Government of the Republic of Hungary

UPDATED CONVERGENCE PROGRAMME OF HUNGARY 2005 - 2008

Budapest, December 2005

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1 Introduction

In accordance with Council Regulation (EC) 1466/97, the Hungarian Government hereby submits to the Council and the Commission the updated version of the Convergence Programme. The updated programme was prepared with due account paid to the requirements on the content and format laid down in the above regulation as amended by Council Regulation (EC) 1055/05 and in the revised Code of Conduct endorsed by the Council in October 2005.

The updated Convergence Programme, approved by the Government at its session of 30 November 2005, was based on the Budget Bill for 2006 submitted to the Hungarian Parliament and, similarly to the updated programme of December 2004, covers the period of 2004-2008. Commitment to the consistent implementation of the convergence programme is increased by the broad dissemination and discussion of the programme. To that end, following its acceptance by the Government, Parliament will be informed about the programme as usual. The positive feedback of Parliament and strong legitimacy are of utmost importance, as the implementation of the programme will span across several government terms.

The programme shows general government data on an ESA basis. It should be noted, however, that, taking into account the transitory period granted in Eurostat Conclusions of 23 September 2004 (Eurostat News Release 117/2004) and similarly to the practices of several Member States, the mandatory, fully funded pension funds are classified inside the general government sector in the updated Convergence Programme.

1.1 Economic policy framework and objectives

The Hungarian Government devised its medium-term economic policy in accordance with the Broad Economic Policy Guidelines applicable to Member States. Following the guidelines will ensure that the Hungarian economy achieves fast convergence, thereby accelerating the economic and social cohesion of the EU.

The medium term economic policy objectives of Hungary include the maintenance of the fast pace of economic convergence, which is conditional upon the continuous and gradual reduction of the general government deficit.

The Government strives for a medium term, gradual adjustment in the general government deficit without unjustified output loss; on the contrary, it should contribute to fast economic convergence by expanding the financing possibilities of the private sector. In respect of economic growth, not only the maintenance of the fast pace but also its healthy structure are priorities. The main driver of dynamic growth continues to be exports and investments. The price stability, prudent wage and budget policy characterising the forthcoming period will ensure sustainable growth of consumption.

In order to achieve its medium term economic policy objectives, the Government adopted structural measures in the framework of the "100 steps" programme announced in the summer of 2005. The elements of the "100 steps" that are relevant for the convergence programme and have medium and long term effects serve partly to enhance the potential growth and partly to organise public services more efficiently, with higher quality and greater cost-efficiency. The government's policy goals for growth and employment are presented in the National Action Programme.

Within the measures adopted in the "100 steps" programme, the improvement of competitiveness and employment is promoted by the five-year reform package of the tax and contribution system. Additional revenues resulting from the enhanced tax discipline and the broadening of the tax and contribution bases mitigate the revenue reducing effects of this measure. The measures taken in the field of employment aim primarily to increase employment, to reduce the burdens on labour, to strengthen incentives to work and whiten the grey economy. As a result of the measures promoting adult vocational education, the Hungarian labour force will become more adaptive to challenges posed by the changing economic environment. The measures implemented in health care play a major role in improving the population's capacity to work. The purpose of measures to modernise the heal care benefit system is to provide effective services with improving quality and continuously adapting to changing needs.

2 Economic situation in 2005

Since 2001, the two-percentage-point growth differential of the Hungarian economy as compared to the EU average appears to have stabilised. This promotes the fast convergence of the country to the average level of development of Member States. The conditions for economic convergence in a sustainable structure were created by the economic policy shift started in 2003; its favourable effects are apparent in 2005 as well, and promote the achievement of a long-term balanced growth path. In 2005, the output gap continued to narrow, and is only slightly negative. Macro-economic developments moved fundamentally along the path outlined in the programme of December 2004, which indicates that the modification of the general government deficit target, attributable mostly to accounting reasons, had no demand increasing effect.

Economic indicators annual percentage change (%)

	2004	2005	
	fact	CP December 2004*	expected
GDP	4.6	4.0	4.2
Household consumption	3.1	3.0	3.0
Gross fixed capital formation	8.4	7.3	7.5
Exports of goods and services	16.4	11.0	10.2
Imports of goods and services	13.2	10.7	8.1
CPI	6.8	4.5	3.6
Employment	-0.5	0.9	0.2
Unemployment rate (%)	6.1	5.9	7.3
General government deficit (in % of GDP)	5.4	3.6**	6.1

* GDP and its components without the allocation of FISIM
** figure included in the March 2005 Council opinion on the 2004 December convergence programme update

As a result of the external economic environment, which showed a gradual improvement, albeit at a slower-than-projected pace, the Hungarian economy has continued on its export- and investment-driven growth path. The increasing diversification of Hungarian export markets also supported this growth path. Backed by improved external environment, investments in the manufacturing sector continued to expand vigorously, and the dynamic motorway construction also contributed to the fast investment growth.

Following a setback in 2004, employment expanded at a slower pace in 2005 than originally projected in the December 2004 programme. However, intra-year developments have indicated a trend-like increase of the participation rate since the beginning of the year. This is primarily attributable to a large portion of the inactive population re-entering the labour market. Some of the inactive persons that appeared as job seekers in the first half of the year found employment in the second half, which is shown by the increase in the number of employed and the stagnation of the unemployment rate.

The growth of household consumption in 2005 is in line with the December 2004 projection. This rate is essentially the same as in the previous year, but the volume growth of this year is accompanied by substantially lower nominal wage growth and inflation.

> In October 2005, the CSO revised the 2002-2004 GDP figures, because, in compliance with Council Regulation 448/98 EU and the Commission Regulation No. 1889/02. EU, it switched to the new methodology for the allocation of the financial intermediation services indirectly measured (FISIM). Financial intermediaries, on the one hand, charge fees directly to consumers for banking services, and on the other hand, they extend other services without explicitly charging fees. In case of indirect fees, the fee for the service is recovered by the financial intermediaries from the difference between the interest rates of loans and deposits. Before October 2005, the FISIM items were not allocated to sectors and industries actually using the services; instead, they were recorded in a nominal sector as services provided to the entire national economy in the form of intermediate consumption.
>
> As a result of the new methodology, both the GDP figure at current prices and its growth rate increased in the affected years. As from now on FISIM will be allocated to final consumption and to net exports, nominal GDP will naturally increase at the approximate rate of 1-1.5 percent according to the observations of Eurostat. In case of Hungary, the impact real GDP growth results from the fact that the ratio of loans and deposits to GDP has been increasing continuously in the past period. We expect the role of financial intermediaries to increase in the forthcoming years as well; therefore the new calculation method is also likely to have an impact on real GDP growth in the future.
>
> While growth was 2.9% in 2003 and 4.2% in 2004 without the allocation of FISIM, the new methodology changed those figures to 3.4% in 2003 and 4.6% in 2004. The year 2004 figures were also altered by the fact that the CSO replaced the previous, preliminary GDP figure with a new one reflecting a higher degree of data processing.
>
> The methodological change and the more detailed figures of last year did not change the GDP growth structure substantively: growth is still driven by exports. In 2004, household consumption rose from the previous 2.5% to 3.1%, and the growth rate of investments and of exports also increased significantly. Gross fixed capital formation rose by 8.4%, instead of the previous 7.9%, and export by 16.4% rather than 14.9% in 2004.

The favourable export growth and, in the first six months, very low import growth, partly attributable to temporary factors, brought about a significant improvement in the foreign trade balance, and the foreign trade deficit for the entire year is expected to be lower than last year. The current account balance to GDP ratio is also expected to improve for the whole of the year, while the external financing requirement will decline even more due to increased capital transfers. Within external financing, the role of net FDI inflow is expected to continue to grow.

In order to achieve the general government deficit target, the Government, in line with the Council recommendations of 8 March, adopted measures during the year to increase revenues and reduce expenditures. The Eurostat decision in September stating that the new motorway construction financing arrangement, included in the year 2005 budget, cannot be recorded outside the government sector, added close to two percentage points to the deficit of this year. An additional change, amounting to approx. 0.5 percent of GDP, resulted from revenue shortfall and additional expenditures in case of some items driven by automatisms rather than the decisions of the Government. On the whole, the general government deficit for 2005 will be 6.1% of GDP.

The rate of inflation will be more favourable in 2005 than originally projected, mostly as a result of the intensive disinflationary trends started at end-2004. The inflation curbing effects of strong competition are present both in the productive and commercial sectors. The favourable disinflation process was slowed down by the inflationary effect of international energy prices, but did not come to a halt; therefore it continues to be present in the second half of the year. This is detectable mostly in the core inflation indicator: it fell below 2% after mid-year. For the whole of 2005, a consumer price increase of 3.6% is expected.

The exchange rate of the Forint was typically stronger than 250 HUF/EUR for more than one year, between early July 2004 and early October 2005, with the exception of May 2005. Since early October, the exchange rate has been only a few Forints weaker than that level. This has contributed significantly to the lasting deceleration of inflation and the attainment of the inflation targets for this year and next year.

3 Macro-economic objectives and forecast

The long-term objective of economic strategy continues to be modernisation and the convergence of the economy to the EU-15 average. Recent economic developments indicate that the growth structure is sound, exports and investment growth being the driving force of the economy. This year, growth is expected to reach 4.2% - with the new methodology of allocating FISIM -, while it comes close to 4% with the old methodology. From among the main courses of action, the expansion of employment and the strengthening of competitiveness and the ability to attract capital continue to be of utmost importance. For the updating of our macroeconomic forecast, we have taken into consideration recent changes.

3.1 External assumptions

For the forecasts concerning the external environment, the Convergence Programme starts from the assumptions of the Commission. The autumn forecast of the Commission reckons with continued dynamic growth of the global economy in the next two years. The favourable growth of the global economy is promoted by low real interest rates as well as the rapid growth of China, India and the oil exporting countries. Global trade will continue to expand significantly, following the outstanding results of 2004, throughout the time horizon of the forecast. The growth of the European Union will slow down temporarily in 2005, but it will resume its potential growth path during 2006-2007. The growth impulse is caused mostly by the strong expansion of domestic demand, but the pickup of net exports will also contribute to the improvement.

The outlook is favourable, but there are significant downward risks around the central forecast. One cause of uncertainty is the impact of high oil prices on business and consumer confidence. Even though the forecast reckons with oil prices higher than originally projected, even above the year 2005 levels, the possibility of a higher price level cannot be ruled out. On the other hand, on the positive side, the oil exporting countries may create additional external demand as a result of their higher revenues, a significant part of which is satisfied by the European Union. The increasing global current account imbalances present further risks. A potential adjustment may have a negative impact on EU exporters and may cause swings in the financial markets.

3.2 Cyclical developments

In line with the commonly agreed methodology, potential GDP was estimated based on the Cobb-Douglas production function. Due to the shortness of the time series calculated with the allocation of FISIM, calculations were prepared for the old time series, without FISIM allocation. According to experience, the allocation of FISIM with the new methodology causes, on average, a 0.4 percentage point additional growth for actual GDP growth. Plausibly, the growth rate of potential GDP changes with the same magnitude, therefore we assume that the methodological change has no substantial effect on the size of the output gap.

Cyclical developments

	2004	2005	2006	2007	2008
GDP at 2000 year prices (growth rate, %)*	4.2	4.0	4.1	4.0	4.0
Potential GDP (growth rate, %)	3.9	4.0	4.1	4.2	4.1
Factors:					
Labour	0.4	0.4	0.4	0.4	0.3
Capital	1.8	1.9	2.1	2.2	2.3
Total factor productivity (TFP)	1.7	1.7	1.6	1.6	1.5
Output gap	-0.2	-0.1	-0.1	-0.2	-0.2

*without the allocation of FISIM

The output gap turned negative in 2003, and will remain slightly below zero until 2008, while the potential growth of the Hungarian economy may be around 4 percent in the entire period. On the other hand, according to the calculations of the Commission, the Hungarian output gap will assume a relatively high negative value between 2002 and 2006, turning slightly positive after 2007. The difference between the two calculations is also substantial in respect of potential growth. According to Commission calculations, potential output increased by 4,5 percent per annum in the second half of the 90's, then it declined gradually to around 3.5%.

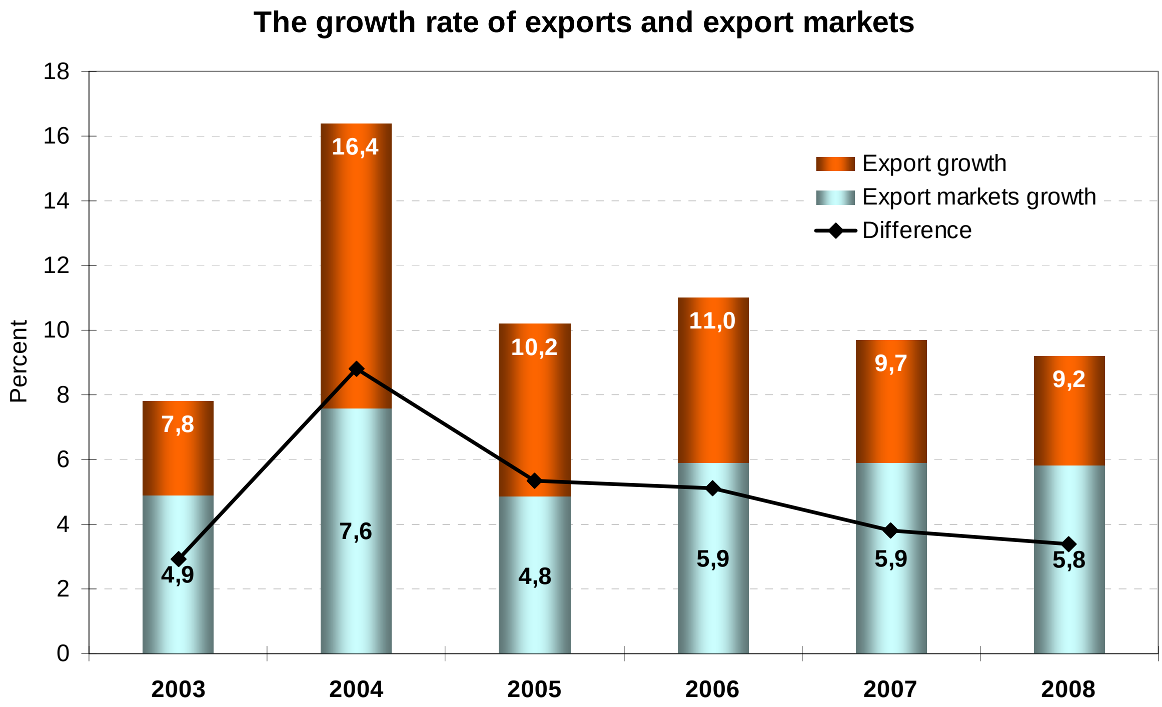
The difference between the two calculations results primarily from the different assumptions used in respect of labour and the total factor productivity (TFP). The assumptions for the decline of the active-age population are very similar, but the Convergence Programme forecasts a more positive development of the participation rate than the Commission does. Taking into account the values typical for converging economies, the annual TFP growth is also slightly higher in our forecast than in the Commission's estimate. According to the forecast in the Convergence Programme, the net capital stock, taking into account depreciation, will expand continuously due to dynamic capital formation, contributing significantly to the performance of the Hungarian economy.

3.3 External demand and exports

For the projection of the demand of Hungarian export markets, the Convergence Programme took into account the import demand of 10 developed countries and our 5 major Eastern European partners. Accordingly, following the fast growth of 2004 and the poor performance of this year, our export markets will show a medium growth rate in 2006-2007. The import demand of the EU-15, in particular Germany, which play a major part in Hungarian exports determines the growth rate of our export markets.

In the forthcoming years, the driving force of growth will continue to be exports, along with investments. The export forecast is based primarily on the forecast of the external demand. The growth of Hungarian exports has exceeded the expansion of our export markets for years, but the growth differential is expected to decrease in the longer term, as our convergence progresses. Alongside the EU-15, and in particular Germany, the share of new Member States and non-EU European countries has been increasing significantly in our exports. The export markets of Hungary have become more diversified, the share of the EU-15 countries in Hungarian exports declined by almost 10 percentage points between 2002 and 2005. The assumption of export growth exceeding external demand is also supported by the intensifying inflow of foreign capital and the creation of new export capacities.

On the other hand, the exploitation of the economic upswing presupposes improved competitiveness, greater ability to attract foreign direct investment, as well as the promotion of market diversification and tourisms.



3.4 Employment

In the forthcoming years the Government implements an employment policy which enhances the willingness of the active-age population to take on employment while at the same time increasing the number of jobs and further improving the qualification structure and the adaptation of the labour demand. These objectives are promoted by the measures taken in the framework of the "100 steps" programme this year. As of November 2005, the system of unemployment benefits has changed and the job-seeking assistance was introduced, with intensive job search being a precondition for its payment. To increase labour market activity, occasional employment became more flexible, and its legal background more secure, as of 1 August 2005. The expansion of employment is also promoted by the measure whereby the monthly flat-rate health contribution decreased from HUF 3450 to HUF 1950 from November 2005, and it will be eliminated after November 2006.

The transformation of the vocational training system will play a major role in the adjustment of the qualification structure to the labour market. As of 2006, the training of skills in shortage will be supported, and a system of performance measurement for trade schools will also be developed. In the entire adult training system, only those institutions will receive supports which prove that a sufficient proportion of persons participating in the training can find jobs utilising their new skills.

In addition to the above measures, the Government also assists in the employment of career starters in the framework of the START programme. In order to facilitate job search, the government assumes part of the public dues payable by the employer in the first two years if career starters are hired. In order to increase the growth, competitiveness and employment of the SME sector, in case of net headcount extension, the Government supports the enterprises – with less than 250 persons – with full contribution exemption from 2006. The condition of the allowance is that the hired persons have to be at least for 3 month registered as job-seekers, and the employer has to guarantee the employment for a further year. This subsidy affects some 500 thousand entrepreneurs, 340 thousand companies and 60 thousand non-profit organisations.

The measures are expected to appreciably increase the participation rate of the 15-64 age group: from 60.5% in 2004 to 62.7% by 2008. For the entire period, a 2-2.5% increase in employment is expected.

Given the gradual increase in employment and assuming a 3-4% productivity growth, the growth rate of GDP may be steadily above 4%.

Employment annual percentage change

	2004	2005	2006	2007	2008
Number of employed persons	-0.5	0.2	0.3	0.8	0.9
Productivity growth	5.2	4.0	4.0	3.2	3.1
Unemployment rate, %	6.1	7.3	7.1	7.0	6.9
Participation rate, %	60.5	61.4	61.6	62.0	62.7
GDP growth	4.6	4.2	4.3	4.1	4.1

3.5 Income and consumption

In line with the lower inflation, the annual wage growth in the business sector will be around 7% in 2005, which is not significantly different from the agreement reached in the National Interest Reconciliation Council. In the budgetary sector, the gross average wage increased substantially faster, at approx. 12%. This is mostly due to the fact that the one-month additional salary was paid in January 2005 instead of December 2004. This sum is disclosed in the labour statistics in 2005, while the national accounts, due to accrual accounting, contain it in 2004. After adjustment for that item, the salary increase in the budget sector would be approx. 7.5%.

For 2006, the National Interest Reconciliation Council agreed on a 4-5% increase of gross average wages in the business sector. As a major progress in interest conciliation, a medium term agreement was reached on the minimum wage for the first time in Hungary. Accordingly, the minimum wage will be HUF 62500 in 2006, HUF 65500 in 2007 and HUF 69000 in 2008. It has also been agreed that a recommended or guaranteed wage minimum depending on qualifications would be introduced.

According to the submitted Budget Bill, the system of support to families with children will be altered in 2006. Concurrently with the reduction of the personal income tax benefit and the elimination of the regular child protection benefit paid by local governments, the family allowance, with eligibility as citizen’s right, will be increased substantially.

Next year the system of the 13th month pension will be completed (to be paid in two equal instalments). The programme of medium term adjustment of pensions will also be commenced.

As a result of declining inflation and lowered tax rates, the real wage per income earner will increase by approx. 4%, and household consumption by 3.5-4% in 2006. The currently projected rate of consumption growth is slightly higher than the figure in the December 2004 Convergence Programme (3%). This is mostly due to the inflation rate declining more substantially than originally projected as a result of the VAT rate cut. The present projection is close to the EU forecast (3.5%). In 2007-2008, real wages may grow in line with the productivity of the national economy, by almost 3% per annum, household consumption rising at a similar rate.

3.6 Investments

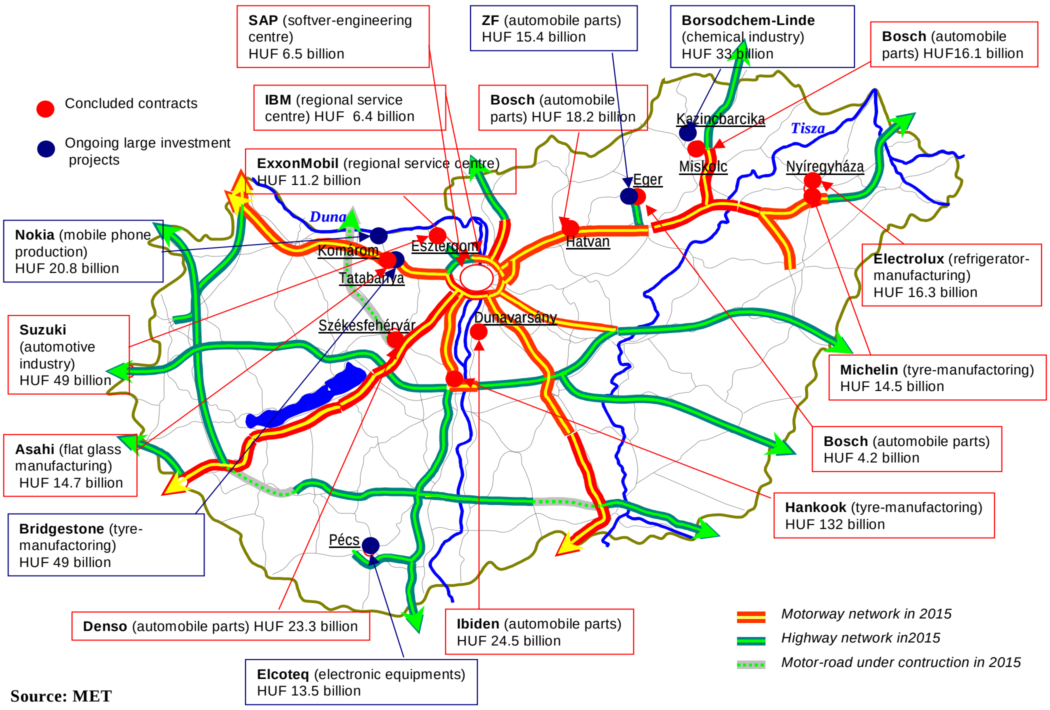
The continuous expansion and renewal of the domestic capital stock is an important prerequisite of the sustainable and fast economic growth assuring our convergence to developed European economies as soon as possible. Following the major FDI inflow of previous years, foreign enterprises tend to reinvest a significant proportion of the profits generated, and they also create new FDI investments as some suppliers of the established companies also set up plants in Hungary. As a result of the expansion of domestic suppliers, the integration of foreign-owned companies in Hungary has been deepening continuously. The fundamental objective of economic policy is to further improve the ability of the Hungarian economy to attract capital and to expand the existing foreign investment projects. The creation of an investment environment attractive to foreign direct investment is assured by a regulatory environment placing modest burdens on economic actors, the streamlining of administration, the favourable corporate tax regime, the major infrastructure improvement projects and a number of investment incentives. Another priority during the elaboration of such programmes is to exploit the favourable geographic position of the country so that Hungary can become the financial, distribution and logistical centre of the region.

The projects encouraged by the favourable investment environment are conducive to the expansion of employment, the improvement of efficiency and productivity, the evolution of an economic potential competitive both on the single European market an in the global economic environment and creating high added value, which assure the fast convergence of Hungary.

In the 2005-2008 period, EU funds that opened after accession and the related co-financing also play a major part in maintaining the investment growth. As a result of the favourable export outlook, the measures implemented in the framework of the "100 steps" programme (10% corporate tax rate cut up to HUF 5 million, gradual phasing out of the local business tax, abolition of the flat-rate health contribution, reduction of the social security contribution payable by employers) and the alignment of wage increases with productivity growth, the profitability of enterprises will improve, which in turn will increase their resources for investment.

Within investments, infrastructure projects will continue to play a significant role in the forthcoming years. By end-2007, the high-speed motorways will have been constructed along the Helsinki corridors crossing Hungary. At present, construction is ongoing on 13 sections and by the end of next year; 546 km of new high-speed roads will be added to the existing road network. As a result of the intensive motorway construction, a number of large investment projects will be implemented (Hankook, Bosch, ZF, Michelin), and capital will flow to less developed regions as well, contributing significantly to the catching-up of those regions. In addition to motorway projects, a number of investments implemented in a PPP scheme will promote the modernisation of the railways, education and health care.

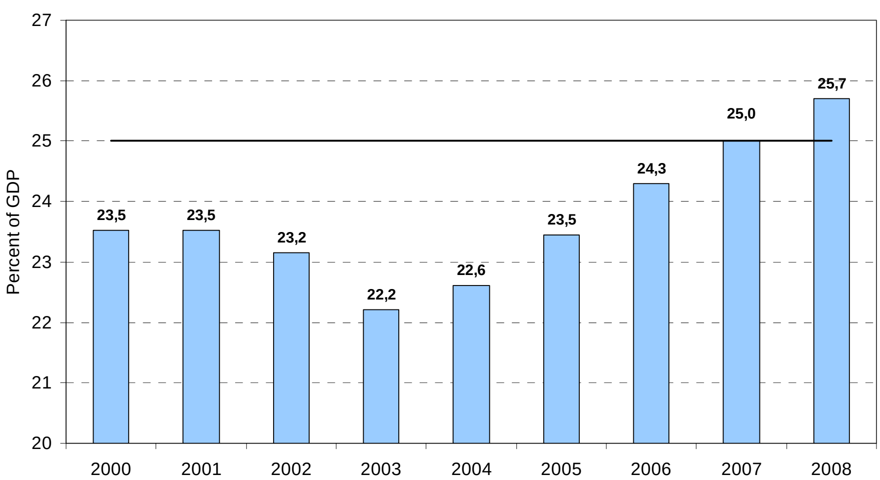
Amount of investments along the motorways under construction 2003-2010



Source: MET

These framework conditions will continue to assure that the average growth rate of 7-8% experienced between 1996 and 2004 can be sustained in the 2005-2008 period. The investment ratio continuously rising since 2004 is likely to reach the 25% characteristic of cohesion countries by 2007.

Investment ratio



3.7 Components of growth

As a result of the economic policy shift started in 2003, investments and exports became the main drivers of growth. According to the projections of the Convergence Programme, the structure of GDP will continue to be favourable between 2005 and 2008, and income and consumption growth will remain in line with the increase of productivity. The declining trend of government consumption is one of the results of the programme of more effective and cost efficient public administration and public services.

GDP components annual percentage change

	2004	2005	2006	2007	2008
Household consumption	3.1	3.0	3.7	3.0	3.2
Government consumption	0.9	1.4	-3.0	-1.5	-1.5
Investment	8.4	7.5	7.5	7.1	6.6
Domestic consumption	*2.8*	*2.6*	*4.2*	*3.9*	*3.9*
Exports (goods and services)	16.4	10.2	11.0	9.7	9.2
Total demand	*8.6*	*6.1*	*7.4*	*6.7*	*6.6*
Imports (goods and services)	13.2	8.1	10.7	9.3	8.9
GDP	*4.6*	*4.2*	*4.3*	*4.1*	*4.1*

In terms of the growth path, there is no significant difference between the outlined macroeconomic path and the autumn forecast of the Commission. The Commission prepared its forecast relying on the old methodology, i.e., without the allocation of FISIM, therefore its GDP growth forecast is lower than the one presented here, with a projected 3.9% GDP growth both for 2006 and 2007. The entire difference is explained by the different methodologies, as the nature of the growth structure (export and investment driven growth) is identical in the two forecasts.

It is appropriate to base the Convergence Programme on the so far presented growth path which can be fulfilled safely, while projections for different growth paths were made as well. If this year's substantial FDI inflow is to continue, then investment growth is expected to persistently stabilize around 8 percent in the medium run. As a consequence, the more rapid expansion of employment and the establishment of new production capacities enable an enhanced export performance. Export growth can be promoted by the proceeding shift of external trade towards the fast growing markets. Assuming a consistent income policy, household consumption rises faster than in the baseline scenario only due to increasing employment. The economic growth – among these conditions – achieves 4,5 percent along the whole forecast horizon. Faster economic growth facilitates the improvement of the external and the internal balance, as well as the accomplishment of the Convergence Programme.

If external conditions – the growth of our major partners – in the following years develop more unfavourably than the projections, then the economic growth of Hungary might somewhat slow down. If exports grow more moderately than in the baseline scenario, it will have an adverse effect on employment and investment. These processes might notably affect the economic growth of 2007-2008, the increase of GDP might be 0,5 percentage points lower than in the baseline forecast. Such a growth path would affect the revenue side of the budget negatively, but - taking into account the low level of the sensitivity coefficient (0.21 %) - the impact on the deficit would be marginal.

3.8 External balances

As a result of the significant increase in corporate investments with high import needs and in exports, import growth will accelerate again after 2006. In the forthcoming period, an import growth close to that of exports is expected, therefore foreign trade deficit will remain unchanged in the medium term.

In the current account, the factors that worsened the balance in prior years disappeared by 2005. As a result of real economic processes, no deterioration of the balance is expected in the coming years and a surplus will be generated in the turnover of services after 2005-2006. The increase of the deficit of the income account is a natural consequence of the fact that the volume of profits increases continuously as a result of the continuous growth of the stock of direct investment and the efficient investment of capital. The nominal deficit of the current account will show only a modest increase, while its ratio to GDP will gradually decline.

Because of the expected continuously growing surplus of the capital account, the trend of the external financing need, which shows the aggregate balance of the current and capital accounts, gives a more accurate picture of the external balance than the current account does. The annual financing need as a percentage of GDP will decline from almost 9% in 2003 to 5% by the end of the period. The structure of financing will also change: debt-creating financing will be reduced as the financing need of the government declines, leaving more room for the corporate sector. At the same time, the ratio of non-debt-creating financing, including privatisation revenues, will increase. Net foreign direct investments are expected to reach 3.5-4% of GDP.

External financing need in % of GDP

	2004	2005	2006	2007	2008
Current account deficit	8.8	8.2	7.9	7.2	6.7
Capital account balance	0.4	0.5	0.8	1.7	1.9
External financing need	8.4	7.7	7.1	5.5	4.8
Debt-creating financing	4.4	3.4	2.0	1.2	0.7
Non-debt-creating financing	4.0	4.3	5.1	4.3	4.1
of which: net FDI	3.0	3.8	3.6	3.5	3.4
of which: reinvested earnings	2.2	2.2	2.3	2.3	2.3

3.9 Inflation

In the forthcoming period, strict fiscal policy, income policy assuring wage increases in line with productivity as well as gradually easing monetary policy applying the system of inflation targeting and cooling down inflationary expectations will play a part in reducing inflation.

Against the environment of the adaptability of the supply side and the intensification of commercial competition, the demand side is not expected to generate inflation. On the other hand, the price increase of oil (and other fuels), including transport and household energy subject to price regulation, constitute factors increasing inflation.

In 2006 the 5 percentage point reduction of the standard VAT rate will cause a one-off major drop in price levels. The effects of this are mitigated by the fact that for some products (tobacco products, alcoholic beverages, new motor vehicles) the excise tax or registration tax will be increased to offset the effects of the VAT cut. As a result of the one-off price reduction, inflation will decline to around 2% next year.

Following the drop in 2006 resulting from non-recurring factors, the rate of inflation may return to the approx. 3% value set as the medium term inflation target, which can be considered as the equilibrium rate of inflation, by 2007. The inflation rate is slightly higher than the EU average because of the fast and major change of consumption structure and also due to the peculiarity that in the service sector the productivity growth, lower than that in the manufacturing sector, is accompanied by wage increases similar to those in manufacturing, which goes hand in hand with greater price increases against the background of expanding demand and lower competition between service providers on Hungarian markets. The inflation trend of subsequent years will be driven by the economic policy toolset aiming at assuring the achievement of the conditions necessary for the introduction of the euro. Economic processes allow for the sustainable reduction of inflation and the fulfilment of the Maastricht inflation criterion.

Due to the requirements of liberalisation and market compatible regulatory practices, the role of the central government in directly influencing prices (and markets in general) will further be reduced, and regulation will only be maintained in a narrow scope, typically covering natural monopolies. Thus disinflation will occur autonomously, through market mechanisms.

Along the outlined macroeconomic path, the rate of inflation, excluding the one-off effect of the VAT change, will gradually reach the medium term level of equilibrium inflation, creating the conditions for joining the euro area.

Price developments annual average, %

	2004	2005	2006	2007	2008
consumer price index	6.8	3.6	2.0	3.0	2.4

3.10 Monetary policy and exchange rate developments

According to the Act on the Central Bank, the primary objective of the central bank is to achieve and maintain price stability. Since mid-2001, monetary policy has been operating within the inflation-targeting framework, accompanied by a wide-band pegged exchange rate system. Given the limits of the exchange rate band, inflation targets can be achieved only by the support of fiscal policy. The monetary policy instruments are essentially harmonised with those of the Eurosystem apart from the fact that the NBH applies passive rather than active-side regulation. The indebtedness of the private sector has increased, but the direct effect of the interest rate channel is weakened by the fact that the majority of new borrowing was foreign currency denominated. The indirect effect of monetary policy works through influencing the exchange rate and, increasingly, inflationary expectations. The inflationary credibility of the central bank has improved in recent years.

The Forint exchange rate may fluctuate against the Euro in a +/- 15 % band. Since the widening of the band, the Forint has always been on the strong side of the band, in the 235-271 HUF/EUR range. Among the currencies of the region, the exchange rate of the Forint produced the least volatility in the past 5 years. Since mid-2004, the Forint has been strong and stable, its volatility significantly reduced compared to the previous period.

Inflation in 2005 and 2006 will be considerably favourable, than the inflation targets set by the joint decision of the Government and the NBH. These developments allowed the Government and the NBH to set, instead of the annual inflation targets, a 3% medium term inflation target for the 2007-2009 period, being consistent with price stability for the converging Hungarian economy. The Government and the central bank will reconsider the medium term inflation target upon our joining the ERM II if the compliance with the inflation convergence criterion requires that measure.

Joining ERM II will represent an important stage of the convergence path, which is not expected to require changes in the present monetary regime: monetary policy will continue to strive to achieve inflation targets in the ERM II as well. Exchange rate stability within the band can be assured by anchoring long-term exchange rate expectations, which requires increasing the credibility of the convergence process.

4 Fiscal policy

4.1 Strategic objectives

With a view to the transitory period granted by Eurostat up to 2007, mandatory, fully funded pension funds are classified inside the general government sector. The projection was prepared accordingly. The indicators adjusted for the effect of the pension reform started in 1998 give a more accurate picture of the impact of fiscal policy. The loss of revenue due to contributions paid into the pension funds instead of the pay-as-you-go state pension insurance system causes additional deficit in the years of transition. This is automatically offset by the savings accumulated in pension funds, therefore the loss of revenue does not generate additional demand in the economy.

Effect of the pension reform in % of GDP

	2004	2005	2006	2007	2008
on deficit	1.1	1.3	1.4	1.4	1.5
on public debt	3.1	3.8	4.6	5.3	6.1

Fiscal policy continues to strive for the implementation of the adjustment in the deficit by 2008, an objective set in the previous convergence programme. However, due to the higher starting level, the correction of the excessive deficit requires greater reduction of the deficit than projected previously, at an annual 1.4 percentage points per annum, after 2006. Considering that the change of the impact of the pension reform between 2006-2008 is only 0.1 percentage point, both accounting methods indicate essentially the same deficit reduction requirement.

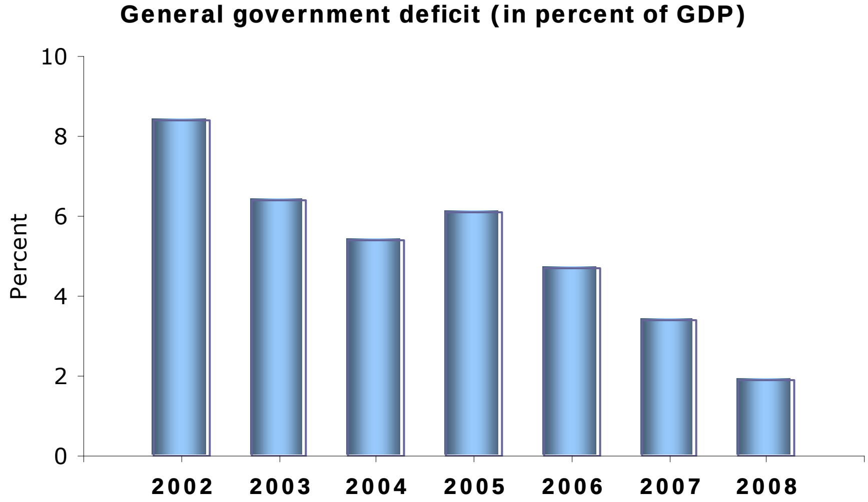
Development of the general government deficit in % of GDP

	2004	2005	2006	2007	2008
Deficit	5.4	6.1	4.7	3.3	1.9
Deficit (with the burden of the pension reform)	6.5	7.4	6.1	4.7	3.4

Since the submission of the previous Convergence Programme, the general government figures have changed significantly, mostly due to methodological and accounting reasons. In the Notification of March 2005, the revision of the accrual-based adjustment of VAT revenues increased the 2003 deficit. The Hungarian figures had been compiled with the method of adjusting cash revenues; the purpose of the fine-tuning of this method was to assure that accrual figures better comply with the requirement that they contain only items actually relating to the year concerned, irrespective of the date of cash payment. Taking into account the position of Eurostat, the September Notification contained two substantive corrections: the uniform handling of the one-month additional salary of the public sector and the re-classification of motorway construction modified the 2004 and 2005 deficit figures upwards.

The accrual-based correction of wage expenditures affected mostly the 2004 deficit. According to regulations, the one-month additional salary is payable to public sector employees in January since 2005, therefore in the previous calculation this increased the year 2005 accrual-based expenditures. However, Eurostat requested Hungarian statistical authorities to account the additional salaries paid this January for 2004. This revision increased last year’s deficit by approximately 1 percentage point as a percentage of GDP. In 2005 the new, proposed PPP arrangement for motorway construction would have improved the balance both on the revenue and expenditure sides. The reclassification of the PPP arrangement worsened the expected 2005 deficit by almost 2% of GDP, therefore this is the primary reason for the – temporary – increase of the deficit this year.

Fiscal policy played a key role in the macroeconomic turnaround implemented since 2003, the adjustment realised between 2002 and 2004 is substantial even after revision. The deficit of the government sector as a percentage of GDP declined from 8.4% in 2002 to 5.4%, or by 3 percentage points, by 2004. The adjustment will continue after 2006, the deficit will drop by more than 4 percentage points until 2008 as compared to the year 2005 level.



The deficit reduction occurs primarily through the improvement of the primary balance, which will show a surplus already in 2008, without the effects of the pension reform. As a result of the improved primary balance, the debt ratio will decline to around 56% of GDP by 2008.

According to the preliminary position of Eurostat, in 2006 and 2007 the military acquisitions (Gripen fighter planes) would increase the deficit by 0.3 percentage points as compared to the deficit figures envisaged by the Government, irrespective of the nature of the arrangement and the timing of actual payments. However, this increase merely reflects the impact of the related accounting method, while it has no effect on demand. Therefore the Government considered that it is unnecessary, and economically unjustified, to offset the temporary expenditure increase resulting from accounting reasons with additional demand-restricting measures, taking into account that this effect will cease to exist in 2008. (The Eurostat decision, expected to be issued in January, will probably necessitate data changes in most Member States because procurement or leasing in long-term financial arrangements is a common practice.)

Until 2008 more than 1 percentage point of GDP improvement is shown in cyclically adjusted term, net of one offs and other temporary measures. After 2006, motorway construction will continue in a PPP arrangement complying with the Eurostat rules, thus the investment expenditures of the general government will be reduced. Consequently, this expenditure reduction is not deemed to be one-off, as its impact will be present all through the programme period. The shift of the motorway constructions into the private sector will substantially lower the level of public investments. On the other hand, the purchase of services relating to the arrangement will appear on the expenditure side of the budget in the long term, extended over time.

Main figures of the general government* in % of GDP

	2004	2005	2006	2007	2008
Deficit	5.4	6.1	4.7	3.3	1.9
Primary balance	-1.1	-2.5	-1.5	-0.3	0.8
Structural deficit	5.4	6.1	4.7	3.2	1.9
Gross debt	57.2	57.7	58.4	57.9	56.2

*without Gripen purchasing

The deficit of the government sector, including the effects of the pension reform, corresponds to 3.4% of GDP in 2008. In accordance with the reformed Stability and Growth Pact, if the general government deficit declines substantially and continuously and reaches a level that comes close to the reference value, the net costs of the pension reform can be considered, regressively, when assessing developments in EDP deficit figures. In 2008, after 40% correction of the burden of the pension reform, the deficit will be 2.8% of GDP, which allows Hungary to be removed from the excessive deficit procedure.

The medium term budgetary objective can be identified after the correction of the excessive deficit. The improvement of the budgetary position will continue after 2008, and the deficit, in cyclically adjusted term, net of one offs and other temporary measures, will have to decline to 0.5-1% of GDP to ensure long term sustainability.

In the forthcoming years the deficit will improve parallel with the reduction of the size of the government sector; fiscal policy aims to reduce both income centralisation and redistribution. The purpose of the tax programme announced in the summer of 2005 in the framework of the "100 steps" programme is to strengthen the competitiveness of the economy by reducing tax burdens and to promote employment growth by reducing the cost of labour. Through changes in the tax and contribution system, the Government encourages the improvement of the participation rate, which is low in international comparison. At the same time, the revenues losses due to the change of tax rates are partly offset by the narrowing of tax allowances, the broadening of the tax and contribution bases and the measures taken to whiten the black-grey economy by more stringent controls.

Along with the tax programme, the balance is improved by the marked cut of expenditures. In the 2006-2008 period, the review of state responsibilities, the elimination of duplications and unnecessary activities and the establishment of a more efficient institutional system will continue.

4.2 Fiscal developments in 2005

Following the successful implementation of the macro-economic adjustment based on substantial fiscal demand restriction between 2002 and 2004 and the setting of the economy on a relatively fast growth path with a sound structure, the Government, when elaborating the year 2005 budget, did not consider any further demand restrictions justified, but it set the objective of further reducing the deficit. Therefore the continuation of motorway construction in a new, PPP arrangement would have contributed to the planned deficit reduction. The new arrangement would have improved the balance both on the revenue and expenditure sides, while the resulting deficit reduction would have had no demand restricting effect.

According to the Budget Bill for 2005, the ESA 95 deficit corresponded to 3.6% of GDP. The budget envisaged to improve the deficit primarily by curbing expenditures. In order to attain the deficit target and manage risks, a number of more efficient safeguards were incorporated into the budget and public finance acts. Of these, the setting up an extraordinary reserve to reduce risks and the imposition of the obligation to retain carried-over unspent appropriations on budgetary institutions had the most significant impacts. In addition to the general and specific reserves, the so-called general government reserve, originally budgeted at 0.5% of GDP, served to manage any risks on the revenue side. According to the act, this reserve could have been used only if the revenues are collected as expected. In order to prevent the overrun of expenditures, the Act specified that budgetary institutions could not increase their expenditures approved for 2005 by using any unspent appropriations carried-over from previous years.

The forecast of the Ministry of Finance reckoned with the fast increase of the deficit because of the effects of the seasonal factors in the first half of the year. Certain expenditures are incurred at the beginning of the year rather than evenly distributed over the year (e.g. the one-month additional salary to be paid according to law in the public sector, payment of agricultural subsidies, motorway payments, etc.); furthermore, interest expenditures are also unevenly distributed during the year. However, it also became clear in the first half-year that the main revenue items (VAT, PIT, social security contributions) are likely to fall below the budgeted levels. The shortfall of revenues was mostly due to the base effect, as the actual 2004 revenues turned out to be lower than expected during the drafting of the budget for this year. In addition, on the macro-economic side, inflation being almost 1 percentage point lower than originally projected and the slower-than-expected expansion of employment also curbed revenue growth. The shortfall of excise tax revenues was attributable to the lower-than-budgeted increase of the legal turnover of tobacco products.

In order to offset the revenue shortfalls and the risks emerging on the expenditure side (higher pension and pharmaceutical expenditures), the Government took several measures during the year to restrict expenditures and increase revenues:

- In March, the extraordinary general government reserve was set at a higher rate than originally envisaged, at approx. 0.8% of GDP, then, in view of the fact that in some areas the overrun of expenditure appropriations cannot be avoided, in June a decision was taken on definitive savings corresponding to 0.6% of GDP;
- in the field of pharmaceutical expenditures, as of 1 July 2005, active substance based flat-rate subsidies were introduced in the priority (100%) subsidy groups, and stricter sanctions were imposed on the illegitimate use of pharmaceuticals;
- in order to avoid that the expenditures of budgetary institutions increase by using unspent appropriation carried over from previous years, a government resolution was adopted early August imposing the obligation to set aside unspent appropriations on certain budget chapters;
- Revenue growth was promoted by the broadening of the social security contribution base, the increase of the flat rate tax on slot machines, the tighter control of the importation of tobacco products, and, from July, the restoring of the previous VAT imposition system instead of the self-declaration regime introduced upon accession on imports coming from outside the EU. The latter measure affects primarily cash revenues, but through the tighter tax-declaration discipline, it has a favourable impact on the ESA deficit as well;
- Furthermore, the government also intended to improve the balance of the government sector by expanding the new financing system of motorway construction: by involving more motorway constructions than originally planned as private investment projects.

Since July, the increase of the deficit slowed down substantially. The second half-year is not burdened with additional expenditures similar to the payments at the beginning of the year, while the expenditures of budgetary institutions and chapter-managed appropriations already show the effects of the freezing of the general government reserve and of the obligation to retain the level of carried-over unspent appropriations. Even though the deficit turned out to be smaller in the third quarter than the relevant monthly forecasts, in September the Government revised upwards the deficit forecast for this year. On aggregate, the tax and contribution revenue shortfall may reach 0.9% of GDP and, taking into account the risk of overrun of the normative expenditures, the change of the revenue-expenditures forecasts, even despite of the expenditure-reducing measures, will cause almost 0.5 percentage point deterioration in the deficit.

However, the greatest change was due to the fact that, in line with the position of Eurostat, the modification of the accounting for motorway construction significantly increased the 2005 deficit. The reclassification of the revenues from the transfer of the previously completed motorway sections worsened the equilibrium by 0.8% of the GDP, the investment costs of the new sections– or rather the absence of their reimbursement – have added another 1.1%. An additional 0.1% is caused by the higher interest expenditures related to motorway construction. This year’s deficit is increased marginally (by less than 0.1% of GDP) by the effects of the Eurostat decision relating to the accounting of the 13th month salaries. In aggregate, the deficit of the government sector is likely to amount to 6.1% of GDP in 2005.

4.3 Fiscal objectives for 2006-2008

Fiscal policy continues to stick to the objective of a smaller but more efficient state, concurrently reducing the size and deficit of the general government. Between 2005 and 2008, a 7 percentage point reduction of the ratio of expenditures to GDP assures the improvement of the balance by 1.4 percentage points on average per annum and at the same time allows for reducing the tax burdens.

From 2006, against the background of a fast economic growth path in a sustainable structure, the major tax bases that determine the revenues will increase slower than the GDP growth, which would result in the reduction of tax and contribution revenues as a percentage of GDP even if the tax regime remains unchanged. The effects of the five-year tax programme announced in 2005 will reinforce the decline of the revenue/GDP ratio. On the other hand, the revenue loss is partly offset by the reduction of allowances, the broadening of the tax and contribution bases and the measures taken to whiten the grey and black economy. On the whole, the ratio of tax, tax type and contribution revenues to GDP (net of the effects of the pension reform, including the contributions paid into mandatory pension funds) will be 35.5% in 2008, 3.5 percentage points down from 39% of 2005. Nevertheless, during the programme period expenditures will be reduced much more markedly in proportion to GDP, even taking into account the EU transfers increasing both the revenue and expenditure sides of the budget. Lower interest expenditures also contribute to the improvement in the fiscal balance, but the main part of the adjustment will be implemented through the reduction of primary expenditures.

In 2006 and 2007, taking into consideration the preliminary position of Eurostat, the change in the accounting for military procurement (Gripen fighter planes) may increase the deficit by 0.3 percentage points. The expected decision of Eurostat, in order to assure uniform accounting, will affect all military procurements implemented in leasing or an instalment payment arrangement which means that irrespective of the type of arrangement and the timing of actual payments, the value of the planes will increase expenditures upon their delivery. In 2008, this accounting effect will no longer be present in the deficit. This methodological change may result in the increase of the public debt by 0.1 percentage point in 2006, by 0.3 percentage points in 2007 and 0.2 percentage points in 2008, as a percentage of GDP.

Main indicators of the general government as a % of GDP

	2004	2005	2006	2007	2008
Tax, tax type and contribution revenues	39.1	39.0	37.1	36.5	35.5
Consolidated revenues	44.4	45.1	42.5	42.5	41.7
Consolidated expenditures	49.8	51.2	47.2	45.8	43.6
Primary expenditures	45.5	47.6	44.0	42.8	40.9
Deficit (without Gripen purchasing)	5.4	6.1	4.7	3.3	1.9
Gross debt (without Gripen purchasing)	57.2	57.7	58.4	57.9	56.2
Deficit (with Gripen purchasing)	5.4	6.1	5.0	3.6	1.9
Gross debt (with Gripen purchasing)	57.2	57.7	58.5	58.2	56.4

In the forthcoming years the more efficient and targeted use of public funds will facilitate the performance of state tasks despite the declining expenditure/GDP ratio. As of 2005, EU funds will play an increasing role in supplementing domestic funds. The expenditure forecast takes into account the domestic co-financing requirement necessary for the utilisation of EU funds.

4.3.1 General government revenues between 2006-2008

In November 2005 Parliament not only enacted the tax and contribution rules effective in 2006 but also adopted the amendments implementing the five-year tax programme entering into force after 1 January 2006.

The tax programme's objective is to gradually reduce public dues in five years, to enforce more consistently the principle of proportionality in taxation, to eliminate unjust privileges and to expand legal employment through whitening the economy. Promoting the interests of law-abiding taxpayers, the changes are conducive to a more fair and transparent tax regime and to improving the competitiveness of the economy.

To promote the objectives of the programme, the adopted legislation provide for the reform of every major element of the tax system.

The key changes effective from 2006 include the following:

Changes in the *value added tax* reduce the tax burden, implement EU harmonisation and narrow the scope for tax avoidance. To that end,

- the VAT rate will be reduced from 25 percent to 20 percent, the VAT on daily papers and other printed products to 5 percent;
- the prorating obligation due to general government subsidies will be eliminated;
- reverse taxation will be introduced in order to curb tax avoidance in the trade of waste materials.

In aggregate, the impacts on the revenues of the VAT rate cut are mitigated by the following changes in the *excise and registrations taxes*:
In case of the excise tax, the *excise tax* on wines will be abolished, in other areas, the tax rates

- will mostly be increased in line with the VAT cut;
- in some products (e.g. cigarettes), the increase will exceed the VAT rate cut;
- in case of fuels, they will remain unchanged.

In case of the *registration tax*, with a view to environmental considerations, EU harmonisation and the VAT changes,

- the tax rates will increase;
- the obsolescence of vehicles will be taken into account;
- the registration tax will not be included in the VAT tax base.

In the *personal income tax*, the reduction of the tax burden, the reform of the system of benefits and the approximation of the tax burdens on incomes earned under different titles will continue. To that end,

- while retaining the two-rate tax regime, the ceiling for the lower tax rate will be increased year by year, and in 2006 the top rate will be reduced from 38% to 36%;
- the family tax benefit will be incorporated mostly into the family support system, while some elements will be retained for families with three or more children, up to a specified income ceiling;
- the so-called "Sulinet" (School Net) tax credit will be available exclusively for the purchase of computers from 2006 onwards;
- the value ceiling of tax exempt fringe benefits that employers may provide will be HUF 400 thousand per annum, irrespective of the salary. The Act gives an itemised listing of tax-free benefits to be included in the calculation of the ceiling;
- the benefit for payments into voluntary insurance account will be replaced by a credit increasing the savings of the fund member, with unchanged rates and conditions;

- the introduction of the precautionary pension savings account creates a new instrument for self-provision for retirement; in the personal income tax regime a credit will be available, similar to the one applicable to contributions paid to voluntary insurance account;
- alongside the increase of the tax-exempt value limit of some employment benefits, the employer may provide certain tax-free benefits above the specified ceiling upon payment of the taxes applicable to in-kind benefits.

In the field of *corporate taxation and the taxation of individual entrepreneur*, the improvement of the competitiveness of enterprises and the reduction of the tax burden on small enterprises will continue. To that end,

- as a new element, in 2006 the tax rate will be reduced to 10 percent, up to HUF 5 million of tax base, for those who pay contributions in respect of their employees for at least one and a half times the minimum wage (or the minimum wage in the most disadvantaged regions), and make use of no tax allowances;
- as of 2006, 100 per cent of the local business tax can be deducted from the tax base;
- the value limit for tangible assets that are deductible in one sum will be doubled.

In 2006, a new tax type will be introduced: *the luxury tax*, to be imposed on high-value residential property (flats, residential buildings, detached houses, holidays homes, manors). The taxpayer is the private person who owns the residential property on the first day of the tax year irrespective of the number of owners of the property. If there are several owners, they must pay the tax in proportion to their ownership shares. If one private person owns several properties, their values are not to be aggregated. The rate of tax is 0.5 percent of the part of the value of property above HUF 100 million. The luxury tax is mandatory and imposed by local governments, and the revenues accrue to the municipal government.

In social insurance, in order to enforce the principle of equitable taxation, to create a national risk community and to reduce the burdens on employers,

- persons who, despite their high income, contribute to health care expenditures only at a below-average rate must pay a 4 percent health care contribution in respect of their supplementary income, up to HUF 400 thousand, equalling the average per capita annual health care expenditures;
- the individual health care contribution is also payable in respect of all income subject to contribution payment that used to be exempted from that obligation (second job, supplementary employment, remuneration for certain officers);
- in respect of persons not having any own income, the central budget will pay the health insurance contribution.

In the contribution system, as indicated in the Convergence Programme of December 2004, the flat rate health contribution has been reduced as of November 2005, and will be abolished as of November 2006.

On 1 January 2006 the new Act on the *simplified entrepreneurial tax and contribution regime* (EKHO) will enter into force, giving the option of simplified tax and contribution payment to private persons typically engaging in artistic activities or pursuing liberal professions, based on their choice. This new, optional mode of tax payment allows private persons and the paying agent in contractual relation with such persons to pay the personal income tax and social security contributions, at separately determined, flat rates, up to a certain income ceiling.

As a result of the above tax and contribution changes, in 2006 the ratio of tax and contribution revenues to GDP will decline by close to two percentage points. Within the internal composition of revenues, the ratio of production taxes will be lowered due to the VAT rate cut.

Tax and contribution revenues in % of GDP

	2004	2005	2006
Taxes	25.5	25.5	23.8
Of which: Tax on production and imports	16.2	16.1	14.5
Taxes on income and properties	9.2	9.3	9.2
Capital taxes	0.1	0.1	0.1
Social contributions	13.6	13.5	13.3

In the framework of the five-year tax programme the following changes will be implemented in 2007-2008:

- *interest received and gains on stock exchange transactions will become taxable* as of 2007, with exemption provided to small investors;
- in 2007 the rate of the *social security contribution* payable by employers will be reduced by 3 percentage points;
- as of 1 January 2008, *the local business tax* will be abolished, and an act will provide for the replacement of the missing local revenues.

Despite the new tax replacing a part of the local business tax and the expected expansion of the contribution base as a result of the fact that the lower contributions lead to expanding employment and whitening the economy, the tax and contribution revenues/GDP ratio will further decrease in 2007-2008. Simultaneously, internal restructuring will take place. In 2007 the weight of contribution revenues will decline and that of tax revenues will increase. In 2008, upon the abolition of the local business tax, the ratio of production taxes will decrease within tax revenues and at the same time the weight of income and property taxes will increase.

4.3.2 General government expenditures between 2006-2008

The reduction of government expenditures will allow for the envisaged deficit reduction and the decrease in the tax burden. Assuring the co-financing necessary for the utilisation of EU funds is a priority; therefore structural changes are required in other expenditure areas. (The considerations and measures to be taken by the Government are reviewed in Chapters 5 and 6.)

The Budget Bill of 2006 contains the elements of the "100 steps" programme announced by the Government, including the reform of the family subsidy system to make it more equitable, which entails re-allocations in favour of low-income groups by the reform of the benefit system. The increased family subsidies and the reduction of revenues due to tax changes are offset by the curbing of several elements on the expenditure side, which allows for the improvement of the balance. The expenditure cuts result primarily from the reduction of public sector's operational expenditures and the elimination of previously existing duplications in development programmes.

In case of budget chapters, planning was based on the appropriations reduced by the general government reserve of this year. Next year's expenditures will also be lowered by the savings resulting from the VAT rate cut and the change of the flat-rate health contribution. The increase of investment and capital expenditures is curbed by the fact that priority is given to EU-support related programmes but no new programmes financed exclusively from domestic sources will be launched. Furthermore, the motorway construction will be carried out in PPP arrangements after 2006 in compliance with Eurostat rules, thus the investments of the government sector may be 1 percentage point lower than in 2005 while achieving the same development objectives.

In order to assure compliance with appropriations, next year's budget, similarly to 2005, requires the setting aside of general government reserves and imposes an obligation on budgetary institutions to retain carried-over unspent appropriations.

Between 2006 and 2008, changes continue to focus on the reform of staff level and salary position of the public sector as well as on the establishment of a more efficient institutional system. The review of state responsibilities and the elimination of duplications and of activities deemed unnecessary will continue. Thus the aggregate cost of the wage bill and of the purchase of goods and services, as a percentage of GDP, will decline by almost 3 percentage points by 2008.

Operational expenditures of the public sector in % of GDP

	2004	2005	2006	2007	2008
Income of employees	12.8	12.6	12.1	11.4	10.8
Purchase of goods and services	6.6	6.6	6.0	5.7	5.6

With a view to the important role of government investment projects in promoting economic growth and catching-up, the adjustment cannot be implemented through holding back investments. Therefore general government investments will expand in line with GDP growth after 2006.

4.4 Public debt

In Hungary the debt to GDP ratio has been below 60% since 1999, but the declining trend of the debt ratio was reversed in 2002, growing continuously until 2005. This is due to the fact that the debt ratio decreasing effects of economic growth were offset by the debt ratio increasing impacts of interest expenditures and of the primary deficit. In the medium term, the economic policy is committed to stabilising the debt ratio below 60% and to gradually decreasing the ratio. By 2007-2008, the continuous decline of the general government's financing requirement and the gradual convergence of yields on the government securities market will assure that the debt ratio resumes the gradual trend of decline seen before 2002.

In addition to the government measures taken, the improvement of the primary balance is safeguarded by the fact that the balance was worsened by temporary factors in the 2004-2006 period, which will not be present in subsequent years. These factors include the one-off VAT revenue shortfall relating to EU accession and the debt assumption of the NA Rt. (National Motorway Rt.) in 2005-2006. Forint yields declined significantly in 2005; gradually appearing in lower interest expenditures and implicit interest rates in subsequent years, parallel with the renewal of the debt portfolio.

Apart from the accrual-based primary balance and interest expenditures, the debt ratio is also influenced by other factors (stock-flow adjustment, SFA). In 2004 the balance of SFA was zero, while in 2005-2006 it is expected to have a debt ratio reducing effect.

In 2004 there were factors working in opposite directions underlying the neutral SFA balance. The differences between cash and accruals reduced the debt ratio by 0.3 percentage points. The net accumulation of financial assets increased public debt ratio by 1.3 percentage points in total. Within that, privatisation proceeds reduced the debt by 0.8 percentage points. In 2004 valuation effects and other statistical adjustments caused a 1 percentage point reduction in the debt ratio, attributable to the appreciation of the exchange rate.

The size of the public debt is sensitive to the following factors:

- *Exchange rate effect:* changes in the exchange rate of the Forint may increase or decrease the public debt, depending on the direction of the change, through the foreign currency denominated debt representing almost 30% of the total public debt, as a result of revaluation (in the form of a foreign exchange gain or loss). A one percent change of the exchange rate, if sustained, may modify the debt ratio by 0.1-0.2 percentage points.

- *Yield effect:* A lasting 1 percentage point change in the yield curve between 2006 and 2008 would change the debt ratio by 0.11 percentage points in 2006, 0.23 percentage points in 2007 and 0.3 percentage points in 2008, while if the yield curve were to depart from the forecasted path by 1 percentage point in a single year, the debt rate would change by approximately 0.1 percentage point both in the base year and in subsequent years.
- *Effect of economic growth:* A lasting 1 percentage point departure of economic growth from the baseline scenario starting in 2005 would modify the debt ratio to an ever increasing extent: by 0.5 percentage points in 2005 and 1.9 percentage points in 2008.
- *Effect of the primary balance:* A lasting 1 percentage point departure of the primary balance from the one used in the calculations starting in 2005 would change the debt ratio by approximately 1 percentage point in 2005 and as much as 3.9 percentage points in 2008.

The HUF and foreign currency denominated government securities issued to finance the deficit and the maturing budget debt are determined by the annual financing plan of the central budget; the framework and directions for this are set in the debt management strategy approved by the Minister of Finance. The purpose of the debt management strategy is to provide funding for the financing requirement of the budget in a uniform approach, minimising costs in the long term and assuming acceptable risk-taking. For the definition of the debt management strategy, the combined assessment of risks and costs is fundamental. To that end, we apply an interrelated system of benchmarks to the entire public debt portfolio. In the forthcoming years we will continue to follow the debt management strategy outlined in the previous convergence programme.

4.5 Structural balance and sensitivity analyses

During the programme period, the growth of the Hungarian economy is expected to be around the potential rate. The output gap will remain essentially unchanged, remaining slightly negative throughout the 2004-2008 period.

According to the calculations of the Convergence Programme, the sensitivity coefficient is 0.21, that is, the balance of the general government changes by 0.21 percent upon a 1% change in GDP. The Commission reckons with a substantially higher 0.46 sensitivity coefficient. The difference is explained by the fact that the Commission took into account tax revenues of the whole economy, while the Ministry of Finance, following the ECB method, quantifies the portion of tax revenues attributable to the private economy, and uses that to weight the sensitivity of the various taxes/contributions.

Cyclical developments in % of GDP

	2004	2005	2006	2007	2008
Output gap	-0.2	-0.1	-0.1	-0.2	-0.2
General government balance	-5.4	-6.1	-4.7	-3.3	-1.9
Primary balance	-1.1	-2.5	-1.5	-0.3	0.8
Cyclically adjusted balance*	-5.4	-6.1	-4.7	-3.2	-1.9
Cyclically adjusted primary balance *	-1.1	-2.5	-1.5	-0.2	0.8

* In the programme period, the structural balance corresponds to the cyclically adjusted balance, since the projection does not reckon with one-offs.

According to the calculations, the deficit is less sensitive to changes in inflation, with a 1% additional inflation resulting in a 0.04 percentage point smaller deficit.

For interest rate sensitivity, assuming an identical change in the BUBOR and the government security yields, a 1% rise in the yield curve would increase the deficit by 0.14 percentage points.

In case of exchange rate sensitivity, assuming the identical difference of the annual average and year-end exchange rates and constant cross rates, a 1 HUF stronger exchange rate would have a negligible effect on the deficit.

5 Long term sustainability of public finances

5.1 Pension system

The sustainability of the pension system is supported primarily by the implemented or announced measures of the comprehensive pension reform launched in 1998:

- the rate of indexation of pension benefits (50 % wage increase, 50 % inflation);
- the gradual increase of the retirement age, announced in 1997 and continuing until 2009;
- as of 2009, the eligibility criteria for early retirement will become considerably stricter;
- for the calculation of the pension, the period for which the earnings must be considered will become longer year from year;
- incentives to work longer have become stronger in the pension system (higher bonus for retiring after the statutory retirement age, after 2013 contribution years for pension eligibility will enter pension calculations linearly and not regressively as before).

In the long term, the introduction of the mandatory fully funded system will improve the sustainability of the social security system significantly. Voluntary entrants of the new system and people starting their career will receive one quarter less benefits from the state (pay-as-you-go) system.

The sustainability analysis of the pension system relies on the 50-year forward-looking calculation submitted with the Budget Bill of 2006and based on the demographic forecast of the Central Statistical Office and the macro-economic projections of the Ministry of Finance. According to the forecasts, the old-age dependency ratio (ratio of the population above retirement age to the active age population) will increase from 30.7% in 2005 to 62.6% in 2050. The demographic effect will be partly offset by the rising employment rate; consequently, the ratio of pensioners to employed persons will rise from 66% to 94%.

The fully funded system will start to have a substantial effect on the expenditure side from the 2020’s. After that time, an increasing part of the newly retired persons will be members of the two-pillar system being eligible to a reduced benefit from the state pillar. According to the projections, the private pension funds will relieve the general government from pension expenditures in excess of 1.5% of GDP in 2050, as compared to a scenario without the reform.

The growth of social security expenditures is moderated by the increase of the retirement age and the indexation of pensions at a rate below the growth of GDP. Measures aiming at increasing the employment rate, whitening the grey economy and improving the efficiency of social security contribution collection help maintain the sustainability of the pension system. The ongoing enhancement of the social security contribution registration system has a similar effect. Expenditures are increased by the introduction of the full 13th month pension, and the measures aimed at correcting disproportionalities of benefits awarded before 1999 will cause a temporary increase (up to 2020).

The revenue side of the public (pay-as-you-go) pillar is affected by lower contributions of the mixed system's members. As a result, a substantial additional deficit, increasing until the 2020's, is generated in the pay-as-you-go system, as a growing part of the active population becomes pension fund member. The second most important revenue-reducing effect comes from the decreasing number of employed persons due to demographic causes. The effects on the expenditure side will show up later. The mixed system is expected to reach full maturity around 2060. Until then, the temporary deficit of the state social security system will be counterbalanced by savings (accumulation) of the same magnitude in the private pension fund pillar.

In the future, the deficit of the Pension Insurance Fund (including the temporary deficit due to the payment of contributions to the second pillar), which finances the overwhelming majority of pension expenditures, will increase steadily. After 2013 pensions will be determined on the basis of gross income and the benefits will become taxable. In 2050 the primary deficit of the pension insurance fund may reach 6.5% of GDP.

As a conclusion, the demographic trends will have an unfavourable effect on the Hungarian pension system, moderated in the long term by the measures of the pension reform in 1997. Nonetheless, the deficit of the state pension system is expected to rise, requiring an increasing contribution of the central budget.

Development of pension expenditures in % of GDP

	2000	**2005**	**2010**	**2020**	**2050**
Gross pension expenditures*	8.6	9.8	9.2	9.6	12.6
Of which: expenditures of the first pillar	8.6	9.8	9.2	9.5	11.1
expenditures of the second pillar	0.0	0.0	0.0	0.1	1.5
Number of pensioners (million)*	2.8	2.7	2.6	2.9	3.2
Of which: in the first pillar	2.8	2.7	2.6	2.6	1.3
in the mixed system	0.0	0.0	0.0	0.3	1.9

* expenditures financed by the Pension and Health Insurance Funds and their beneficiaries

5.2 Health care

Similarly to the budgets of the previous two years, expenditures on preventative health care are under strict control in the 2006 budget proposal of the Health Insurance Fund. Budgetary targets were met in 2004; expenditures did not exceed the original appropriation. The same is expected for 2005. In-kind expenditures to GDP ratio will decline by 0,5 percentage points according to the budget for 2006. In the past years, regressive financing prevented the overrun of output volumes, and service providers were forced to increase cost efficiency by moderate service fee increases, a tightening of output accounting, and programmes promoting structural changes (elective day case surgery, improvement of emergency care, development programme of chronic care hospitals). In the field of curative-preventative health care, the modified government regulation will be approved by the end of December. In order to meet budgetary targets, regressive financing and output accounting should be tightened, and fees should not be increased in 2006. Some elements of the "100 steps" programme, resolving structural problems by economic incentives, will also support budgetary compliance through economic incentives (one global budgetary ceiling for in-patient and out-patient health care services, fee harmonisation, revision of Homogeneous Diseases Groups, development of cost efficient professional protocols, incentives for their application, and verification of mandatory minimum requirements). According to the Government's plans, structural measures modernising and rationalising public health care will be supported by restructuring and development programmes in the framework of the National Development Plan.

In the field of pharmaceutical subsidies, the objective is to slow down the intensive expenditure growth trend of the previous years.
The sustainability of budgetary targets is supported by the following measures:

- For the admission of new products in the social insurance system, proof of evidence of therapeutic effects and cost efficiency, and the certification of health care technologies in accordance with the EU transparency directive is required.
- Implementation of the agreement on contribution by pharmaceutical producers.
- Introduction of an on-line settlement and eligibility verification system, first in the field of free medication to the needy.
- Introduction of an incentive system in the subscription of pharmaceuticals (income level of the previous year can be reached only by expenditure savings).
- Broadening of the range of pharmaceuticals included in the flat-rate subsidy scheme.

In 2006 negotiations will be started with pharmaceutical producers to reach a long-term agreement, aiming to increase the contribution by producers, and to achieve contractual terms reducing budgetary risks.

In-kind expenditures of the Health Insurance Fund in % of GDP

	2001	2002	2003	2004	2005	2006
Total in-kind expenditures of the Health Insurance Fund	4.2	4.5	5.0	4.9	4.9	4.4
Of which: Curative-preventive care	2.8	3.0	3.3	3.2	3.2	2.8
Pharmaceutical subsidies	1.2	1.3	1.4	1.4	1.5	1.3
Other expenditures	0.2	0.2	0.2	0.3	0.3	0.2

5.3 Education and vocational training

Measures implemented and planned in the field of education and vocational training are aimed at improving the quality of education, thus increasing the flexibility of the education system to meet continuously changing economic needs and to adapt to demographic trends. In addition to improving the quality of education, the changes will also promote the sustainability of the system. The education system, in particular vocational training and higher education, can actively contribute to improving the competitiveness of the economy, to the creation and dissemination of innovation, to the expansion of sectors producing high value added products and services, therefore also to GDP growth.

These objectives are supported by the ongoing management and financing reform in public education. The conversion to a structure in complying with the Bologna process will start in the 2006 school year.

- In public education, the development of key competences laying the basis for marketable knowledge and the reform of education content has been started. The introduction of the new national basic curriculum in an ascending system, the dissemination of competence-based education, the development of cognitive, personal and social key competences, the promotion of IT skills, the founding of entrepreneurial culture, the enhancement of language skills all contribute to enhancing employability and competitiveness.

  The efficiency of the education system is improved by measures aiming to eliminate the fragmentation of the education's institution system and the development of an EU-compatible system of measurement and assessment to provide sound foundations for efficient decisions. Increased geographic concentration of education will improve the quality of education through economies of scale. The reform of the organisation structure and management and the introduction of a managerial approach in the governance of institutions also promote efficiency. The simplification of regulations, the reduction of administrative burden and the introduction of an identity card in order to reduce abuse may contribute to lower budgetary expenditures as well.

- The relationship of the economy and education is strengthened by the direct involvement of economic actors in the governance of higher education. The participation of the business sector in higher education may result in cost savings, and can facilitate early contacts of career starters with the business world during their studies, that will make it possible to adjust the course of their studies more effectively to the needs of the labour market.

  The new higher education act transforms higher education in the spirit of the Bologna process. The new system allows students to alter the direction of their education in response to market needs or to obtain interim qualifications. The new system, gradually introduced from 2006 onwards, will introduce a 3-year basic (bachelor level) training for students, which will provide more general but also more practical knowledge than the current practice. In this period, the students will participate in mandatory practical training, which increases their chances in job search later, and they will receive more immediate feedback about market needs. After three years of studies and in possession of professional experience, the students will be able to make more informed decisions about the specialisation of their university studies after the three-year phase.

  By strengthening R&D and innovation capacities, the education sector may directly contribute to the profitability and competitiveness of enterprises. The new higher education act and the measures proposed in the 2nd National Development Plan promote the establishment of spin-off companies and the more efficient exploitation of research findings in the economy by assisting more flexible employment of teachers, providing additional support to research universities and creating financial incentives to higher education institutions, the support of the cooperation of businesses and higher education institutions.

  The new higher education act will be instrumental to a comprehensive academic, financing and structural reform, facilitating a more economical, organisationally more rational structure of academic and educational activities, and makes the provision of budgetary funds conditional on performance.

- The direct involvement of economic actors in governance is also important in the field of vocational training. In the spirit of the Bologna process, advisory bodies ,including the representatives of the business community, and sponsors of the school, the heads of the central training location and the managing organisation, will be set up in the regionally integrated vocational training centres (the so called ‘TISZKs’) and in larger vocational training schools. The dissemination of career orientation and monitoring systems and their connection to the employment databases will be instrumental to a better compliance with the economy’s labour demand. The increase of the number of student contracts and the support of training in skills in undersupply will have a similar effect. In the course of the review of the National Vocational Training Register, a new, modular structure of vocational training will be introduced, including partial vocational qualifications that will improve students’ chances of entering the labour market. The modular structure of training with the possibility of transferring credits will enhance the use of funds both for trainers and for participants.

6 Quality of public finances

6.1 Central government expenditures

The Government aims at reducing the size of the public sector and increasing the efficiency of public services in the forthcoming years by reforming the institutional structure. The institutional system needs to be organised more rationally, taking also into account the institutional development requirements due to Hungary’s EU membership. As a side effect of the transformation process, employment rate in the public sector will also be lower. The changes started in this field in the past two years focused mostly on determining the optimum size of organisational units, concentrating overall systems or functional elements establishing service provision by networks of municipalities, reducing the number of decision making levels, eliminating duplicate functions, limiting budgetary determinations and creating conditions for more professional management and more flexible operation within institutions.

Changes may take the form of close-down (where functions are not justified), increasing the scale of operation (in case of the merger of institutions), geographic concentration (within settlements or to the regional level), concentration of the same function in a single institution (in case of financial services, physical or intellectual infrastructure management activities), optimisation of the organisational and operational system (adjustment to the funding structure, and where some tasks can be transferred to the market) and the elimination of own capacities (where outsourcing is possible).

According to the decision of the Government, the ministries had to investigate their own institution system and work out action plans to improve the short and long term sustainability of public finances.

In order to provide a solid foundation for the budgets of 2006 and the subsequent years and to create a conceptual framework, in line with the concept of a smaller state, the Government intends to carry out a comprehensive, centrally managed, consistently implemented reform in the central budgetary institution system taking into account the professional positions of the ministries. The considerations behind the reform have been only slightly modified since 2004, and a preliminary plan broken down to individual institutions has been prepared on that basis.

One direction of future changes is to reduce the number of ministries and to merge or close down some of the background institutions operating under the ministries. This is accompanied by the streamlining and re-regulation of public administration processes, and in part the decentralisation of functions.

6.2 Reform of the local government system

The overhaul of the local government system is expected to take place in the period up to 2008. The reform of the local tax system has been started, the value-based property taxation of real estate with a value over HUF 100 million will be introduced on 1 January 2006, and the elimination of the local business tax, one of the key funding sources of local governments, has been announced effective from 1 January 2008. This will be replaced by a general value-based property tax on companies and potentially other local taxes, depending on the outcome of the review.

The transformation of the financing system of local governments is linked to the reform of the entire local government system, which requires a broad social consensus as the adoption of the fundamental acts regulating this sector requires a 2/3 majority in the Parliament. Such a decision is necessary, first and foremost, for the establishment of elected regional governments and the imposition of a statutory obligation to perform certain functions on micro-regional level.

During the review of the current levels of service provision, the main consideration is to assure that tasks and decisions are delegated to the level where they can be made the most efficiently, and where the most information is available. This requires decentralisation in several areas, and centralisation in others. A significant portion of currently centralised functions should be delegated to the local government sector, while some of the current tasks of municipalities should be organised on a micro-regional level. The regional level should be responsible, inter alia, for the organisation of health care (in particular the optimisation and development of the hospital network), the maintenance and improvement of the public road network (with the exception of motorways and speedways) and the operation of long-distance bus transport. On the other hand, the micro-regional level should be responsible for public education (with the potential exception of the first four grades) and for administrative activities supporting municipal government assemblies that require special expertise. In 2004 Hungary made considerable progress in this area by encouraging the establishment of multi-purpose micro-regional associations. The proposed financial management rules in the general government system – establishment of optimal organisational unit sizes, allowing more professional management and flexible operation – are also conducive to the greater operational efficiency of local government institutions.

To assure a more efficient operation of local governments, the work of municipal assemblies should be streamlined, in order to reduce the number of representatives where required, and to review and rationalise the remuneration of elected officials and local representatives.

7 Institutional features of public finances

7.1 Budgetary procedures

The Hungarian parliament is a unicameral legislative body. Its Standing Order shall be passed on a two-third majority while the Committee of the House shall decide on the details in specific cases. The opposition is entitled to a proportionate representation in the Committee of the House where decisions shall, on a general understanding, be made unanimously.

The constitution stipulates that the Parliament determines the government balance sheet and approves the government budget as well as its execution.

The organic budget law (dated from 1992) with its execution decree regulates the budget process.

The Standing Orders contain quite detailed rules of the budget debate, which consists of two rounds. In the first round principally any sort of amendment can be submitted to the bill, while amendments in the second round cannot affect the headline figures accepted at the end of the first round.

Time table of the budget process

Unit of measurement: month	Responsible body	Absolute date for FY 2006	Relative date	Duration
Adoption of guidelines	Government	2005 April	t-8	
Elaboration of ministries' plans	Line Ministries (LM)			3
Issue of planning circular	MoF	2005 July	t-5	
Elaboration of ministries' budget plans	LM			1
Submission of ministries' proposals	LM	2005 August	t-4	
Discussion within government				1
Submission of budget to Parliament	Government	2005 September	t-3	
First stage of Parliamentary debate	Parliament			2
Adoption of headline figures		2005 November	t-1	
Second stage of Parliamentary debate	Parliament			1
Passing and promulgating the Budget Bill		2005 December	t	
Fiscal year	Government			12
Fiscal year-end		2006 December	t+12	
Preparing closing accounts	MoF			6
Submission of closing accounts	Government	2007 June	t+18	

7.2 Public finance statistical governance

Statistics on the government sector are compiled by the Central Statistical Office (CSO) and the National Bank of Hungary (NBH). In the current division of labour, the CSO is responsible for non-financial accounts, the NBH for financial accounts.

The above mentioned division of labour applies to the compilation of data up to the (t-2) period within the Excessive Deficit Procedure, while the deficit of the (t-1) period is calculated by the Ministry of Finance (MoF) and the debt by the National Bank of Hungary (NBH). The change of the deadline for the first Notification from end-February to end-March allows the CSO to take over the calculation of the deficit figure for the (t-1) period, thus conformity with the national accounts can be assured.

The statistical working group comprising the representatives of the CSO, the NBH and MoF operates on the management and expert level, and a cooperation agreement sets out procedural issues of data flow, division of labour and methodological assessment.

Key data sources of the statistics of the government sector include the government finance information system, the annual and interim reports of the units of legal government (incl. local governments), statistical data collection from corporations and non-profit entities classified within the general government sector as well as the statistical collection of banking and securities data for the entire government sector.

7.3 National budgetary rules

In Hungary, fiscal rules regulate certain commitments of the local governments. According to the Local Government Act, debt-creating commitments of local governments (borrowing and related charges, as well as bond issues, guarantees and sureties issued, leasing arrangements) should not exceed their adjusted own revenues. Loans up to the maturity of one year or taken out to assure continuous operation of public services and public administration tasks are exempt from the restriction.

Table 1

Macroeconomic prospects

	ESA code	2 004	2004	2005	2006	2007	2008
		HUF bn	percentage change				
1. Real GDP at 2000 prices	B1g	15 554,1	4,6	4,2	4,3	4,1	4,1
2. Nominal GDP	B1g	20 413,5	9,5	6,9	7,1	7,1	6,9
Components of real GDP							
3. Private consumption expenditure	P3	8 992,5	3,2	3,1	4,3	3,6	3,8
4. Government consumption expenditure	P3	3 546,7	1,8	1,8	-0,8	-0,7	-0,4
5. Gross fixed capital formation	P51	3 984,8	8,4	7,5	7,5	7,1	6,6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	-186,2	-1,2	-2,5	-2,4	-2,2	-1,9
7. Exports of goods and services	P6	13 814,5	16,4	10,2	11,0	9,7	9,2
8. Imports of goods and services	P7	14 598,2	13,2	8,1	10,7	9,3	8,9
Contribution to real GDP growth							
9. Final domestic demand		-	4,4	4,2	4,3	3,9	3,9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	-1,4	-1,4	0,0	0,1	0,1
11. External balance of goods and services	B11	-	1,7	1,5	0,0	0,0	0,0
Price developments							
12. GDP deflator		-	4,6	2,5	2,7	2,9	2,7
13. Private consumption deflator		-	4,5	3,1	2,2	2,7	2,2
14. HICP		-	6,8	3,5	2,1	3,0	2,4
15. Public consumption deflator		-	4,3	5,3	3,8	2,2	2,4
16. Investment deflator		-	2,8	3,1	3,0	3,2	3,0
17. Export price deflator (goods and services)		-	-1,4	-1,4	1,4	1,0	1,0
18. Import price deflator (goods and services)		-	-0,9	-0,7	1,4	0,9	0,8
Labour market developments							
19. Employment ('000)		3 900,4	-0,5	0,2	0,3	0,8	0,9
20. Unemployment rate (%)		-	6,1	7,3	7,1	7,0	6,9
21. Labour productivity, persons		-	5,2	4,0	4,0	3,2	3,1
22. Compensation of employees	**D.1.**	9 281,7	8,0	7,5	5,2	3,6	5,9
Sectoral balances (in percent of GDP)							
23. Net lending/borrowing vis-à-vis the rest of the world	**B.9.**	**-**	-8,4	-7,7	-7,1	-5,5	-4,8
of which:							
- Balance of goods and services		-	-3,1	-2,2	-2,2	-2,0	-1,8
- Balance of primary incomes and transfers		-	-5,7	-6,0	-5,7	-5,2	-4,9
- Capital account	**B.9./EDP B.9.**	-	0,4	0,5	0,8	1,7	1,9
24. Net lending/borrowing of the private sector	**B.9.**	-	-3,0	-1,6	-2,4	-2,2	-2,9
25. Net lending/borrowing of general government		-	-5,4	-6,1	-4,7	-3,3	-1,9

Table 2

General government budgetary prospects

	ESA code	2 004	2004	2005	2006	2007	2008
		HUF bn	Percentage of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13.	-1 098,2	-5,4	-6,1	-4,7	-3,3	-1,9
2. Central government	S.1311.	-1 221,7	-6,0	-6,6	-5,5	-3,9	-3,1
3. Local government	S.1313.	-48,6	-0,2	-0,3	-0,2	-0,1	-0,3
4. Social security funds	S.1314.	172,1	0,8	0,9	1,0	0,7	1,5
General government (S13)							
5. Total revenue	TR	9 059,4	44,4	45,1	42,5	42,5	41,7
6. Total expenditure	TE	10 157,6	49,8	51,2	47,2	45,8	43,6
7. Net lending/borrowing	EDP B.9.	-1 098,2	-5,4	-6,1	-4,7	-3,3	-1,9
8. Interest expenditure (incl. FISIM)	EDP D.41.+ FISIM	883,8	4,3	3,6	3,2	3,0	2,7
pm: 8a. FISIM		20,8	0,1	0,1	0,1	0,1	0,1
9. Primary balance		-214,4	-1,1	-2,5	-1,5	-0,3	0,8
Selected components of revenue							
10. Total taxes		5 206,0	25,5	25,5	23,8	24,2	23,2
11. Social contributions	D.61.	2 772,5	13,6	13,5	13,3	12,3	12,3
12. Property income	D.4.	280,9	1,4	0,9	0,9	0,8	0,6
13. Others (13=14-(10+11+12))		800,0	3,9	5,2	4,5	5,2	5,6
14.=5. Total revenue	TR	9 059,4	44,4	45,1	42,5	42,5	41,7
Tax burden (D.2.+D.5.+D.61.+D.91.-D.995.)		7 997,5	39,2	39,0	37,1	36,5	35,5
Selected components of expenditure							
15. Collective consumption	P32	2 200,1	10,8	10,6	9,9	9,4	8,9
16. Total social transfers	D.62 + D.63.	5 582,0	27,3	27,6	26,8	25,8	25,1
16a. Social transfers in kind	D63	2 681,4	13,1	12,5	12,1	11,5	11,0
16b. Social transfers other than in kind	D62	2 900,6	14,2	15,1	14,7	14,3	14,1
17.=8. Interest expenditure (incl. FISIM)	D41+ FISIM	883,8	4,3	3,6	3,2	3,0	2,7
18. Subsidies	D3	316,7	1,6	1,4	1,5	1,1	0,9
19. Gross fixed capital formation	P51	730,7	3,6	3,6	2,6	2,8	2,6
20. Other (20=21-(15+16+17+18+19))		444,3	2,2	4,4	3,2	3,7	3,4
21=6. Total expenditure	TE	10 157,6	49,8	51,2	47,2	45,8	43,6
Pm: compensation of employees	D.1.	2 619,2	12,8	12,6	12,1	11,4	10,8

Table 3

General government debt developments

Percentage of GDP	ESA code	2004	2005	2006	2007	2008
1. Gross debt		57,2	57,7	58,4	57,9	56,2
2. Change in gross debt ratio		5,4	4,3	4,5	3,4	2,0
Contributions to changes in gross debt						
3. Primary balance		1,1	2,5	1,5	0,3	-0,8
4. Interest expenditure (incl. FISIM)		4,3	3,6	3,2	3,0	2,7
5. Stock-flow adjustment		0,0	-1,8	-0,2	0,1	0,1
Implicit interest rate on debt (%)		8,4	6,8	5,9	5,5	5,0

Table 4

Cyclical developments

Percentage of GDP	ESA code	**2004**	**2005**	**2006**	**2007**	**2008**
1. Real GDP growth at 2000 prices (%)[1]		4,2	4,0	4,1	4,0	4,0
2. Net lending of general government	**B9**	-5,4	-6,1	-4,7	-3,3	-1,9
3. Interest expenditure (incl. FISIM recorded as consumption)	**D41 + FISIM**	4,3	3,6	3,2	3,0	2,7
4. Potential GDP growth (%)		3,9	4,0	4,1	4,2	4,1
contributions:						
- labour		0,4	0,4	0,4	0,4	0,3
- capital		1,8	1,9	2,1	2,2	2,3
- total factor productivity		1,7	1,7	1,6	1,6	1,5
5. Output gap		-0,2	-0,1	-0,1	-0,2	-0,2
6. Cyclical budgetary component		0,0	0,0	0,0	-0,1	0,0
7. Cyclically-adjusted balance (2-6)		-5,4	-6,1	-4,7	-3,2	-1,9
8. Cyclically-adjusted primary balance (7-3)		-1,1	-2,5	-1,5	-0,2	0,8

[1] Without allocation of FISIM

Table 5

Divergence from previous update

	2004	2005	2006	2007	2008
Real GDP growth (%)					
Previous update[1]	3,9	4,0	4,2	4,3	4,6
Current update[2]	4,6	4,2	4,3	4,1	4,1
Difference	0,7	0,2	0,1	-0,2	-0,5
General government net lending (% of GDP)					
Previous update	4,5	3,8	3,1	2,4	1,8
Current update	5,4	6,1	4,7	3,3	1,9
Difference	0,9	2,3	1,6	0,9	0,1
General government gross debt (% of GDP)					
Previous update	57,3	55,3	53,0	50,6	48,3
Current update	57,2	57,7	58,4	57,9	56,2
Difference	-0,1	2,4	5,4	7,3	7,9

[1] Without allocation of FISIM
[2] With allocation of FISIM

Table 6

Long-term sustainability of public finances

Percentage of GDP	2000	2005	2010	2020	2030	2050
Pension expenditure[1]	8,6	9,8	9,2	9,6	10,1	12,6
of which:						
Social security pension	8,6	9,8	9,2	9,5	9,8	11,1
Occupational pensions (if in general government)[2]	0,0	0,0	0,0	0,1	0,3	1,5
Pensions contributions[3]	7,8	7,6	7,0	6,2	5,3	4,6
Pension reserve fund assets[4]	1,3	5,0	10,1	18,4	24,2	27,6
Of which: consolidated public pension fund assets[5]	0,3	1,3	2,5	4,6	6,0	6,9
Assumptions						
Labour productivity growth	4,2	4,0	3,3	3,7	3,5	2,9
Real GDP growth	5,2	4,2	4,2	3,5	3,2	2,5
Participation rate, males[6]	69,8	69,8	72,0	74,8	75,5	77,2
Participation rate, females[6]	58,8	59,2	62,6	66,1	67,1	69,2
Total participation rate[6]	64,4	64,5	66,9	70,1	71,0	72,9
Unemployment rate	6,4	7,3	6,6	6,0	6,0	6,0
Population aged 65 +over / total population	15,0	15,6	16,6	19,8	21,5	26,8

[1] Social security pensions (from Pension Insurance Fund and Health Insurance Fund) and private pension funds expenditure without pension-type social allowances

[2] Pensions in private pension funds included in mandatory social security system

[3] Employers' and employees' pension contributions and contributions into private pension funds

[4] Assets of private pension funds including government bonds

[5] Without government bonds

[6] Economically active population from 15 to the actual retirement age

Table 7

Basic assumptions

	2004	2005	2006	2007	2008
Hungary: short-term interest rate (annual average)	11,1	6,7	5,2	4,6	4,0
Hungary: long-term interest rate (annual average)	8,2	6,4	5,3	4,9	4,4
HUF/EUR exchange rate (annual average)	251,7	249,0	252,5	254,0	254,0
World excluding EU, GDP growth	5,9	5,1	4,9	4,6	4,5
EU GDP growth	2,4	1,5	2,1	2,4	2,4
Growth of foreign markets of Hungary	7,6	4,8	5,9	5,9	5,8
World import volumes, excluding EU	13,9	8,6	8,7	8,4	8,4
Oil prices (Brent, USD/barrel)	38,3	55,0	61,4	60,3	60,0