inflation report, the current projection indicates a lower deficit by 0.2 percentage points for 2006, and higher deficits by 0.3 and 0.1 percentage points for 2007 and 2008, respectively.

The 2007 budget outlines a realistic fiscal plan but limited reserves compared to risks. In recent years the Government frequently failed to meet the deficit target set out in the budget act, so the 2007 budget contain higher than before reserves in order to meet the deficit target specified. In the 2007 budget act the Government set aside a total of 225 billion forints in reserves to meet the deficit target safely, however, the reserves actually available remains significantly behind (for more details see the box below). According to previous years experience, the general and earmarked reserves set aside in the budget will be spent in all likelihood. In other words, only the additional approximately 130 billion contingency reserves can be realistically counted on as collateral reserves in light of the experiences of previous years. Since according to our central projection the deficit – not counting the reserves – will be 0.2 percentage points higher than what is contained in the budget act, it means an additional 50 billion forints less from the reserves actually available. Furthermore, the usual uncertainty concerning the forecast of the deficit of local governments outside the scope of direct control by the central budget constitutes an additional 0.1-0.2 percentage points risk factor, concerning the implementation of which the Government will have any information only after the end of the year to which the budget pertains. More specifically, the amount of the reserves that may be disposed of during the course of the year in the event of any unfavourable turn of events in the budget, that is effectively available is estimated around 30-55 billion forints instead of the 225 billion forints shown in the Government's plans.

Budgetary developments in 2006

Due to the significant exceeding of expenditure limits, in spite of the measures introduced during the year to reduce the deficit, the ESA deficit of private pension funds may reach 9.9 per cent of the GDP, without adjustments, instead of 6.1 per cent as planned. Our baseline projection predicts a deficit level the 0.2 percentage points lower relative to the August forecast, attributed for the most part to the higher than expected tax revenues for the third quarter.

Close to one-third on the 4 per cent excess of 2006 deficit targets may be tied to statistical methodology reasons and the remaining two-thirds to a budget policy that turned out be looser than planned. The ESA deficit target set for 2006 fundamentally deviate from that number which were justified by both the budgetary trends and the statistical methodology employed by Eurostat. The accrual-based accounting of the costs of Gripen fighter purchases and highway construction costs should have to be taken into account when defining the ESA deficit target. This way the statistically correct accrual-based accounting of deficit target would have been around 7.5 per cent of the GDP. Therefore, exceeding the deficit relative to the proposed budgetary path is realistically estimated at 2.4 percentage points of the GDP. The higher deficit level is the result of surpassing the undershot expenditure projections combined with other over-expenditures (e.g. decumulation of unused appropriations by the budgetary units).

Risks of the deficit forecast for 2006

The 9.9 per cent ESA deficit projected in our baseline projection for 2006 is associated with slightly asymmetrical distribution of risks pointing towards a higher deficit.[20]

As regards the expected development of cash-based deficit, uncertainty is significantly higher than usual on account of any possibility of debt assumption inside the government sector, however, it has no effect on ESA deficit.

As for the risks related to tax revenue projections, we foresee symmetrical risks in connection with VAT revenues. However, our risk assessment for all tax revenues is not symmetrical, for the actual impact of the measures introduced in September to increase tax revenues is not yet evident. Hence there is a risk that increasing the tax burden will produce less tax revenues than expected, if tax evasion grows considerably to a dimension exceeding our projections.

Actual spending of appropriations of the chapters and budgetary units did not reach the levels we have estimated for the third quarter, therefore, in our view, it is a positive risk that savings may be realised in this particular expenditure projection relative to the increased annual appropriation.

[20] The potential assumption of nearly HUF 350 billion in 2006 of the total HUF 500 billion borrowed by NA Zrt. could add 1.5 per cent to the cash based deficit. However, this debt assumption would not affect the ESA deficit, as, according to the ESA, NA Zrt. is part of general government, so earlier investment by the company in the road infrastructure had been shown in the ESA deficit. (As the 2007 budget bill only contains the assumption of HUF 146 billion, we assume that the HUF 350 billion loan package will be assumed this year.)

Table 4-6

Factors of uncertainty in our deficit forecast for 2006
(as a percentage of GDP)

GFS-balance baseline projection: - 9.5 per cent			
Tax revenues will be higher than projected in the baseline forecast.	+0.1	Tax revenues will be lower than projected in the baseline forecast.	-0.4
The expenditures of public sector agencies and chapters will be less than previously expected.	+0.2	The investment expenditures of local governments will be higher, investment cycle.	-0.1
Impact of favourable developments on balance	*+0.3*	*Impact of unfavourable developments on balance*	*-0.5*
GFS deficit under favourable circumstances	-9.2	GFS deficit under unfavourable circumstances	-10.0
ESA deficit adjustments	-0.4	ESA deficit adjustments	-0.4
Lower highway construction costs	+0.1		
ESA deficit under favourable circumstances	-9.5	ESA deficit under unfavourable circumstances	-10.4

Estimated budgetary developments in 2007

The draft bill contains extraordinary high appropriations for reserves in order to ascertain meet that deficit target for 2007 are met. The purpose of the extra provisions is to reduce the risk of failure of the implementation of the budget. The 6.5 per cent projection for ESA deficit relative to GDP is built on the presumption that the contingency reserves – comprising close to 0.5 per cent of the GDP – will not be appropriated. In our view the risks of implementation remain significant, as it is indicated by the fact that the pessimistic deficit scenario (7.7%) estimated without the spending of reserves is much higher that the deficit target.

The risks of implementation are considered significant since a number of measures, comprising part of the convergence program, are yet to be specified in detail, whereas the appropriations of the draft bill are based on the assumption of these measures being fully executed. (Of the measures outlined in the convergence program aimed at reducing expenditures, the Government is yet to finalise the proposed concepts for restructuring the natural gas compensation scheme, and the system of subsidies for local public transportation and long distance transportation). There are less errors in planning compared to previous years, however, the proposed figures for the social security system is still overly optimistic.

The baseline projection for the 2007 deficit path are based upon the following assumptions:

- On the expenditure side, we supposed that the freezing of wages and transition to the management of the overall wage bill will be realised in accordance with the plans of the government. Furthermore, we were building on the assumption that the various expenditure items in the central budget were planned with due caution, and that they can be realistically met.
- A forecast was prepared for the interest balance based on the forward yield curve.

The background of our deficit forecast differs from the macroeconomic conditions assumed in the draft bill:

- The draft bill indicates a lower inflation path compared to the MNB forecast, which means that the loss of expenditure in real terms caused by inflation will be higher through the usual planning mechanism for expenditure projections.
- The projection contained in the draft bill for the increase of gross average wages in the private sector is well over our projection. Consequently, the draft bill indicates higher tax and contribution revenues in connection with wages compared to our baseline projection.

Our forecast relating to the deficit of the central budget sub-sector is 1.0 percentage points lower than what is contained in the budget act. Compared to the budget act we expect 0.3 percentage points higher revenues, while our projection for interest expenses is 0.2 percentage points lower. Another 0.5 percentage points difference can be explained by the assumption of the permanent blocking of the contingency reserves. The deficit target of the government sector can be achieved if those reserves are not spent. The reason our projection for revenues is higher is that because we expect more net VAT revenues slightly higher revenues from corporate taxes than what is contained in the budget act.

With respect to the balance of social security funds there are two major differences between the budget act and our own forecast:

- The budget act expects higher revenues from contributions, approximately by 0.2-0.3 percentage points of the GDP. The difference is primarily attributed to the deviations between the projections for next year's wage increases.

- The estimate contained in the budget act for the expenditures of the Health Fund (payments for pharmaceuticals and medical aids) is approximately 0.2 percentage points lower than our own central projection. The reason our forecast differs from the budget act this much is that because there is no agreement with pharmaceutical companies as of yet concerning the rate of compensation they are required to pay in the event any over-spending in the medicine fund, and because the system of subsidies for pharmaceutical products is not yet available.

Risks of the deficit forecast for 2007

Our central projection contains a relatively wide range of risks, between 5.6 and 7.7 per cent. However, since we rely on the assumption that the reserves will be appropriated in the event of favourable developments in terms of deficit, the actual range of risks will be somewhere between 6.1 and 7.7 per cent. Risks indicating higher deficit are found in VAT revenues, in the net expenditures of budgetary units and chapters, expenditures if the social security system, in the expenditures of local governments, and in highway construction costs. The realistic projection of the net expenditures of budgetary units and appropriations of chapters cannot be accurately assessed based on the limited information we have available. In accordance with our forecasting rules, we assume that the expenditure projections contained in the budget act will be observed, therefore our baseline projection is considered conditional. There is significant uncertainty surrounding the freezing of wages in general government, particularly at local governments and their budget units, as the central budget has no direct influence on their wage policy.

We foresee a possibility for lower deficit than predicted in the baseline scenario in connection with higher VAT revenues and personal income tax revenues, and due to lower deficit in social security funds. Since our 6.5 per cent main projection was based on the assumption that the contingency reserves will not be appropriated, therefore, if the deficit turns out to be lower than that, it is likely that the contingency reserves will be appropriated. Consequently, our central projection also constitutes the lower edge of our risk band.

Table 4-7

Factors of uncertainty in our deficit forecast for 2007
(as a percentage of GDP)

GFS-balance baseline projection: -6.5 per cent			
Tax revenues will be higher than projected in the central projection.	+0.2	Taxes and contributions will be lower than projected in the central projection.	-0.3
Contributions will be higher than projected.	+0.2	The expenditures of local governments will be higher than predicted in our central projection.	-0.2
Expenditures in the social security system will be reduced faster than projected in the central projection.	+0.2	The expenditures of budgetary units will be higher the projected.	-0.4
		Expenditures in the social security system will be higher than planned.	-0.2
EU funds will finance the underground construction.	+0.3	Costs of highway construction will be higher than planned.	-0.1
Impact of favourable developments on balance	*+0.9*	*Impact of unfavourable developments on balance*	*-1.2*
GFS deficit under favourable circumstances	-5.6	GFS deficit under unfavourable circumstances	-7.7
Contingency reserves spent	-0.5	Contingency reserves permanently blocked	0.0
GFS deficit after the appropriation of contingency reserves	-6.1	GFS deficit after the blocking of contingency reserves	-7.7
ESA deficit adjustments	0.0.	ESA deficit adjustments	0.0.
ESA deficit under favourable circumstances	-6.1	ESA deficit under unfavourable circumstances	-7.7

Box 4-1 Means of risk assessment: contingency reserves

The Government increased the budget reserves in an attempt to reduce the risks in meeting next year's deficit target. According to the draft of the 2007 budget act a total of approximately 225 billion forint will be set aside in reserve.

According to previous years experience, we are of the opinion that the general and earmarked reserves and provisions set aside in the budget will be spent during the year, for the purpose of these provisions is to eliminate "normal" expenditure related tensions that may arise during the course of the year. Therefore, only the "*central contingency reserves*" and the "*chapter contingency reserves*" can be construed as effectively available from which to finance the adjustments that may become necessary in the event of budgetary slippages. The two reserves contain close to 129.6 billion HUF, enough to cover adjustments up to about 0.5 per cent of the GDP. As our baseline projection indicates a deficit in the neighbourhood of GDP 6.5 per cent of the GDP without the appropriation of the contingency reserves, it leaves only about 80 billion forints worth of contingency reserves to meet the deficit target for 2007. The contingency reserves reduced to 0.3 per cent of the GDP could in principle be sufficient to manage the risks in meeting deficit target, however, in this case the chapter contingency reserves should left open for transfer for the management of risks arising in other areas of the general government. The table below illustrates the Government's room for manoeuvre in case of budgetary slippages.

Our conclusions are in applying the principle of prudence. Previous experience indicate that the risks in meeting the deficit target of local government is estimated around 0.1-0.2 per cent of the GDP, therefore, in line with the principle of prudence, the Government should set the deficit target this much lower with regard to the central government sub-sector directly under its control with a view to the safe implementation of the convergence program. This means that approximately 25 to 50 billion forints should be blocked for this purpose from the contingency reserves before the end of the year (provided that the deficit path will not shift in the direction of positive risks relative to our baseline projection). Notably, if the Government considers the risks imminent in the local government sector as exogenous factors, and handles the risks according to the principle of prudence, the amount of reserves actually available in the central government sector to eliminate other risks in connection with meeting the deficit target will be around 30 to 55 billion forints.

Table 4-8

Estimated size of actual reserves
(billion HUF)

A	Reserves total	225
B	o/w general and earmarked reserves	95
C = A-B	Contingency reserves	130
D	Blocked reserves covering slippages included in our central projection	-50
E = C+D	Reserves consistent with meeting the target	80
F	Risks related to projected deficit of the local governments	-25-50
G = E-F	Available contingency reserves	30-55

** The baseline projection is revised to 7.0 per cent of the GDP due to the appropriation of reserves, which is 0.2 percentage point above the deficit target.*

Estimated budgetary developments in 2008

If the deficit target set out in the 2007 budget act are met, fulfilment of the 4.3 per cent deficit target specified in the convergence program for 2008 appears realistic. We wish to point out that the implementation of next year's budget and developments in next year's fiscal developments will essentially underline the fulfilment of deficit target for 2008.

There are substantial risks involved in the implementation of the 4.3 per cent deficit target in view of the fact that our baseline projection does not contain any reserve by contrast to the fiscal path of 2007 for the eventuality of any mishap in the deficit target. In our estimation, the measures intended to increase revenues will not be able to generate any improvement in balancing the budget in 2008, which means that additional measures aimed at reducing expenditures will be required in order to meet the proposed deficit target.

Based on the measures outlined in the convergence program aimed at reducing expenditures, meaning wage freeze for the most part, and on the estimated changes in one-off items the ESA deficit for 2008 may be reduced by an additional 2.3 percentage points in relation to the GDP by comparison to 2007, however, the baseline forecast indicates substantial asymmetric risk distribution toward higher deficit levels. The impact of one-off items (Gripen fighter purchase; outsourcing motorway construction into PPP schemes) on the improvement in the balance accounts for around 1.0 per cent of GDP in the reduction of the deficit in 2008, which constitutes close to half of the proposed reduction of ESA deficit.

Table 4-9

Factors of uncertainty in our central projection for 2008
(as a percentage of GDP)

GFS-balance baseline projection: -4.0 per cent			
Tax revenues will be higher than projected in the baseline forecast.	+0.2	Tax revenues will be lower than projected in the baseline forecast.	-0.2
Revenues from social security contributions will be better than expected.	+0.2	The proposed wage-freeze in the government sector will not be implemented.	-0.3
EU funds will be lower than expected, hence co-financing requirements will also be lower	+0.1	Public sector agencies and target-specific appropriations chapters are exceeded.	-0.2
EU funds will finance the underground construction.	+0.3	The deficit of local governments will be higher than planned.	-0.2
		Expenditures in the social security system will be higher than planned.	-0.2
Impact of favourable developments on balance	+0.8	*Impact of unfavourable developments on balance*	-1.1
GFS deficit under favourable circumstances	-3.2	GFS deficit under unfavourable circumstances	-5.1
ESA deficit adjustments	-0.2	ESA deficit adjustments	-0.2
ESA deficit under favourable circumstances	-3.4	ESA deficit under unfavourable circumstances	-5.3

4.3. External balance

As official announced, during the first half of 2006 the sum of the current account and capital account balance, meaning the external financing requirement – similar to the data in 2005 – was 6 per cent of the GDP. As far as financing is concerned, the "bottom-up" external financing requirement rose due to the higher methodological uncertainty: in terms of financing, the row "Errors and omissions" of the balance of payments indicated 1.2 billion Euro for the first half of 2006, that is significantly higher compared to the same period in 2005.

Box 4-2 Revisions made in current account statistics

In September 2006, MNB performed substantial revisions in the current account statistics for the 2003-2006 period in line with the GDP-statistics. Following the revision the 2003 and 2005 current account deficit dropped by EUR 450 and 520 million, respectively, while there was no substantial change in the 2004 deficit. In consequence, during those years the external financing requirement was also lower – by 0.6 per cent of the GDP – than the figure indicated before. The revision primarily involved services and income balance, and was conducted due to the following factors:

- Instead of the amount of reinvested earnings estimated for 2005, the actual data conveyed in the corporate questionnaires filled out consistent with the balance sheet and profit and loss account were applied, or the amount of dividends calculated for 2006 also on that basis. Furthermore, the amount of profit or loss after tax for 2006 varied according to these new figures. Induced by the revision, in 2005 the income balance deficit was reduced by close to 120 million Euro.

- With a view to cross-checking data and information with the CSO, in its current account statistics MNB used the data obtained from the CSO questionnaires in connection with services. Induced by the revision, the surplus of service balance increased substantially during the 2003-2005 period.

The amount indicated under "errors and omissions" in the current account did not change significantly. As far as financing is concerned, revisions involved the debts and other similar receivables of companies from abroad, therefore the external financing requirement shown in the various external balance indicators declined simultaneously.

Table 4-10

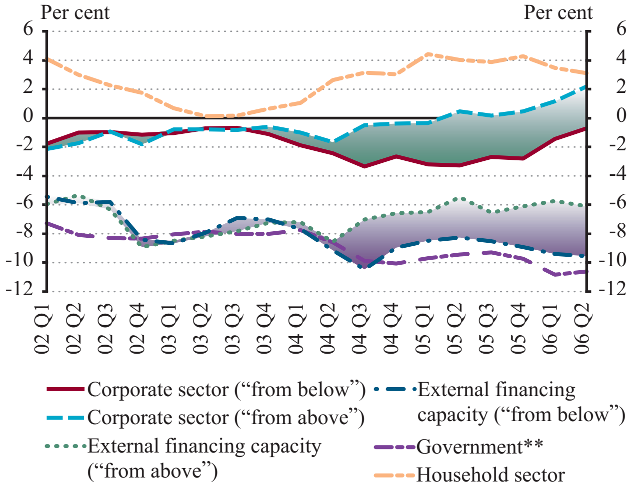
Effect of revision on external balance indicators

Before revision	2003	2004	2005
Current account deficit (as percent of GDP)	8.7	8.6	7.4
Current account deficit (in EUR billions)	6.4	7.0	6.5
External financing capacity, "from above" (as percent of GDP)	8.7	8.3	6.6
External financing capacity, "from below" (as percent of GDP)	8.4	10.0	8.9
After revision	**2003**	**2004**	**2005**
Current account deficit (as percent of GDP)	8.1	8.5	6.8
Current account deficit (in EUR billions)	5.9	6.9	6.0
External financing capacity, "from above" (as percent of GDP)	8.1	8.2	6.0
External financing capacity, "from below" (as percent of GDP)	7.8	9.9	8.2

The stability in the external financing requirement for the first six months occurred due to considerable loosening of the budget, decreasing financial savings in the household sector and the decreasing financing requirement of the corporate sector. The consolidated financing requirement of the general government came close to 11 per cent of the GDP, that in turn may be attributed to decreasing tax revenues due to the lower VAT rates, the rising expenditures in the family support system in excess of GDP growth, higher gas price compensation, and to one-off items such as flood cleanup efforts and the cancellation of the debt of Iraq. Household savings

Chart 4-4

Developments in the financing capacity of the sectors*



** Adjusted by the difference caused by imports brought forward on account of EU accession and by the import increasing impact generated by customs warehouses terminated due to EU accession.*

*** In addition to the fiscal budget, the consolidated general government includes local governments, the ÁPV Zrt., institutions attending to quasi-fiscal duties (Hungarian State Railways [MÁV], Budapest Transport Limited [BKV]), the MNB and authorities implementing capital projects initiated and controlled by the government and formally implemented under PPP schemes.*

dropped by close to 3 per cent in spite of substantial payments of wages and modest growth in consumption.[21] The combined GDP-proportionate financing requirement of the two sectors rose to 7.5 per cent, that was offset by the setback in financing requirement of the corporate sector, that may predominantly ruled by improved profitability and by lower investment activity of the sector during the second quarter.

In spite of budgetary measures, in 2006 the GDP-proportionate financing requirement of the general government – taking into account the accounting of 0.3 percentage points in connection with the Gripen purchase – may be close to 11 per cent. The net financing capacity of households, following the rise that took place between 2003 and 2005, is decreasing since the end of 2005, and is expected to level out in 2006 at 3-3.5 per cent annually in proportion to the GDP. Due to growing corporate revenues, the sector's financing requirement may fall back in spite of rising investment expenditures in proportion to the GDP, that is expected to offset the increase of the financing requirement of the general government and of the households. Hence the GDP-proportionate external financing requirement of the economy may settle at the level of 2005, that means 6 per cent for the official "top-down" value. The "bottom-up" external financing requirement may increase to 8.5 per cent of GDP due to higher "Net errors and omissions".

Table 4-11

GDP-proportionate net financing capacity of sectors

	2002	2003	2004	2005	2006	2007	2008
	Estimation				Forecast		
I. Consolidated general government*	-8.8	-8.4	-8.5	-9.3	-10.7	-6.9	-4.9
II. Households	2.7	0.2	2.4	4.2	3.4	2.5	3.0
Corporate sector and "error" (= A - I.- II.)	*-0.7*	*0.1*	*-2.0*	*-0.9*	*1.3*	*0.4*	*-0.7*
A. External financing capacity. "from above"(=B+C)**	-6.8	-8.1	-8.2	-6.0	-6.0	-4.1	-2.6
B. Current account balance**	-7.1	-8.1	-8.5	-6.8	-7.1	-5.5	-4.3
*- in EUR billions ***	*-5.0*	*-5.9*	*-6.9*	*-6.0*	*-6.2*	*-5.2*	*-4.3*
C. Capital account balance	0.3	0.0	0.3	0.8	1.2	1.4	1.7
D. Net errors and omissions (NEO)***	0.3	0.3	-1.7	-2.1	-2.6	-2.6	-2.6
External financing capacity "from below" (=A+D)	-6.5	-7.8	-9.8	-8.1	-8.5	-6.6	-5.1

** In addition to the fiscal budget, the consolidated general government includes local governments, the ÁPV Zrt., institutions attending to quasi-fiscal duties (Hungarian State Railways [MÁV], Budapest Transport Limited [BKV]), the MNB and authorities implementing capital projects initiated and controlled by the government and formally implemented under PPP schemes.*
*** Uncertainties over calculations related to trade statistics point to higher current account deficit and external borrowing requirement between 2004 and 2006.*
****Assuming that "Net error and omissions" stabilises at the cumulative level of the last 4 quarters.*

[21] During the first half of 2006 some major contradictions emerged among the data available on the household sector. The real growth of wages on an annual level reached 5.4 per cent during the first six months, while the real value of social monetary benefits (pension, family allowance) is close to 10 per cent higher than a year before, that indicates strong growth in household incomes. At the same time, such growth is not justified based on the volume of household expenditures: the volume of financial savings and investment during the first six months remain behind the same period of the previous year, while household consumption increased by less than 3 per cent. The contradiction may be resolved by actual incomes below what is indicated in wage statistics, or by purchases above what is indicated in GDP-statistics.

Table 4-12

GDP-proportionate current account structure *
(in proportion of the GDP, per cent, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008
	Final/Preliminary data					Forecast		
1. Balance of goods and services **	-1.5	-2.4	-3.9	-2.7	-0.8	-1.0	0.0	1.1
2. Income balance	-5.5	-5.5	-5.0	-6.1	-6.2	-6.5	-6.2	-6.1
3. Balance of current transfers	0.8	0.8	0.8	0.3	0.2	0.5	0.6	0.6
*I. Current account balance (1+2+3)***	*-6.2*	*-7.1*	*-8.1*	*-8.5*	*-6.8*	*-7.1*	*-5.5*	*-4.3*
*Current account balance in EUR billions***	*-3.6*	*-5.0*	*-5.9*	*-6.9*	*-6.0*	*-6.2*	*-5.2*	*-4.3*
II. Capital account balance	0.6	0.3	0.0	0.3	0.8	1.2	1.4	1.7
External financing capacity (I+II)**	-5.6	-6.8	-8.1	-8.2	-6.0	-6.0	-4.1	-2.6

** In 2006–2007 the forecast includes the import resulting from the Hungarian Army's Gripen fighter lease, amounting to close to 0.3 per cent of the GDP.*
*** During the 2004–2008 period, uncertainty in the measurement of foreign trade statistics point toward higher current account deficit and higher external financing requirement.*

In 2007, as a result of the budgetary measures the general government's financing requirement is expected to drop by close to 4 percentage points, to 6.9 per cent. Induced by lower deficit and by faster inflation in connection with these measures household real income will fall back in 2007 by more than 4 per cent, accordingly, household financial savings – because of consumption smoothing – is expected to fall back even further in 2007. The financing requirement of the corporate sector may increase, while profits will be reduced on account of the fiscal policy aimed to reduce demand and investment will grow slightly. In 2007, the external financing requirement may be reduced at a rate below the fiscal narrowing of demand, by 1.9 per cent of the GDP. In 2008, the government's financing requirement will drop even further, by an additional 2 percentage points that, due to the narrowing of demand, may bring about further reduction in the net financing capacity of the private sector, and a reduction in external financing requirement by one and a half percentage points.

In view of the structure of the current account balance, real economy balance deficit may remain in 2006 at around the level of 2005 as a result of low domestic absorption, significant growth in export sales and the temporary impact of the Gripen deal to increase deficit. The GDP-proportionate deficit of income balance may slightly increase due to increasing debts and forint yields and due to broader weight of foreign exchange financing. The GDP-proportionate deficit of the current account balance may rise by 0.3 percentage points on the aggregate relative to 2005, representing an EUR 6.2 billion deficit.

Financing the current account deficit

During the first half of 2006, the "bottom-up" external financing requirement was around 4 billion Euro, and it exceeded 9 per cent of the six-month GDP. Approximately one-third of the total financing requirement, 1.3 billion Euro, was financed by non-debt type capital inflow, that is slightly higher than in 2005, after adjustments by the proceeds from privatisation. However, the beneficial developments in the financing structure from the standpoint of investors are also the result of contradicting tendencies and may be attributed to individual items to some extent. In the first half of 2006, apart from the relatively high 1.9 billion Euro of net direct capital inflow, outflow of portfolio-type securities was 0.5 billion Euro.

- The sale of MOL's gas division for close to 1 billion Euro constituted a major part of the high value of direct capital inflow. In the second quarter, however, significantly less foreign direct investment arrived, parallel with the drop in investment activity.

- In the case of portfolio-type securities, there was a slight increase during the first half of 2006 in the volume of securities held by foreigners. Local institution investors, on the other hand, increased their investment in foreign securities by more than 0.7 billion Euro, similar to the intensity in the last quarter of 2005, bringing the amount of net outflow to over 0.5 billion Euro.

Foreign credit of banking sector was a significant factor in increasing debt generating capital inflow, that is a result of further increase in foreign exchange credit of the private sector.

Boxes and special topics in the Report, 1998–2006

May 2005*

August 2005

November 2005

May 2006

November 2006

* Recurring analyses are not listed here.

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