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Economic development and trust

For today's Hungarian society, realistic planning of our convergence process and discernment of the directions and the stakes of the economic and social transition going on in our days is of crucial importance. Beside the numerous positives¹, clarity in considering the weight of negatives² and whether we can overcome these in due time is essential.

A few more years need to pass by until, based on actual economic performance and the quality of citizens' life, a substantiated evaluation can be given on the position of our region including Hungary in the new global economic order, the success and particularities of the economic and social system.

The decade of the nineties was a period of a great social and economic transition for the Hungarian economy. The principal elements of the economic regime change were stabilisation, modernisation and the establishment of the conditions of sustainable growth, while a fairly high level of social peace needs to be maintained in order to be able to meet these goals. Stabilisation³ was equally necessitated by the imbalances inherited from the controlled economy, the economic crisis concomitant of the regime change, and the mistakes of economic policy made while controlling it.

Sharply narrowed down, stabilisation could be identified with stopping indebtedness alone,

but it is more expedient to link the stabilisation process with the requirement whereby even the Hungarian economy should seek to comply with the Maastricht criteria⁴ in the long term, although compliance with these financial criteria was not yet a condition to acceding the European Union.

Our current economic policy taking firm steps for adjustment focuses on reinstating the financial balance. The tolerability of the financial balance alone certainly will not be sufficient to start off sustainable growth. Without a modernisation⁵ process completed, financial stabilisation cannot be successful, as it only facilitates growth along the lines of a wrong structure. A market economy has not been fully established. On the one hand, the institutions established still do not fully comply with the practices of developed European market economies in terms of their actual mechanisms. On the other hand, the transition of certain systems of institutions (for example the great distribution systems of public finances) is still in the initial stage.

It may be a lesson to be learnt in the next one and a half decades that the establishment of the market economy does not provide automatic protection against a number of unfavourable phenomena. In this way, serious macro-imbalances may emerge and have emerged in

Hungary, monopolistic positions occur, abuse of dominance is frequent, unfair market conduct is widespread, including hidden economic activity relying on tax frauds, and due to unreliable information, discernment is difficult both in terms of certain features of the macro-economic situation and the micro-economic sphere.

In relation to the transition to a market economy, the behaviour and performance of enterprises have considerably changed. The transitional period has come to a conclusion in the business sphere. The change, however, is extremely differentiated over a number of areas. Both the historical traditions and the difficulties of transition suggest that the Hungarian economy has a strong disposition to boost unfavourable processes of market economy. For this reason, protecting the macro-economic balance, maintaining the fairness of competition and gradually confining the hidden economy are key responsibilities of the economic policy.

Reforms in the market economy and modernisation were prerequisites to an effective operation of the resources available in the economy. These resources are still highly scarce. The essence of the modernisation process includes not only structural changes whereby the institutions of the market economy are established, but also accumulation of the capital required for competitive production on an international scale to be achieved through these. In addition to the efficient mobilisation of the existing resources producing reinvestible profits, permanently high amounts of domestic savings and foreign capital influx are also necessary for that. (The generation and influx of capital, on the other hand, are closely connected to the economic environment that motivates investment, which is also to be established as a part of modernisation.) It is seen as a great opportunity for the following years that the level of operating capital influx is continuously high, and that, with the disburse-

ment of the EU supports, another capital influx of approximately USD 2 billion annually (that does not constitute a debt) is apparently realistic for the next seven years.

After all, the Hungarian economy started to follow a new course as early as before the millennium (in 1997). In the wake of the significant results achieved through the stabilisation and modernisation process, economic growth has accelerated. Among the favourable circumstances of global economy, Hungary's accession to the NATO and the EU has had special benefits. It may have been decades since the Hungarian economy had had such a good chance to keep up with European development, and, what is more, to approach the average European development standard slowly and gradually, as it did at the beginning of the new millennium.

The sustainability of growth is strongly dependent on the actual capacity of the economy, on the effect that the stabilisation and modernisation policies followed so far have produced on the behaviour and expectations of economic actors, and on external conditions; furthermore, on how correctly the government has evaluated these properties in the process of decision-making, and how actively it is capable of responding to unexpected processes on perceiving them.

Subject to the dynamics of these factors described above in the framework of the potential scenarios, ECOSTAT presents from time to time the development potentials of the Hungarian economy for the next 10–15 years.

THE SITUATION OF THE HUNGARIAN ECONOMY IN 2006

Earlier tendencies in the development of the domestic economy took a somewhat different course in 2006. The gross domestic product is expected to grow by 4 percent. The rate of

growth is slowed down due to a lower expected domestic consumption and a slight drop in the investment activity. GDP growth is maintained by a dynamic increase in export. At the same time, internal deficit grew and the deficit of public finances significantly rose, which were intended to be remedied by the adjustment measures adopted as of last autumn and planned to be carried on with in 2007. As an effect of the re-balancing measures, the deficit is significantly decreasing this year, by approximately 3 percentage points in relation to the GDP, whereas the rate of growth is moderate. According to our model calculations, GDP dynamics will be around 2.5 percent in 2007.

In the first three quarters of 2006, the economic processes did not considerably differ from the previous year's trends, and gross domestic product grew by 4.2 percent. In the third quarter, however, the growth rate of the GDP slowed down, the volume rose by 3.8 percent over the period one year earlier, and 1 percent over the previous quarter. On the demand side, production increase was basically ensured by the dynamically growing export. The rise in retail consumption lagged behind the rate of GDP and the growth rate of real wages.

In 2006, the accumulation of gross fixed capitals remained at the previous year's level, and it is expected in our model calculations to decrease by half a percent, while a marked drop was registered for Q2 and Q3 of the year. The first nine months' performance declined by 0.4 percent compared to the base period, which also had a negative effect on the GDP dynamics. This decline was caused by the insecure business environment and a drop in government investments, in addition to the high base values of 2005. Due to the base effect, and as a result of the investment boosting effect of EU transfers, the accumulation of gross fixed capitals may grow in excess of GDP dynamics in 2007. In the second half of 2007, investment

activities will be more active, reaching a rate of 4.4 percent over the whole year.

The foreign trade product turnover grew intensively over the first nine months of 2006, export dynamics calculated in euros exceeded 15 percent and import dynamics reached around 13 percent. The foreign trade balance is currently much more favourable than was one year ago. Domestic economy keeps on developing in an export-oriented way, the export dynamics in the product turnover being permanently higher than that of import.

The public finance deficit calculated using cash flow data amounted to HUF 1510 billion in the first ten months of 2006, excluding local governments, which corresponds to 6.5 percent of the expected annual GDP. Expected tax revenues were outperformed, and the increased deficit is principally a result of a jump in expenditures. Social security funds between January and October show a deficit of HUF 188 billion, despite the fact that the central budgetary contribution was measurably increased in 2006.

Based on the first six months' data, the deficit of the current balance of payments inclusive of services, revenues and funds transfers in the first six months exceeds that of the base period by EUR 200 million. The need for external financing will be moderate as of 2007 due to a declining financing requirement of the public finances. The borrowings – external financing requirement – of households are expected to decrease later, resulting in a restrained deficit of the current balance of payments. Capital transfers from the EU also improve our financing position. In total, the deficit of the current balance of payments may decrease from 7.1 percent of 2006 to 6.1 percent by 2007, in proportion to the GDP.

Inflation in the first quarter was low, from May it showed a tendency of growth, and in September and October, the rate of price increases doubled, as a result of an increased VAT (general turnover tax) rate, in particular.

Price increases will continue in 2007, inflation will be boosted primarily in the wake of controlled increase in prices and the VAT rate, and the tendency of deflation will be temporarily broken. The changed VAT rate has raised food prices; the increase in gas prices has affected the price of household energy. In early 2007, inflation will accelerate following further price increases and the transformation of the price subsidy system. The increase in the price level will reach equilibrium mid-year, and price increases will be moderate in the second half of this year, and an average price increase around 6.4 percent is predicted over the year. Producer prices will rise at a rate below the inflation.

In 2006, the central bank base rate was raised from 6 percent to 8 percent. The forint was stabilised, with the medium-term inflation pressure still high; consequently, the standard interest rate may only decrease slowly in this way. The interest paid on two-week central bank deposits may be reduced to 6.5 percent by the end of 2007.

By the end of 2006, the forint exchange rate significantly strengthened, yielding an annual average rate of 265 forint/euro. Starting from Q1 of 2007, further strengthening is assumed as a consequence of a reconsolidation of financial trust. For the whole of 2007, a forint/euro exchange rate of 256–257 is seen probable.

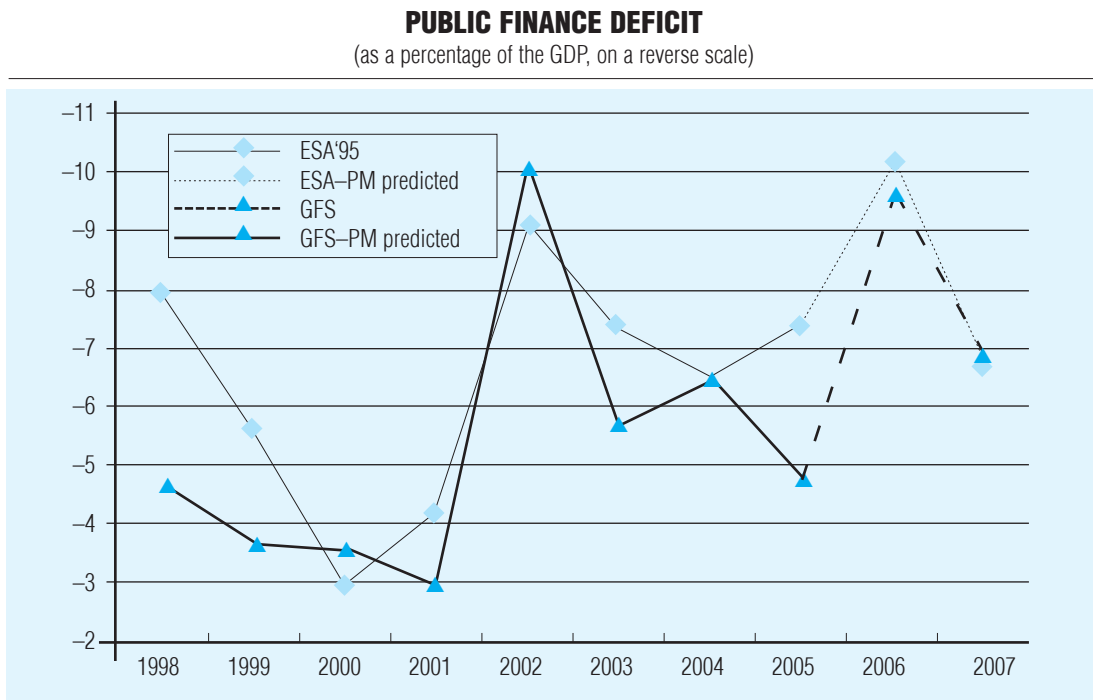
In the first nine months of 2006, the gross average wages grew by 7.7 percent, with 8.3 percent and 7 percent measured in the competitive sphere and in the central budgetary institutions respectively. Due to the fact that taxes and contributions decreased at the beginning of the year, net wages rose at a pace above the gross rate, by approximately 8 percent. For real wages, growth in the first three quarters amounted to 4.8 percent. Increase in the private consumption stays significantly behind increase in real wages. Over the year 2006, real wages are to grow by 3 percent. As a result of the rebalancing measures, the private savings

grew, in order to provide cover for extra costs. In 2007, gross wages will rise at a rate slightly below inflation, and real wages are expected to decrease by 3.5 percent.

By 2007, a moderate, export-controlled economic growth is expected to stay on. To our model calculations, the GDP dynamics in 2007 will be around 2.4 percent, final consumption will decline by 0.6 percent, including a 0.5 percent decrease in private consumption.

A key priority in economic growth is a gradual and permanent improvement of the financial balance. A short-term goal is to restore the balance of public finances in the period between 2006 and 2009. This may be achieved through cutting down on expenses on the one hand, and through increasing taxes and contributions, on the other hand. An important component of this programme is the broadening of tax bases, and the development of a more balanced system of public dues. Achievement of permanent growth and setting the economy on a sustainable course of convergence are in the focus of long-term goals. According to the draft budget for 2007, measurable movements will take place in the income and expenditure side structures of public finances. Tax and contribution revenues will significantly increase, current and investment expenditures of the government will decline, and the system of price subsidies will be transformed. To our calculations, the deficit of public finances in proportion to the GDP in 2006 will reach a single-digit value, namely 9.6 percent. Gradual implementation of the rebalancing and reform measures is a realistic goal. As a result of the government measures, the balance of public finances may considerably improve, declining to 6.2–6.8 percent in 2007. The success of the adjustment is seriously dependent on the extent revenues can be increased and expenses decreased through higher rates of taxes and contributions, and on the success of permanent structural transformations.

Figure 1



Source: Eurostat, Ministry of Finance

Fiscal policy

The draft budget for the year 2007 was developed along the lines of the measured and principles presented in the New Equilibrium Programme issued on 10 June and the convergence programme submitted to the European Commission on 1 October. According to the objectives set, the deficit of public finances will decrease from 10.1 percent expected for 2006 to 6.8 percent by 2007, in proportion to the GDP, using the ESA95 methodology. The indicator disclosed on a cash basis approach will be reduced from 9.7 percent to 6.9 percent. (See Figure 1)

The government seeks to cut down on the public finance through the following measures:

- increasing tax and contribution revenues;
- cutting back price subsidies;
- reducing the expenses of the social security fund;
- adopting a stricter requirement for accumulating reserves.

The details of changing tax and contribution revenues have already been presented in the New Equilibrium Programme. The intention to increase revenues affects each revenue owner (see Figure 2), considering that:

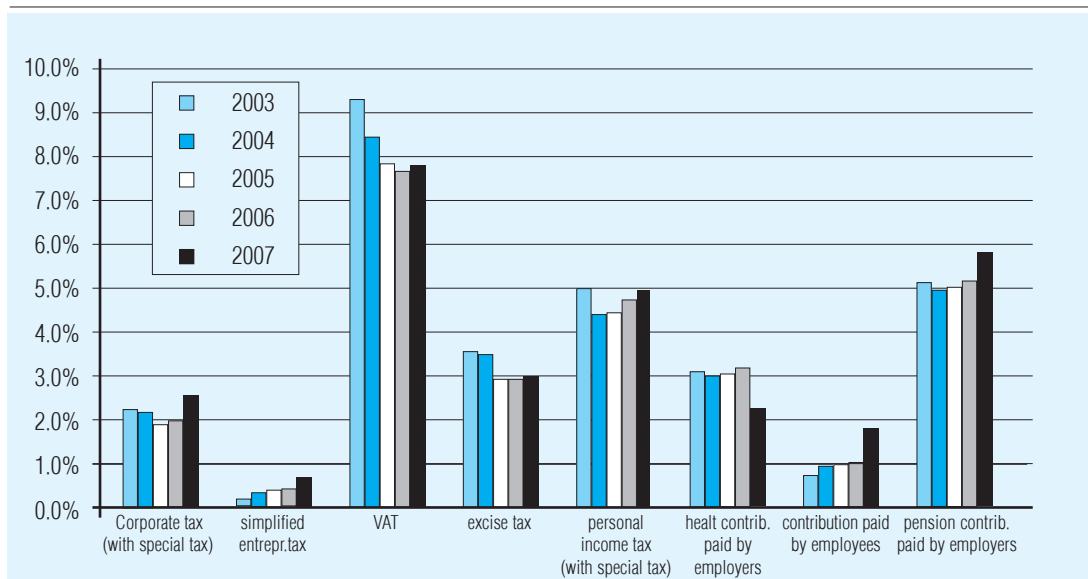
- a special corporate tax is introduced for businesses, the rate of the simplified entrepreneurial tax is raised, and the contribution base is increased;
- private burdens will grow through a cut-back in allowances in personal income tax. The amended VAT rate and the increased contributions also raise revenues, parallel to adversely affecting households.

These changes also affect the structure of social security funds. Beside unchanged contributions payable by employers, the structure is changing, i.e. the revenues of the pension fund are rising against the health care fund. The centres of gravity of tax burdens remain unchanged; the weight of indirect taxes (VAT) is not reduced, while direct taxes

Figure 2

CHANGE IN TAX AND CONTRIBUTION REVENUES IN THE PAST YEARS

(as a percentage of the GDP)



Source: Ministry of Finance

[personal income tax and corporate tax] are increased.

The government expects half of the savings to be achieved through increased tax revenues; the items mentioned above represent 1.7 percent of the GDP. The success of the adjustment is seriously dependent on the extent revenues are increased through higher rates of taxes and contributions. An important issue for 2007 is how the tax base will change. This is basically influenced by two factors:

- how much the production/output/consumption is restrained by increased burdens;
- the (potential) extent of tax evasion,

The first question may be restricted to how gross domestic product and inflation will change in 2007. A glance at the three key pillars of the GDP (household consumption, accumulation of fixed capitals, net export) shows that the adjustment steps considerably affect the first two items; i.e. through an unfavourable change to the population's revenue position and slowing investment projects, the dynamics

of domestic demand may be restrained or potentially decreased. Increase in exports is primarily restricted by external demand. Although the business cycle of the European Union will reach a recession phase this year, i.e. in 2007, this gives rise to no significant decline. To our model calculations, the GDP may rise by around 2.5 percent in 2007. Inflation will jump in this year chiefly due to a controlled increase in prices, accompanied by a tendency of growth in the core inflation. In total, a consumer price index of 6.4 percent is expected on average over the year. Weighing the consequences of the measures, it is expected that the high inflation rate that took shape by the end of 2006 will keep on growing in the first half of 2007, and the rate of price increase will be more restrained in the second half of the year.

In the draft budget for 2007, the government considered a 2.2 percent increase in the GDP and a 6.2 percent inflation rate. Although the growth of gross domestic product is low, the increase in the tax base does not stay below

that of the previous years due to the high inflation. The tax bases of the various actors are worth distinguishing here.

▀ The tax base of households will increase at a smaller pace due to a reduced dynamics of wages. Through consumption (VAT) and savings (interest tax, exchange rate profit tax), the tax revenue is growing to a smaller extent.

▀ The income of businesses changes depending on the demand and the tax burdens. Similarly to domestic demand, foreign demand will not become more active, either, in 2007, which suggests a decreasing tax base here, too.

The government took the first steps already in the second half of 2006 in order to cut back price subsidies. The rationalisation of gas price compensation and the adoption/development of a system of social price compensations are aimed at providing decreasing central budgetary compensation for the rising prices of the global market.

The medicine subsidy has become an expenditure item representing a rapidly growing weight in the budget in the past few years. By changing the price formation, the amount pro-

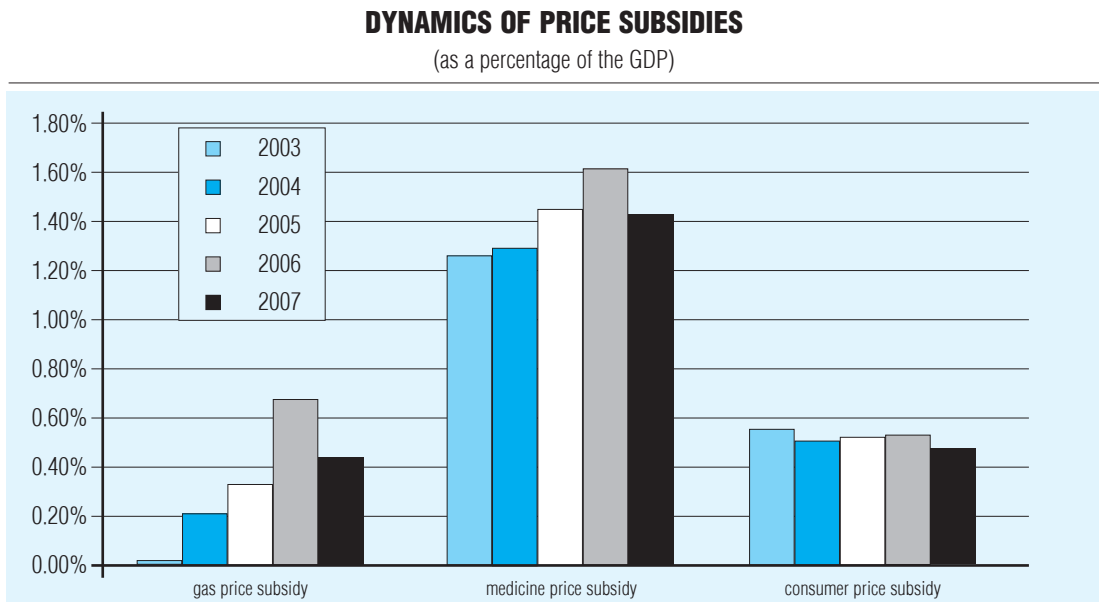
jected for this purpose in 2007 would be significantly lower (even considering the dedicated reserves). Although the budget allocated to medicines was underplanned on end in the previous years' budgets, the announced transformation of the system may guarantee actual savings this year.

The consumer price subsidy line in the central budget contains the compensation paid on the traffic services used. The budget considers a smaller amount of savings on this line, although in 2007 the system of financing will also be changed at this point – according to the announced plans. However, no information is available on specific concepts yet, which makes the decrease in expenditures doubtful. (See Figure 3)

The expenditures of the health care fund may be reduced from 6.9 percent of 2006 to 6.6 percent in 2007, in proportion to the GDP. The financing system of the fund was already modified in 2006, and the consequences of additional modifications are as follows:

- the revenue from contributions paid by employers decrease, while the amount paid by the insured grows;

Figure 3



Source: Ministry of Finance

- the amount of medicine subsidy is lower;
- the amount applied to healing and prevention diminishes.

The balance of the fund – or the expenditures used from the central budget to cover the deficit of the fund – is equally improved by increased income and decreased expenses.

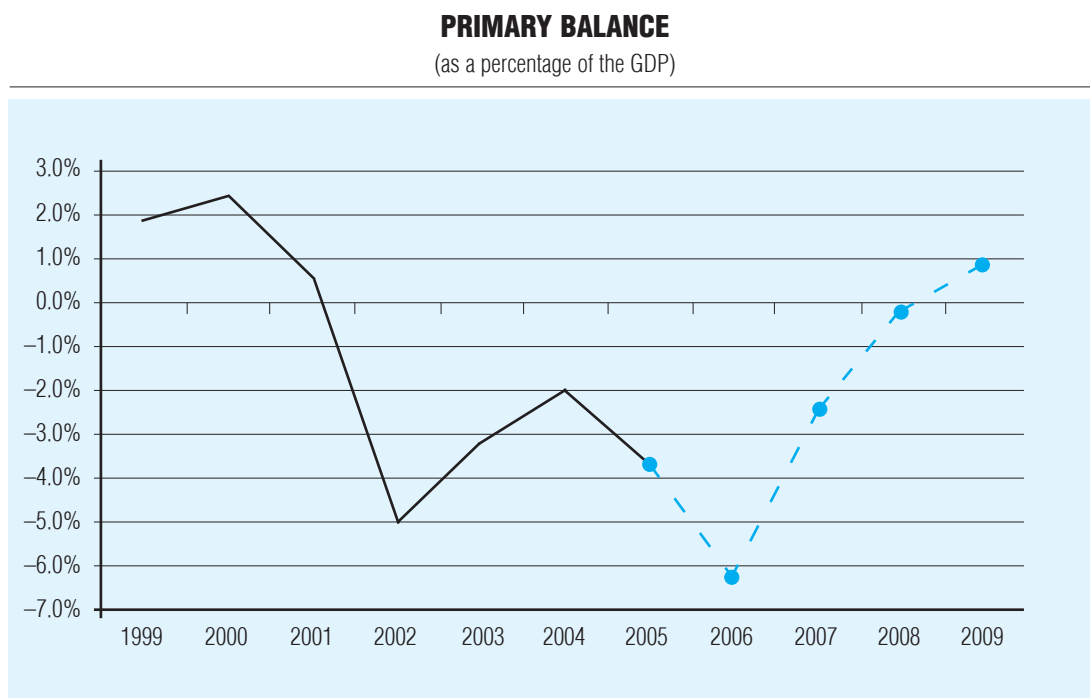
The system of reserves in public finances will be modified in 2007. While chapter reserves were allocated in addition to general budgetary reserves in earlier times, two further reserve elements will be added to the system this year. In addition to the provision allocated to cover streamlining and the development of a new public service personnel policy, a balance-related reserve is also introduced at the level of chapters. The latter can only be used on meeting the chapter-level budget plans. Accordingly, as opposed to the aggregate HUF 70–80-billion reserve of the previous years, a total of HUF 225 billion is allocated in the budget for 2007, which approximately amounts to 1 percent of the GDP.

In our opinion, the following three factors guarantee reduction of the budget deficit for 2007:

- the decisions that yield increased revenues also in the short term were already passed in the last quarter of 2006;
- as opposed to the previous, extremely unfavourable practices, in the areas where only draft decisions are available, no savings are considered (e.g. consumer price compensation);
- a significant amount of chapter balance reserve is available, with strict rules of application.

In addition to these guarantees, savings amounting to 2–2.5 percent of the GDP can be “taken for granted”. Beyond that, further decrease in the deficit will also be feasible, if the promises made to Brussels are kept as scheduled in the convergence programme. In 2007, the deficit may fluctuate within the band of 6.5–7.0 percent.

Figure 4

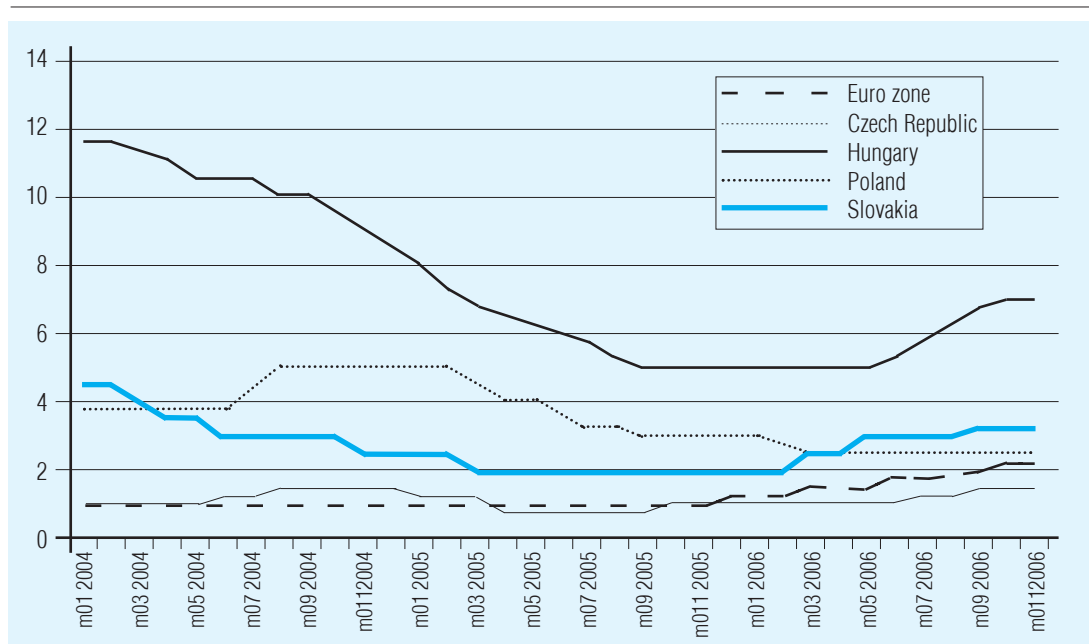


Source: Eurostat, Ministry of Finance

Figure 5

CENTRAL BANK DEPOSIT INTEREST DYNAMICS

(at month end)



Note: the central bank deposit interest rate disclosed by Eurostat does not necessarily equal the “standard interest rate” of the particular country, but is fixed to it.

Source: Eurostat

Due to the considerable deficit accumulated in 2006, public debt also rises significantly. The GDP-proportionate indicator that in 2005 did not reach 60 percent is expected to reach 65 percent in 2006, and to keep on growing in 2007, and approach 68 percent. The primary balance – according to the convergence programme – may become positive again in 2008, which means that an opportunity for debt reduction will only be available at the end of this decade. (See Figure 4)

Considering the draft of and the debate on the budget, as well as earlier commitments, we consider the new deficit predicted by the government for 2006 to be feasible; this is why the deficit calculated as a percentage of the GDP according to ESA95 may be somewhat over 10 percent. Gradual implementation of the rebalancing and reform measures is a realistic objective, which may result in the deficit for 2007

being reduced to 6.8 percent of the gross domestic product.

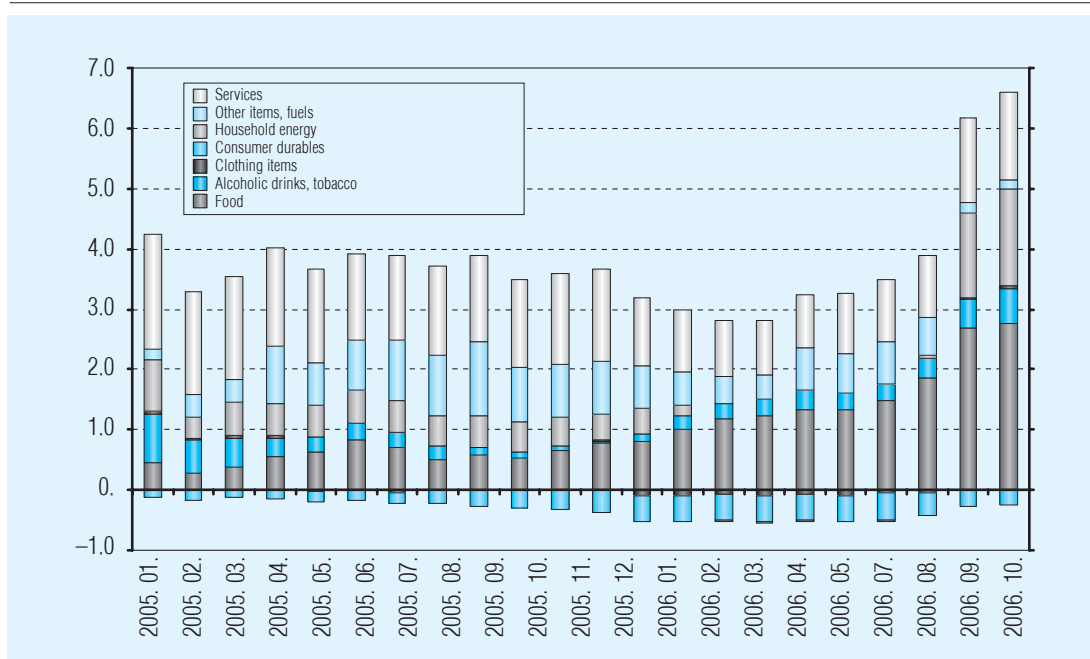
Monetary policy

Due to the increasing exchange rate volatility, the growing need of the public finances for financing, and the inflation pressure, the central bank base rate in 2006 rose from 6 percent to 8 percent. Our country has the highest interest level in the region. Beside a stabilising forint, the medium-term inflation pressure is still high, which causes the standard interest rate to decrease slowly. (See Figure 5)

In the short term, the exchange rate fluctuation is still definitive. The exchange rate change that also reflects the trust of foreign investors still restricts the movements of the central bank.

Figure 6

CONTRIBUTION OF KEY GROUPS TO THE 12-MONTH PRICE INDEX



Source: Central Statistical Office (KSH)

Inflation

The first six months of last year were still characterised by strong deflation. The 12-month consumer price index in the first quarter was between 2 and 3 percent, which represented a historic low point in the inflation rate in March. In the first few months of the summer, the price increase of seasonal foods slightly raised the price index. In the autumn, however, following the announcement of the controlled price increases specified in the New Equilibrium Programme (gas price, VAT rate increase, change in the excise tax), the rate of price index jumped above 6 percent. (See Figure 6)

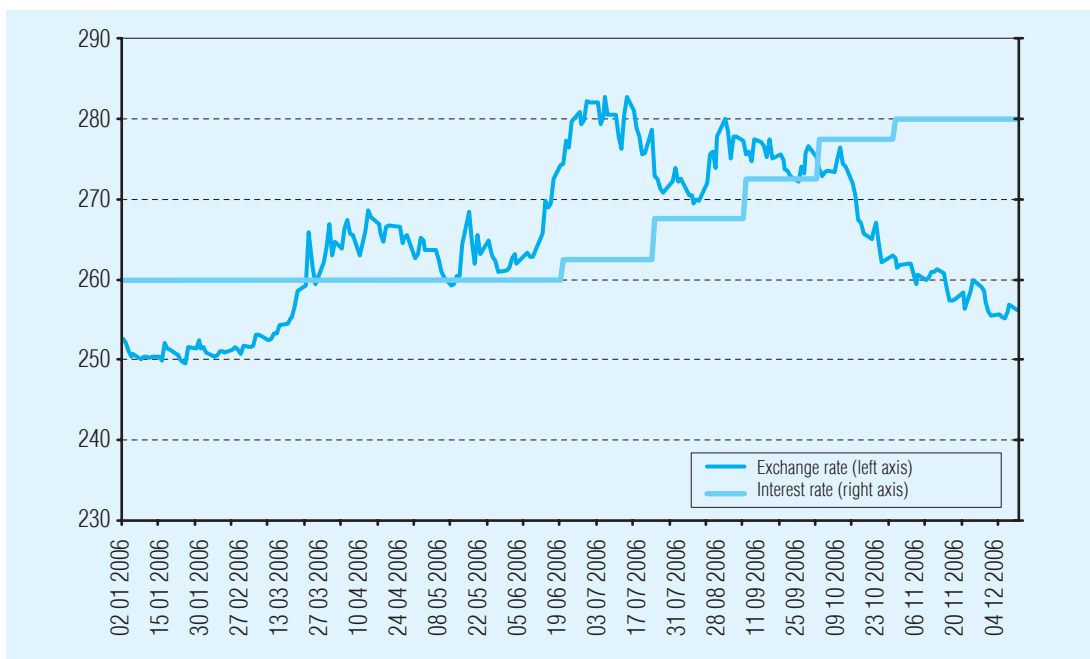
Two typical tendencies can be discerned to be underlying the price increase of products and services. On the one hand, it is apparent that food prices went up before the measures were announced, and the rate of price increase did not slow down later, either. On the other

hand, controlled price increases also raised inflation through direct and indirect effects.

In the past few months, almost every food product has become more expensive. Typically, the prices of meat, meat products, dairy products and cereals rose as of the end of summer. Exceptions to this are vegetables, where a considerable price increase took place at the beginning of the year (above 30 percent), while the rate of price increase declined in the second half of the year. The price rise was the lowest in the category of coffee, tea and refreshments. The jump in the price index in this product group did not come as completely unexpected, as prices were expected to jump as a result of the low price indices of the past years, the easing of competition (primarily through imported products) and the rising costs. The increased price level is expected to reach another equilibrium state in mid 2007, and in the second half of the year the rate of price rise will slow down again.

Figure 7

THE FORINT/EURO EXCHANGE RATE AND THE CENTRAL BANK BASE RATE



Source: MNB

The controlled price increase affected the price of food through a changed VAT rate and the price of household energy through the gas price rise. 1.6 percent of the 6.4 percent consumer price index in October was already owed to the more expensive household energy. At the beginning of the year, further central price measures will be taken, which will push the inflation rate up even at an annual level.

Among consumer durables that have represented a decreasing price index for years, no price rise is expected for 2007, either, and the index is anticipated to converge to zero. The year-end strengthening of the forint continues to diminish the price rise in this product group, which basically consists of import. For other items, primarily clothing products – according to earlier experience – the multiplying effect of the controlled price rise will be strong, which may result in an increased price index.

In 2006, inflation remained below 4 percent at an annual level, owing to the low price

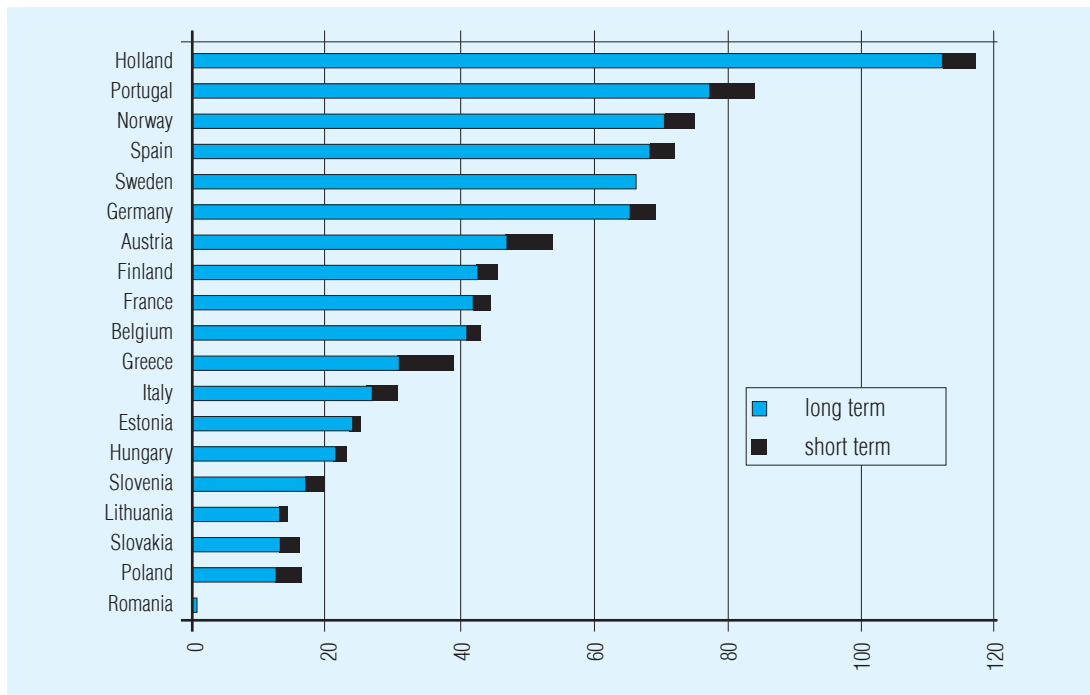
indices at the beginning of the year. This is how an average price increase of 3.9 percent exceeding that of the previous year was achieved. As the resultant of the abovementioned tendencies, inflation in 2007 will exceed 6 percent. At an annual level, a price rise of 6.4 percent is to be expected.

Exchange rates

The exchange rate of the forint took a unique course – departing even from the central European currencies at times – between the spring and the autumn. In the wake of the competition of promises staged before the elections, the growing need of public finances for funding, as well as the domestic political tension mounted in the autumn, the forint followed a roller-coaster track, and considerably weakened against the euro. The situation started to normalise in early October, after the

Figure 8

SHORT- AND LONG-TERM BORROWINGS OF HOUSEHOLDS AND NON-PROFIT ORGANIZATIONS
(as a percentage of the GDP in 2005)



Source: Eurostat

details of the convergence programme sent to the European Commission became known. The rise of the central bank base rate supported this process, and in early December, the forint was back near the level it reached at the beginning of the year. (See Figure 7)

The domestic currency is expected to move in a band of 250–260 forint/euro. The New Equilibrium Programme presented in June, as well as the convergence programme tabled in early October and renewed on 1 December laid the foundations to a permanent decrease in the deficit, which was of paramount importance from the aspect of foreign investors (lenders). Guarantees for cutting deficit are visible – even in the short run (tax increases adopted, provisioning, price subsidies changed). The basic principles of a consistent public finance reform are mostly missing as yet, which leads to the tension lingering on in 2007. The first turning point

is anticipated for the spring when the European Commission issues an opinion on the results achieved to date. If the report is favourable, relaxing of monetary policy will be justified.

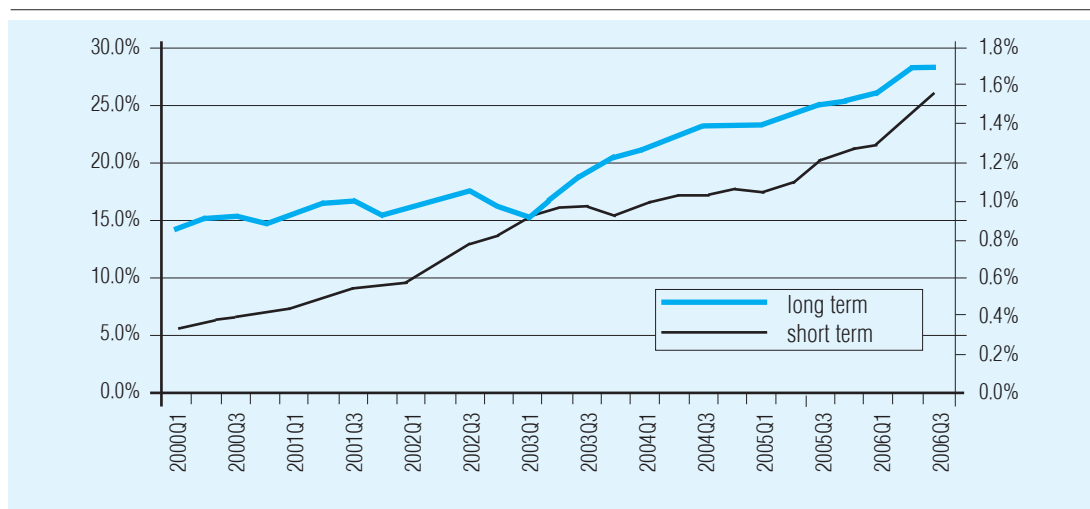
The central bank base rate of 8 percent as of the end of 2006 will decrease less probably at the beginning of this year and more probably later. At the end of 2007, the interest rate paid on two-week central bank deposits may drop to 6–6.5 percent.

Balance of payments

The deficit of the current balance of payments reached EUR 3 billion as early as in the second quarter of 2006. The balance of services and goods is more favourable, while the balance of income was more adverse compared to the corresponding period of the previous year.

Figure 9

THE RATIO OF SHORT AND LONG-TERM LOANS AS A PERCENTAGE OF FINANCIAL ASSETS



Source: MNB

The need for external financing will decline in 2007 owing to the decreasing need for funding of public finances. The borrowings – the need for external financing – of households are expected to decrease later. This means that foreign borrowings – following the logic of twin-deficits – will diminish at a more moderate rate compared to that of the public finance deficit. The question is when private consumption, or consumer loans borrowed, reaches a ceiling where the efforts made to smooth out consumption and the deteriorating real wage position become incompatible.

Based on international comparisons, it is seen that the domestic retail borrowings are still below the level of western Europe and also that observed in some of the eastern European countries. (See Figure 8) What was apparent from the Q3 data of 2006 was that the volume of long-term loans (basically related to property purchase) increases at a declining rate, while the volume of short-term (consumer credits) remains dynamic. (See Figure 9)

Retail borrowings are expected to decrease as of mid 2007. This will improve our need for external financing, which leads to a decreasing

deficit of the current balance of payments. The capital transfers from the European Union also result in a more favourable position. In total, the current balance of payments for 2006 may be reduced from an annual 7.1 percent to 6.1 percent by the end of this year, in proportion to the GDP.

DEVELOPMENT OF THE REAL ECONOMY

The basic tendencies of foreign trade will hardly change in 2007, and the growth will continue to be dynamic. The difference between the growth rates of exports and imports will decrease. Based on international and domestic processes of production and goods turnover, it is seen that exports in 2007 will grow by 11 percent and imports by 9 percent. The demand for imported products will be strong, chiefly as a result of expanding investments, with only a slight increase in domestic use.

The conditions of the global economy are favourable to meet the objectives of balance and to keep the economy in motion. The current business cycle of the global economy

reached its climax in mid-2006. According to the predictions given by international organisations and institutions, the growth that has been going on for four years may yield an expansion above 5 percent this year. In the next eighteen months, the growth rate may drop a few tenths of percentage points. The external conditions of business activity will remain favourable on the whole, and the growth rate of the global economy in 2007–2008 will approach 4.5 percent. The tendencies of the global economy are similarly promising. The international trade volume in this year will exceed that of the previous year by 9 percent. Turnover in the next two years is also expected to undergo strong intensification.

In the last months of the year, the price increase of oil came to a halt, and it seems to stabilise around USD 60–65 per barrel. The prices of raw materials and base materials will permanently go up, particularly as a result of the intensifying east Asian demand. In order to offset the inflation pressure, the correction of low interest rates will continue. The period of interest raise may soon be over, and growth will advance to become an increasingly perceptible priority in the economic policy of leading countries.

At the end of November 2006, the dollar had the weakest exchange rate against the euro in the past eighteen months. The pair consisting of a strengthening euro and a weakening dollar is a primary consequence of American macro-economical results less favourable than expected. The intensifying European growth and the stuck series of American interest rises support the strengthening of the euro.

Growth in countries considered to be the engines of international economy was slightly above earlier expectations in the first half of 2006. In Q1 of 2006 a 3.7 percent annual growth was recorded in the United States of America, which decreased to 3.5 percent by Q2, and to 3 percent in Q3. In 25 EU member

states, output compared to that of the previous year increased by 2.9 percent in Q3, and by 2.7 percent in the euro zone. Economic performance in Japan in the same year was fluctuant, and the economy of the islands is expected to expand by 2.7 percent over the year. The dynamic development of the new EU accession countries continued. A few of “the ten” recorded a growth above expectations.

The autumn forecasts of international organisations estimate the growth of global output for 2006 at 5.1 percent. International analyses and business activity assessments predicted slightly decreasing dynamics in the economy for 2007, the International Monetary Fund assumes a 4.9 percent, and the European Commission's forecast a 4.6 percent rise in production, whereas analysts expect slightly more intensive growth for 2008. The business activity indicator calculated for the global economy was fluctuating all year at a high level and in a narrow band. The business activity indicators of OECD predict a slow increase in the economy. It is also perceivable from predictions that the business cycle of international economy followed a descending branch in the second half of 2006. Owing to the strong fundamentals, the loss of pace will not be intense in the next eighteen months.

The domestic business activity assessments conducted by Ecostat indicate improving business prospects in the last months of 2006. The confidence indicators reached their lowest point in September, while in October and November, the optimism of businesses gradually improved. The slight reinforcement of confidence suggests that the majority of companies have recovered from the shock caused by tax increases and measures reducing demand, and they assess their short-term development opportunities more calmly and realistically.

For the first few months of 2007, large companies take account of difficulties and tensions

building up both in the macro-economy and their own businesses. On the market side, 52 percent of large companies consider expansion of their production as a realistic opportunity at the end of 2006. Small and medium sized enterprises assess the situation of the national economy as relatively favourable. Optimism is rising also in terms of assessing their own prospects. In the opinion of this group of companies, the development of small companies is mostly restricted by the expected reduction of real wages and real pensions, and the limited domestic purchasing capacity. Both groups of companies evaluate export possibilities as positive.

Development ideas are different with the two groups of companies. The confidence of large companies has improved; approximately two thirds of them plan to perform perceivable development to their companies. The willingness of small and medium-sized enterprises to invest is stagnating at a low level.

A dynamic growth in the accumulation of gross fixed capitals was broken in the spring of 2006. Intense growth was seen in *investment projects* in the first quarter, at a rate over 10 percent, in the second, however, a 3.3 percent decrease, and in the third a 4.1 percent decrease took place compared to the corresponding period of the previous year. For 2006, stagnation (a 0.4 percent decline) is considered for investment projects. The loss of impetus in terms of fixed capital formation is a transitory phenomenon, and an inevitable consequence of an economic policy emphasizing the re-establishment of balance.

The previously high rate of state-owned motorway constructions was reduced in 2006, the willingness of the production sector to improve was restrained over the year, retail property developments lost impetus, only a slight improvement is expected in the field of production investments. Diminishing demand is indicated by a permanent and significant drop in the number of applications submitted

on residential construction, as well as a diminishing and low volume of orders in the construction industry. It is a favourable phenomenon that the growth of construction works and machinery procurement is starting to balance.

The declining pace of and a subsequent temporary drop in investments took place earlier and more powerfully for government plans and banking forecasts; a considerable drop in the pace of developments was expected by 2007. According to our calculations, a gradual intensification of investments is expected as of 2007, the foundations of which may be provided by the expansion of EU resources, the influx of operating capital, and the improvement of the macro-economic balance.

In the past two years, significant developments have been implemented and efficient capacities have been put into use in the processing industry, which ensured the extension of production in 2006. The investment projects in the sector in 2006 are expected to stay 5–6 percent below those in the base period; this raises concerns in terms of the 2007 production and export. The improvements of the medium weight commerce in the first nine months of the year rose by 10 percent. Based on market information, the maintenance of a fast development is to be considered. Developments providing electricity supply are still delayed, progress is represented by minor rationalisation developments. Construction of waterworks, gas and public utilities is going on at a good pace. The agricultural warehouse construction programme was completed in the first half of the year, and the development of machinery and equipment is going on at a low level; the volume of 2006 investment projects is expected to lag behind that of the previous year, 2005, by 10 percent.

The investment projects of the public service providing sectors grew unsteadily in the first nine months of the year, by a total of 4.5 percent. Education development and health care

maintenance were allocated 3.3 percent and 7 percent more than a year earlier respectively.

The volume of investment projects may rise in 2007; extension of EU funds, a significant amount of operating capital and a gradual increase of entrepreneurial investments are considered. As a combined effect of these factors, the growth of investment projects in 2007 may reach 3–4 percent.

The property market was characterised in the medium term by intense growth, in the past few years the development became balanced, the growth rates declined, the development and the turnover of various property types were different. Based on the medium term tendency and expected conditions, a moderate growth is considered for the property market, developments will be differentiated by property group. The ECOSTAT Property Barometer's index in the third quarter of 2006 was 42.7 percent, which is approximately 4 percentage points lower than that of the previous quarter, and, in total, it suggests further slackness of the property market. Supply exceeds demand, and the volume of new developments decreases with only a few exceptions. The sales periods become longer, prices hardly rise, stagnate, or at times decrease for used property.

In the market, tendencies are different by property type. Performance figures in the residential property market, which constitutes the crucial volume, started to decline in the first half of 2006. In the market of newly built flats, similarly to 2006, a drop is expected in this year; however, flat renovations are permanently expanded, generally coupled with upgrading investments. In terms of used flats, excessive supply is and will be strong. The gloomy forecast of the residential property market is supported by a drop in residential building permits, which reaches 20–30 percent. The volume of residential property construction in 2006 is below the result of 41 thousand of the previous year. In this year, 33–35 thousand flats are predicted to be put in

use. In the next years, the results of residential property construction are expected to keep declining; approximately 30–32 thousand new flats will be delivered in 2007.

In the office market, significant developments are expected until the end of 2007, while demand will only grow moderately, with a low utilisation rate. The majority of investment projects are still implemented in the capital city. The market of commercial properties will remain lively, with the centre of gravity for development transferred to towns outside the capital. In the warehouse market, demand will primarily grow for logistical facilities.

In the opinion of the prevailing market actors, property construction and sale may surge in the medium term, and the consequences of the earlier boom in property construction and sale will affect the next few years. Demand may change to various extents and in various directions by property type. The perceptible drop in the residential property market may be followed by a gradual saturation of the office market. For the time being, the continuous expansion of commercial and warehousing facilities is not endangered by market restrictions. Prices and rental fees also change in a differentiated way, the rate of price increase will be relatively low due to a relative saturation of the markets.

The added value of *agriculture* in 2006 was 6–8 percent below the value measured in the previous year. The revenue realized in the sector will be higher than that in the base period. The volume of gross domestic product from agriculture and fisheries in January – September lagged 7.5 percent behind the previous year's figure. The performance of crop farming declined slightly above the average. The output of animal farming is stagnant, no significant movements are seen in the sector compared to 2005. The transformation programme of the sectoral structure has been produced for the medium term, focussing on restoring the balance of crop

farming and animal farming, and on satisfying the need for raw materials in bioenergetics. The implementation of this programme requires a high level of prudence, as a conflict of interests may emerge between animal breeders and the actors of bio-business. The rapidly growing demand for cereals is expected to send prices soaring, which animal breeders will not be able to manage, consequently, animal farming may increasingly lose ground.

Intervention procurement had a considerable role in raising crop prices. As a result of an extremely good harvest and a buyers' market, Hungary has been the EU member state that keeps the largest crop reserve for two years. In the past two years, 8.1 million tons, 26 percent of the 31 million ton domestic harvest was procured in the framework of the intervention. Until September 2006, one quarter of the procured crop was sold, three quarters are in stock. The shortage of warehouses was terminated by the beginning of the new intervention phase.

The sale of agricultural products saw a continuing tendency of decline in 2006, and stayed considerably below the previous year's results. The sale of livestock and animal products representing over 60 percent of the full sales came to 4 percent less compared to 2005. The import of meat increased considerably, partly due to prices being below the domestic ones, and partly due to the defect of quantity.

The price level of agricultural products in the first three quarters of 2006 grew by 9.4 percent in comparison with the previous year. The price level of plant products and livestock rose by 16 percent and 3.5 percent respectively. The respective price rise of vegetables and fruits was 18 percent and 17 percent compared to one year earlier. The foreign trade turnover of agricultural products and products of the food processing industry in the first eight months grew by over 11 percent. The increase of exports was repeatedly below imports, the balance of trade was positive, at a value of EUR 410 million. In

this period, the highest sales revenue was represented by the export of meat and meat products, in addition to cereals and cereal products. Imports were dominated by protein fodder and meat products.

The investment activity in agriculture in the first nine months of 2006 was slack, and no upsurge was seen in the fourth quarter either. The volume of investment projects in the examined period was 9 percent below the previous year's figure. In the third quarter, the rate of decrease exceeded 14 percent. The drop in improvements is related to the diminishing central resources. Over the year in 2006, a lag of 5–10 percent was seen in fixed capital accumulation in comparison to 2005.

In 2007 and 2008, growing EU funds will have a favourable effect on investment projects and profitability, and may trigger a long urged development of animal breeding. The overwhelming weight of plant farming will be sustained permanently, due to biofuels gaining ground. According to the draft budget, HUF 456 billion is available to be applied to agrarian and rural development in 2007.

The penetration of bio-based fuels may generate a new industrial-energetic raw material producing sector within agriculture, the role and significance of the agrarian sector may gain more weight among the branches of agriculture, and its contribution to the GDP may also increase.

The volume of retail commerce in the first three quarters of 2006 exceeded the level of one year before by 5 percent. The turnover increase gradually slowed down over the year, the 6 percent growth of the first quarter was followed by a 4.5 percent increase in the autumn months. The growth of retail sales was high in an international comparison, twice the rate of the EU average.

The turnover of motor vehicles and spare parts was stagnant in the second quarter of 2006, and dropped by 3.5 percent in the third.

The turnover for nine months grew by a slight 2.7 percent. The sales of fuels over the one-year period elapsed showed a high rate of increase, irrespective of the extremely surging prices. The converse changes in motor vehicle purchases and fuel consumption balances each other, and had no perceivable effect on the sectoral indicator.

The expansion of turnover in the commerce of used articles, medicine and clothing items was above the average. The medicine turnover representing a significant ratio over the year 2006 achieved an outstandingly high and even growth of turnover (between 12 and 14 percent).

In the moderately slowing tendency of sales in 2006, the negative impact of the budget rebalancing measures on solvent demand was felt already. Expert forecasts predicted an improving disposition to buy for the year-end, and indeed, consumer spending was only moderately affected by forced saving. Based on all these, a turnover growth between 4.5 and 5 percent was implemented over the year in 2006, calculated at unchanged prices. As of the first months of 2007, however, a gradual decline of shop sales is expected, and approximately 2.4 percent annual growth of retail turnover is considered.

The two-year dynamic expansion of *tourism* lost some impetus in 2006, and the results of the first three quarters are below those of 2005. Passenger traffic is still lively, but the duration of stay and the average spending is gradually decreasing. Between January and September 2006, 30 million foreign tourists visited Hungary, which is 6 percent more than a year earlier. Three quarters of the guests are holiday-makers or transit passengers, and only stayed one day in Hungary. The number of visitors spending multiple days here has decreased by 8 percent over the year.

Foreign visitors spent HUF 726 billion in Hungary in the first nine months of 2006, of which visitors spending here more than a day spent HUF 545 billion, i.e. 75 percent of the

total expenditure. The decrease in the number of visitors staying for more days lead a decreasing income from tourism. The declining demand for accommodation was seen in terms of the most significant western European visitors, where the specific spending is above the average. The attraction observed in the period of accession to the EU has diminished by today, marketing campaigns launched in time brought modest results, and the appeal of cheap discount airlines for passengers has perceivably deteriorated.

In three quarters of the year, the Hungarian population travelled abroad on 12.8 million occasions, which is 7 percent below the figure of one year earlier. The number of visitors staying for more days decreased at a rate above the average. Exit passengers spent HUF 423 billion on services, i.e. 12 percent less than in 2005. This facilitated an improvement in the asset-generating role of tourism in the balance of payments.

The modest inland touristic activity of the Hungarian population in 2006 was characterised by a moderate growth. The total spending and accommodation expenses increased. Those travelling for five or more days spent HUF 40 billion, which represents a 6 percent and a 2 percent growth in terms of current prices and volume respectively, in comparison to the previous year.

In 2006 added value in tourism increased only to a moderate extent, and employment and investment performance also improved somewhat. The growth of domestic tourism likewise slowed down as a result of shrinking solvent demand. In 2006 tourism grew by 0.5%. It contributed to the improvement of the equilibrium of the balance of payment chiefly due to slack outbound tourism. We expect an increase in the performance of domestic tourism beyond the average. In the 2007 season we do not expect any significant change in performance.

Industrial growth in the whole of 2006 was favourable. The gross output of the sector in the first nine months grew at a rate exceeding 10%. Value added in industry grew by 9% thanks to the significant excess output of the processing industry. Immaterial manufacturing in the first quarter grew by 12%, in the second by 7.3%, and in the third by 8.7%.

Performance increase in the processing industry came primarily from the chemical industry and the machine industry sectors. Production in the national economy sector began to increase with monthly volume growth exceeding 10% compared to the same period in the previous year. From a demand point of view the dynamic growth of the processing industry is primarily due to the 13.7% growth of exports. Domestic sales, too, ran up somewhat compared to previous years, expansion of nine months amounted to 5.7%. Manufacturing of electric machinery, and instruments, representing 0.4% of processing industry exports rose by approximately 20%. Vehicle manufacturing managed to increase its exports from 25% by further 15.5%.

The approximately 5% dynamics of domestic trade is a quite new phenomenon. Indicators next to stagnation were typical in this area earlier on. Monthly statistics indicate that growth of domestic sales swung over the local peak, and the growth rate was continuously dropping to reach 3.7% by September. Dwindling domestic sales are ascribable mainly to measures announced halfway through the year. One has to take account of the fact that the actual effect of the adjustment will begin to be felt toward the middle of 2007 in the months after current orders are delivered.

European growth stimulates industrial growth, which helps the maintenance of the high rate of export sales. The reality of that expectation is supported by previous export orders and optimism voiced by the corporate sector.

All the above fuelled expectations that the 2006 growth of industry would slightly increase, and preliminary statistics actually prove a 10.5% growth rate. 2007 output will come under the effect of several opposite factors: the moderate lowering of domestic sales volumes may continue, while the dynamics of export will remain at the same level until mid 2007, and will likely shrink in the second part of the year. As a combined effect of these, industrial output is expected to produce a surplus of 6–8% in 2007.

The boom in the *construction industry* has been characterised by a two-digit growth over the last 2–3 years. The boom peaked in the middle of 2005, and in the last quarter the growth rate shrank to around 10%. In 2006 dynamic growth was followed by stagnation, and then gradual setback partly as a result of the demand limiting effect of the stabilisation measures.

In the first three quarters of 2006 the output of the construction industry dropped back by 2.1% compared to the same period last year. The growth rate followed an unbroken downward trend in 2006 the only exception being March. The trend continued more intensively in September when a setback of 4.8% was registered on the same period in the previous year. In the product group called buildings, the first nine months saw a situation close to stagnation, while with other constructions setback was conspicuous probably due to the lost momentum in motorway constructions.

The average delivery time of contracts in the construction industry was 1.5–2.5 years. The demand generated by bulging order-books in late 2004 is soon coming to an end these days, and that effect cannot be offset by the low volume of new orders. Demand in the construction industry has been on a downward course.

Due to the volatile nature of order-book sizes, and the re-scheduling of roads and

motorway constructions, and the uneven base effects the output of the construction industry in 2006–7 can only be estimated with an error margin larger than the average. In 2006 the output of the construction industry will be 2–3% less than originally assumed computed from current tendencies. By 2007 the shrinkage is expected to move in the 3–4% band.

The value added by *transportation, warehousing, post and telecommunication* grew by 3.1% in the first nine months of 2006. The weight of goods transported grew by 6.4%, and the number of kilometres per ton of goods doubled, i.e. to 14.1%. The distance of road transportation is continually on the increase. The number of passengers in long-distance passenger transportation hardly changed since 2005, and the number of kilometres per passenger grew steadily by 7% for three quarters of the year. Air transport is gradually gaining ground, in 2006 it had a share of just below 30%.

Based on market tendencies, goods transportation, and warehousing is expected to rise by 3% in 2006. In 2007 the performance of the transportation sector may exceed the 2006 level by 2–2.5 percentage points. Public road development projects are progressing at different rates, surplus performance may reach 10%. Railway development is expected to gather greater momentum in 2007.

The technical standards and output of telecommunication and IT are rising continuously and at a high pace, thanks basically to intensive technical research and development. Subscriptions to broadband Internet are increasing at a medium rate, while the number of landlines is dropping. Mobile telephone subscribers grew by 157 thousand in the third quarter, and in September the number of subscribers per 100 inhabitants reached 95.4. The annual pace of growth is ever more slack as the market is becoming saturated.

The market of Internet services is strongly

concentrated. The number of service providers is in excess of 200 while 19 firms control 90% of the market. Restructuring among Internet subscribers has speeded up. Especially cable subscriptions are spreading fast. Wi-fi is likewise rapidly gaining popularity, with over 180 thousand subscribers it has reached a share of 16%. Net sales from Internet services in the third quarter exceeded 22 billion HUF, 39% higher than in the previous year.

In 2006 post, telecommunication, IT are growing at a favourable rate, the value of services rises by 3–4% at comparable prices. In 2007 in that sub-branch the expected development and growth rate equals that in 2007.

Economic activity of the population improved slightly in the past year. In the period June–September 2006 the number of economically active persons increased by 30 thousand. Within the active population the employment count grew by 20 thousand and the unemployed count by 10 thousand. In the age band of 15–74 the activity rate amounted to 55.3%. In 2006–2007 no significant improvement of the activity rate can be expected. Some increase may derive from the rising number of working age unemployed persons.

The average employment count in 2006 grew by 24 thousand on the first nine months of 2005. The employment rate continues to be low at 51.1%. In September 2006 there were 2791.4 thousand persons in full time employment. That number is virtually unchanged compared to the same period in the previous year. There were 1.8% less people working for budgetary organisation than in September 2005, and the employment rate in the competitive sector rose by 0.5%. The business sector cannot absorb larger numbers, while there are plans to dismiss 15–20 thousand people from public administration. Serious efforts are being made at finding employment for them, yet part of the labour shed will remain out of work. In 2006–2007 no palpable improvement is expect-

ed in employment. With downsizing in the public services sector dropping employment rates seem a more likely forecast.

The average number of unemployed in the first three quarters was 318.3 thousand, 10 thousand more than in the previous year. The unemployment rate in accordance with the last report equalled 7.5%. Compared to the 5–6% of previous years that is an apparent rise, approaching the EU average. The unemployment count may further increase in 2006 and 2007 to a small degree to reach 7.8% by the end of the year.

Earnings rose in the first three quarters of the year. Gross average earnings increased by 7.7%, and net average earnings by 8% than one year before. Real earnings exceeded previous

year's by 4.8% in the first nine months of the year at a 3.1% inflation. We expect that real revenues will grow at a pace slower than real earnings. Its rate in 2006 was around 3%, and by 2007 real earnings may drop by 3.5% likely resulting in lowering living standards of large groups of society.

Using services has an increasing role in consumption by the population, in excess of 40%. The volume of services rises at a pace slower than that of goods. In 2006 private consumption expanded by about 1.6%.

The savings rate of households has been following an unbroken downward tendency over the last years, but rose in 2006. No correlation can be demonstrated between savings and earnings. Cash savings by the population amounted

Table 1

DECEMBER FORECAST BY ECOSTAT CONCERNING THE DEVELOPMENT OF THE HUNGARIAN ECONOMY

(change compared to the previous year, at comparable prices)

Indices	2004	2005	2006 expected	2007 forecast
Gross domestic product (%)	4.6	4.2	4.0	2.5 – 2.8
Final consumption of households (%)	3.1	3.8	1.6	0–0.5
Community level consumption (%)	0.9	0.2	–4.7	–1.1
Gross accumulation of fixed assets (%)	7.9	5.6	–0.4	2.5
Export (based on national accounts %)	16.4	11.6	15.7	10.8
Import (based on national accounts %)	13.2	6.8	10.5	9.0
Balance of foreign trade (billion EUR)	–3.9	–2.8	–2.5	–1.4
Annual consumer price index (%)	6.7	3.6	3.9	6.4
Balance on current account (billion EUR)	–7.5	–7.6	–6.3	–6.2
Direct capital investment (billion EUR)	4.0	4.1	4.0	4.1
ESA95 balance of Public finance as a percentage of the GDP	–6.5	–7.4	–9.6	–6.6 – –6.8
Unemployment rate (%)	6.1	7.2	7.6	7.8
Gross average earnings (%)	6.1	8.8	7.5	6.5
Industrial production (%)	8.3	7.3	10.5	7.0
Output of the construction industry (%)	6.8	16.6	–1.5	–3.5
Total volume of retail trade (%)	5.7	5.6	4.8	2.5
Deposit interest (two week CBH) ^{a)}	9.5	6.0	8.0	6 – 6.5
ECOSTAT growth index ^{b)}	47.84	47.9	48.0	49.0
ECOSTAT Real estate barometer	50.8	47.4	47.0	46.5

Note:

^{a)} at the end of the year

^{b)} quarterly average confidence of TOP-100, SME businesses and the population

to 20 thousand billion HUF until September 2006, rising 6.6% on the end year value of 2005. The structure of savings is rather rigid, the ratio of savings in cash and in deposits is above 35%, while securities continue to be quite low. Total borrowings by the population were above 6 thousand billion, that value is 20% more than the corresponding value at the end of 2005. The borrowing rate is around 26–27% of the GDP, not high even by international standards. For 2006 we expect a 5–6% increase in savings, and 20% in private borrowings. For 2007, however, we prognosticate the moderation of the two above financial services.

The financial effect of the New Equilibrium Programme concerns almost all social groups to varying degrees. Families with low income are provided with a variety of assistance in the transition. One of the most important effects to be introduced as already as September is the 5% rise of the middle rate of the VAT. That is a major burden on households with children and working age persons. The significant increase of energy prices in 2006 and 2007 compensated by Government through gas-price subsidies to those in need. From September 2006 the health

insurance contribution of employees grew from 4 to 6%. The health contribution increased from 6 to 7% from January 2007, resulting in a 1% increase in nominal earnings.

Besides measures to improve equilibrium the implementation of reform programmes also accelerated. From among programmes of a social implication mainly in education and health the measures already taken are continuously followed by further steps aimed at adjustment, and convergence. (see Table 1).

LONG-TERM PROSPECTS

Our long-term forecasts refer to the period 2008–2015. In the models applied in the estimates we use annual figures as they have been developed specifically for the macroeconomic analysis of longer periods⁶.

The internal and external set of conditions of the model corresponds to the most recent convergence programmes approved in September 2006. Even though it does not give a date for the introduction of the EUR, in model computations we have assumed a fixed exchange rate

Table 2

MAJOR MACROECONOMIC PARAMETERS

(growth index at unchanged prices, in percentages)

Name	2008	2009	2010	2011	2012	2013	2014	2015
Gross domestic product (GDP)	4.5	3.9	3.4	4.3	3.7	4.3	4.7	3.9
Final consumption	2.7	2.7	2.5	2.5	2.7	2.8	3.6	3.0
Private consumption	3.0	2.9	2.9	2.6	2.8	2.9	3.7	3.2
Community level consumption	0.5	1.0	0.0	1.4	1.9	2.4	3.4	1.4
Gross fixed asset accumulation	6.0	8.1	6.8	5.9	5.1	5.6	3.3	4.1
Gross accumulation	6.2	8.4	7.0	6.1	5.2	5.7	3.3	4.1
Domestic use	3.6	4.2	3.8	3.5	3.4	3.7	3.5	3.3
GDP export	5.5	8.2	7.6	7.1	7.0	7.1	7.2	7.2
GDP import	4.6	8.6	8.1	6.4	6.9	6.6	6.2	6.9
Inflation	4.0	2.7	3.0	3.0	2.9	2.9	2.9	3.0
Balance of public finance as a percentage of the GDP (ESA)	-3.9	-2.7	-2.1	-1.8	-1.4	-1.7	-1.5	-0.8

Source: ECOSTAT – ECO-Trend-modell

of 270 HUF from 2011 onward which, from the point of view of the model is equivalent to replacing the national currency at a given time and exchange rate. We have likewise assumed that by 2010 interest levels will converge to the value characteristic of the Euro zones.

In accordance with estimates by the ECO-STAT the gross domestic product will reach a growth rate of 4.5% by 2008, and will oscillate around 4% by the end of the period under review. The dynamics of private consumption remain below that during the whole period, and in community level consumption we expect growth to be even more modest. The growth of accumulation of gross fixed assets will speed up again from 2008 persistently exceeding the pace of GDP growth. We expect some slack by the end of the period, by which time, however, a high rate of accumulation may build up in the Hungarian economy, which is an indispensable ingredient of the convergence process. Our

forecast suggests that the growth rate of export and import as indicated in the GDP-balance will stabilise in the 6–8 percent band, and net exports may remain in the positive range for most of the period under review. That results in the gradual improvement of the balance of foreign trade and the rise of its ratio compared to the export GDP. (*see Table 2*)

In accordance with our model computations the Hungarian economy can deliver the most important criteria for the introduction of the Euro by 2009. That suggests that the ESA-based deficit of public finance and the inflation may likewise drop below 3%, and the levels of yield investigated will converge with values of the Euro-zone. The level of public debt will, however, quite probably exceed 60% of the GDP even in 2009, which, however, will be a downward tendency by that time, and will not be an obstacle to the currency replacement as soon as possible.

NOTES

¹ The termination of the almost forgotten shortage economies and their concomitant phenomena, the right of private property and enterprise without any limitation of scale, influx of the global technological and cultural novelties, the removal of any obstacles in maintaining personal and economic relations with foreign countries, the establishment of parliamentary democracy.

² The explosive growth of unemployment, the erosion of state services, the significant decrease in and spectacular emergence of extreme differences in average consumption, the spreading of crime, the moral crisis of society and politics.

³ What is generally meant by stabilisation is principally a lasting halt in external indebtedness, i.e. the deficit of the current balance of payments not to exceed the amount of capital influx, a gradually decreasing ratio of state expenditure compared to the GDP, decreasing public debts and a harmonised deficit of the public finances, as well as achieving a single-digit inflation.

⁴ According to the Maastricht criteria, the current deficit of the public finances cannot exceed 3% of the GDP, and the gross public debt 60% of the GDP; in addition, these indicators should converge with the above ratios on a continuous basis. Inflation and interest on long-term loans cannot exceed an average of the three EU member states that achieve the lowest inflation by more than 1.5 percentage points and 2 percentage points respectively, which currently represents an inflation rate around 3 percent. The Hungarian forint should be able to participate in the exchange rate cooperation mechanism among member states, which, among others, excludes the possibility of an official devaluation in the two years preceding the accession.

⁵ What is meant by modernisation is to make the structure of a controlled economy similar to those in developed market economies – practically in the states of the European Union. No exact criteria are defined for this, as there are considerable differences in the operation of certain market economies, due to the traditions, development, particularities or the

chosen economic policy. In addition, the countries selected as examples are also changing; it is sufficient to think of the consequences of establishing a monetary union, or the reform of welfare systems kept on the agenda in almost each member state. (It should not be forgotten, either, that the EU itself does not belong to the most dynamically developing regions of global economy.) As a result of the modernisation changes, in the past decade, the Hungarian

economy has, in terms of its major features, also become a European market economy.

⁶ See: Socio-Line, the model of sustainable development, *ECOSTAT September 2006*, in the series 'Methods of economic analysis', 2006/1, page 98; and the analysis of long-term growth scenarios with the Eco-trend model, *ECOSTAT, November 2004* in the series 'Methods of economic analysis', 2004/1, page 84

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