GOVERNMENT OF THE REPUBLIC OF HUNGARY

UPDATED CONVERGENCE PROGRAMME OF HUNGARY

2008-2011

Budapest, December 2008

Contents

In line with the requirement of EU membership, Members States submit stability programmes, and Member States, which have not yet adopted the euro submit convergence programmes to the Commission and the Council each year.

The programme is the updated version of the December 2007 convergence programme. As in the previous year, the Government published two reports as well in 2008, in April and November, on the progress of the implementation of the convergence programme. The progress reports gave detailed information on the budgetary development for 2008 and progress in structural reform. The updated programme covers the period 2007 to 2011.

The Government adopted the programme on its meeting of 17 December 2008, which was consulted by the National Interest Reconciliation Council on its meeting of 19 December. The updated convergence programme is based on the 2009 Budget adopted on 15 December and, for 2008, the most recent macroeconomic projection.

The updated programme was prepared with due account paid to the requirements on the content and format laid down in the Council Regulation (EC) 1466/97 as amended by Council Regulation (EC) 1055/05 and in the revised Code of Conduct endorsed by the Council in October 2005.

The convergence programme is in line with the National Action Programme (NAP), in which the Government summarises the measures aiming to increase employment and productivity. As a consequence, the updated convergence programme does not go into the details of measures concerning sector- and development policy, however, it takes into account their effects on the macroeconomic and budgetary path presented in updated the programme.

1. Assessment and economic policy priorities

The fiscal consolidation process launched in 2006 resulted in a better-than-planned improvement in the external and internal balances of the Hungarian economy. The results of the consolidation also exceeded the pace required under the October 2006 recommendation of the Council (Ecofin). In terms of GDP, the deficit of the general government sector is expected to be reduced from 9.3% in 2006 to 3.4% in 2008, while both the current account deficit and the net external financing requirement have been decreasing. These factors have contributed to the decreasing vulnerability of the Hungarian economy.

The financial turbulences stemming from the US mortgage markets in the summer of 2007, which have been escalating to a global turmoil in recent months, coupled with the lowering risk appetite of investors have resulted in a general tendency of lowered inflow or start of outflow, of foreign capital in emerging markets. This trend also appeared in Hungary, where in the autumn of 2008, notwithstanding the improving indicators of internal and external balances, the risk of substantially reducing inflow of foreign capital had to be faced with, given the still high levels of internal and external debt and the slow economic growth.

In order to secure the external financing which seemed to be mitigating and to restore investors' confidence, in November 2008 the Hungarian government, in agreement with Magyar Nemzeti Bank (National Bank of Hungary), reached an agreement of a credit facility of EUR 20 billion with the European Union, the International Monetary Fund and the World Bank. Simultaneously – in accordance with the lines of action determined in the Ecofin conclusions of October 2008 and the conclusions of the European Council – a number of measures were prepared, taken and implemented in order to strengthen the stability of the financial system, to secure depositors and to enhance market liquidity:

- Adoption by Parliament and entry into force of the legislative amendment increasing the coverage of the deposit guarantee scheme form HUF 6 million to HUF 13 million, supplemented by a commitment of the Government for unlimited guarantee on deposits;
- Agreement with the commercial banks on the management of risks related to the households' FX loans;
- Adoption by Parliament of the law on strengthening the stability of the financial intermediary system (the law sets the conditions on the basis of which the Hungarian State may provide guarantee for the debt of, or increase capital in ,credit institutions so as to strengthen and secure the stability of the financial intermediary system);
- Magyar Nemzeti Bank introduced a number of measures aimed at enhancing market liquidity, also supported by the FX swap agreement concluded with the European Central Bank.

From the second quarter of 2008, it became evident that the impact of the protracted and escalating problems of the global financial system would have a considerable impact on the real economy in Europe. According to the Autumn forecast of the European Commission and based on data and forecast indicators available since then, risks of a European recession have substantially increased. In this context, the Hungarian government welcomes the Commission's initiative for a 'European recovery plan' and the agreement concluded in this respect at the December 12-13 European Council and fully agrees with the lines of action laid down in these documents. Hungary's room for manoeuvre is, however, determined by the fact that in order to maintain confidence in the Hungarian economy, the financing need of the government sector has to be reduced at a faster pace than planned in the November 2007 convergence programme. Therefore, this convergence programme update reckons with a bigger cut in the general government deficit than envisaged earlier. Thus, fiscal policy can be characterised in the first part of the programme horizon by pro-cyclical fiscal tightening.

Given the fact that in the present context there are no possibilities to provide a fiscal stimulus to the economy, the Government aims to offset the negative impact of the financial crisis through the re-structuring of budgetary expenditures and through measures not having an impact on the budget.

Measures to stimulate the economy and to mitigate the negative employment impact of the financial crisis

The measures implemented or planned to have a short term impact are as follows:

- In order to speed up and extend the availability of funds for the enterprises, a re-structuring between and within the operative programmes of the New Hungary Development Plan will take place. In order to ease the conditions of the availability of funds, the application regime will be simplified;
- In the case of projects aimed at economic development, the scope of procedures facilitating faster implementation (so-called normative application procedures) will be extended. The obligations of the applicants will be eased;
- The conditions of the so-called micro-credit programme will be changed, in order to facilitate the financing needs of SMEs. Based on the Loan programme for SMEs, a financing framework with favourable conditions is available for commercial banks to finance investment projects of HUF 10 to 100 million of SMEs. Regarding the 'de minimis' support of technological developments, the scope activities and beneficiaries subject to subsidies is being extended. The government guarantees attached to the loans to SMEs is increased;
- SMEs being hit by the financial crisis will have an opportunity to receive loans or capital injection through enterprises or intermediaries specialised in developing and financing SMEs;
- From the beginning of 2009, preferential loans for financing working capital will be available through commercial banks with the involvement of the Hungarian Development Bank;
- Within the framework of application schemes and priority projects, measures aimed at the support of construction activities will be introduced;
- In order to support export activities, export promotion will be enhanced, short term export credits of SMEs will be secured by state-based export credit insurance and the advisory services fort his purpose will be extended ;

- A re-location programme for new investments by foreign investors in Hungary is being applied and investments in labour intensive sectors and in less developed regions will be promoted ;
- The toolkit of the sub-contractors' programme will be developed;
- Strategies and implementation programmes based on comprehensive analyses of the sectors having a considerable impact on growth and employment will be elaborated (e.g. in the case of IT, car manufacturing, pharmaceuticals, biotechnology, logistics and special tourism sectors);
- Administrative burdens on entrepreneurs arising from national legislation and rules will be reduced by at least 25% till 2012.

The mitigation of the negative impact on employment of the financial crisis is an outstanding economic policy priority. Within the 'Pathway to work' programme, the long-term unemployed receiving regular social allowance will be encouraged to work, labour market policy measures to prevent the displacement of unskilled workers in active age from, and to enhance integration of undereducated young people to, the labour market will be introduced, including subsidised education programmes and extension of available workplaces targeted to unskilled young people. The maintenance of employment will also be promoted through targeted social security allowances. The re-structuring of job-seeking allowances, the increased support for disadvantaged employees and development of vocational training may, in the medium term, contribute to the increase of employment.

In addition to the short-term crisis management measures, the adoption by the Parliament (in November 2008) of the fiscal responsibility act contributes to the medium and long term sustainability of public finances. The law sets new fiscal policy rules. The expenditure ceilings and budget balance limits included in the law ensure that fiscal policy will be conducted in the forthcoming years and in the longer term in a balance-oriented manner.

2. Macroeconomic objectives and forecast

2.1. External assumptions

For the long-term forecast of the international environment, the convergence programme relies on the European Commission's 2008 Autumn Forecast. (Among alternative scenarios it takes the uncertainties of external demand forecasts into account.) As a result of the impacts produced by the economic crisis on real economy, the output of developed countries will significantly drop throughout 2009, and in 2010 it will start to grow again at a slow rate. In 2008, 3.7% world economic growth is expected, which will slow down to 2.5% in 2009, and will reach merely 3.2% during 2010. Nor in the middle run can it be expected that the extent of the world economic growth will reach the rise at record level attained in recent years. The expansion of world trade will be generated solely by the import demand of developing countries in the coming years. Although economic output is worsening also in these countries, the rate of growth will nevertheless exceed that of the developed countries.

The Commission's forecast projects stagnation in the European Union in 2009. The growth of the EU will decrease from 1.4% in 2008 to 0.2% in 2009. Only in 2010 can some pick-up be expected; then the GDP might rise again by 1.1%. Recession will affect consumption as well as investments and net exports. An important element in the Commission's forecast in terms of Hungarian export prospects is that in the new EU Member States, in spite of the economic recession, a permanently higher growth can be expected than in the old Member States over the entire forecast horizon.

2.2. Cyclical developments

In the period between 2001 and 2006, the Hungarian economy was growing above its potential growth, by a rate over 4%, which resulted in a positive output gap. The economic growth exceeding the potential was brought about primarily by the strong fiscal expansion that characterised the period. In 2007-2008, due to the impact of adjustment measures and soon after the global crisis, current growth slowed down to a rate lower than the potential one; thereby, the positive output gap started to decrease. Notwithstanding, the level of output is expected to fall below the level of potential output only from 2009; i.e., the output gap will become negative from that time. Until the end of the forecast period the output gap will remain negative because the actual growth of economy will exceed its potential growth only at the end of the forecast horizon.

During the past year the anticipation about potential growth has considerably changed. The previous convergence programme assumed potential GDP growth to be about 3.5-4%. Based on the processes of the past period, however, it has become clear that given the present structure determined by labour, capital stock and the level of technical development, the economy is able to grow only at a much slower rate (2-2.5%). In order to return back to the earlier growth path at around 4%, structural measures are required to stimulate expansion of resources; i.e., labour supply, investments and technical development.

Cyclical position

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
GDP (growth rate, %)	4.1	1.1	1.3	-0.9	1.6	2.5
Potential GDP (growth rate, %)	3.2	2.9	2.6	2.4	2.3	2.3
Contributions:						
Labour	0.1	0.1	0.1	0.1	0.1	0.1
Capital	1.6	1.4	1.3	1.2	1.2	1.2
Total factor productivity (TFP)	1.5	1.3	1.2	1.1	1.1	1.1
Output gap	**3.2**	**1.4**	**0.1**	**-3.1**	**-3.8**	**-3.6**

Potential output – differences in estimation approaches of some institutions

The potential output and the output gap are neither directly observable nor exactly defined economic indicators therefore their estimations prepared by several institutions may differ substantially from each other. There is a wide variety of estimation methods ranging from the different filtering techniques to the econometric modelling. In accordance with the recommendations of the European Commission, for the convergence programme, the estimation of the potential output has been based on the Cobb-Douglas production function approach. In order to filter out the fluctuations caused by cyclical and other factors, the components of the production function have to be estimated by applying several smoothing procedures. For the sake of international comparison, when carrying out these and other parameter estimation steps, the Commission prefers to use identical procedures for all countries. Given the specificities of the Hungarian economy, the estimation model applied for the convergence programme slightly differs from the commonly used one.

The most important distinctions are as follows:

- The Commission extends the input data with its own forecast for the years until 2010 and these series are extrapolated up to 2013. As a rule, these series take the present recession as starting point for extrapolation which has a lowering impact on the forecast of potential growth. The calculations for the convergence programme have been based on the forecast of the actual data until 2012 which period already involves some years of recovery as well.
- For the new Member States, the Commission estimates the NAIRU by adjusting the actual unemployment rate through the elasticity of unemployment with respect to the wage share. On the contrary, for the convergence programme, as Hungarian data do not reveal significant relationship between the wage share and the cycle, the unemployment rate is smoothed by a simple HP-filter.
- In the Commission approach the capital stock is fixed in the base year of 1995 as twice the GDP and is being proceeded for the whole period by means of investment and a depreciation rate. The approach in the convergence programme uses the CSO capital stock data which are available for the period 2000-2006. These data are lengthened by the same way back and forward in time.
- Introducing the modifications mentioned above results in a more stable estimation of TFP as compared to the one implemented by the Commission. By the principle of Solow-residual, the TFP involves the impact of factors other than capital and labour and it has to be smoothed in order to obtain the trend TFP. While the calculations of the Commission forecast a strong breakdown in TFP growth after 2007 resulting in a close to zero contribution to growth towards the end of the forecast horizon, the convergence programme estimates that the growth contribution of TFP remains above one percent.

The following table compares the estimate of different institutions on the cyclical developments:

Potential growth and output gap by some institutions

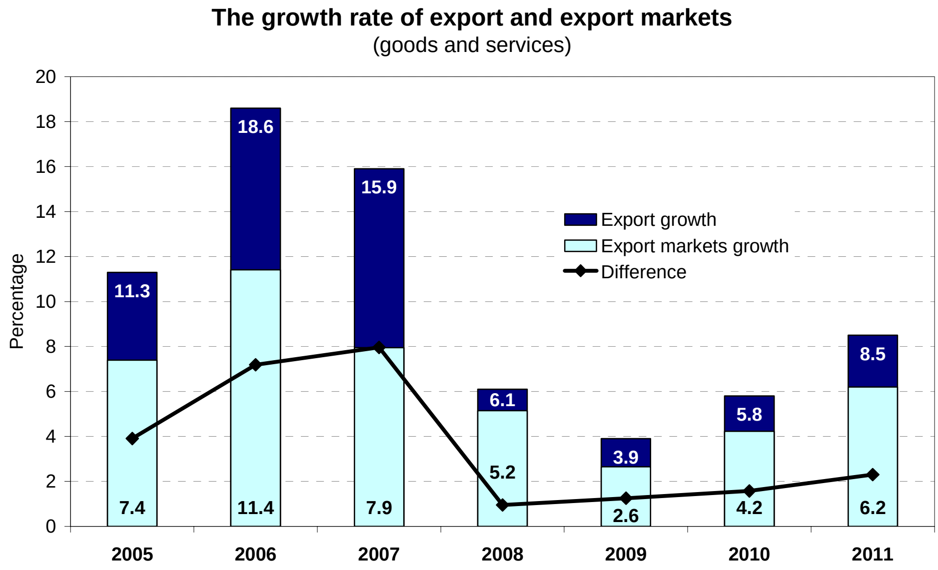
		2005	2006	2007	2008	2009	2010	2011
Convergence programme	potential growth	3.5	3.2	2.9	2.6	2.4	2.3	2.3
	output gap	2.2	3.2	1.4	0.1	-3.1	-3.8	-3.6
European Commission	potential growth	3.3	2.5	2.1	2.0	1.9	1.8	1.3
	output gap	1.1	2.6	1.6	1.2	0.0	0.0	1.1
OECD	potential growth	3.6	3.4	3.2	3.0	3.1	3.2	
	output gap	1.4	2.1	0.1	-1.4	-4.9	-6.8	
IMF	potential growth	3.6	3.2	2.8	2.8	2.5	2.6	2.8
	output gap	0.8	1.5	0.1	-0.9	-4.4	-6.4	-7.3

2.3. External demand and exports

For determining the demand for Hungarian exports, the import demand of the countries most important for Hungary's export has been taken into account, relying on the European Commission's 2008 Autumn Forecast. On this basis, Hungary's export markets will expand by 5.2% in 2008, and at a slower rate by 2.6% in 2009 and 4.2% in 2010.

The export projection is primarily based on the prognosis of external demand. The growth of Hungarian exports has significantly exceeded the expansion of Hungarian export markets for years, since the expansion of manufacturing industry capacities at an increasing rate allowed the rapid growth of exports. In 2008, in response to the crisis, multinational companies, however, have suddenly reduced their capacity utilization, which has lead to considerable slow-down of export dynamics.

Hungary's export structure is getting further diversified; in the past few years the share of new Member States and non-EU European countries in exports has significantly increased. In 2008, this tendency seems to continue. The ratio of the EU-15 Member States in exports of goods has decreased to 57.4%, while it has somewhat grown (to 20.3%) on the side of new Members States, and more significantly non-EU countries (to 22.3%).



Due to the deteriorating overall international economic climate, in 2008 the growth of foreign trade has slowed down compared to the previous years' performance. Improvement of the balance of goods has continued in 2008; so, for the entire year it can be approx. EUR 0.3-0.5 billion better than last year. The export structure has been favourable also in 2008, exporting machinery and means of transport – more specifically telecommunication instruments and motor vehicles – has reached expansion of volumes over the average. The high oil prices typical of the first half of the year will presumably determine the deterioration of the terms of trade for the entire year of 2008, which will attain approx. 1%. Given the fall in oil prices, the ratio of exchange in 2009 might considerably improve, while they are not supposed to change much during 2010-2011. In 2009, the volume of exports and imports will fall due to unfavourable external conditions, whereas the contribution of net exports may rise because of lower import need of domestic demand. During 2010-2011, slow external growth might begin; simultaneously, foreign trade volumes might expand faster compared to the previous year, while owing to pick-up in domestic demand the contribution of net exports might attain a lower level. Prospects, nevertheless, carry considerable uncertainty subject to changes in the international environment.

2.4. Employment

The employment prospects of the national economy in 2008 are determined basically by two factors. One of them is the mandatory rise of the minimum wage and the wage minima in force as from January 2008, to which several companies have adapted through higher wages. The other factor, of uncertain magnitude for the time being, is the decrease of external and domestic demand arising from the impact of the sub-prime crisis, and the worsening of profit conditions brought along, which gives rise to adjustment both in wages and headcount. As the result of all these impacts, the number of employed in the national economy might decrease by around 1% in 2008. The unemployment rate will rise to 7.7%. On the other hand, external and internal recession will produce its effect also in the long run. In 2009, employment will continue to decrease, while the number of the unemployed will grow.

Accordingly, the Government's employment policy will focus on two key priorities. On the one hand, similarly to previous years, in the long run it will continue to be an objective to encourage the working age population to enter the labour market at a rate as high as possible (that is, to enhance labour supply), and to strengthen the intensity of job seeking of the unemployed.[1] On the other hand, as a consequence of the economic development of the past period, the basic target of the coming years is to moderate the negative employment impact of turbulences on the financial market; that is, to maintain jobs (i.e., to encourage demand for labour), and possibly extend their range.

The Government intends to stimulate labour supply through the Pathway to Work programme (for detailed description see subchapter 5.3). This programme intends to be conducive to helping permanently unemployed persons who receive regular social allowance to take up jobs as well as to preventing working age, unskilled employees from being forced out of the labour market[2], and advancing the group of young adults without schooling or incomplete schooling to be tied to the labour market through considerably raising the number of jobs that can be offered to them as well as by supported trainings, increased involvement in labour market programmes and providing services. The measures formulated in the programme might potentially affect approx. 100,000 persons.

In order *to encourage job seeking* the Government plans to introduce a degressive premium system as from 2009. The core of it is that during the disbursement of job seeking allowance job seekers who establish at least daily four hours employment for an indefinite term, will receive 80% of the sum, in one amount, payable for the rest of the period, in the event that they establish employment in the first half of the disbursement period. In the second phase, they will receive the 30 % of the remaining amount.

The Start card line supporting the employment of disadvantaged employees will be also extended[3]. Setting out from the regulation regarding the Start Extra cards as a basis, the Government introduces contribution allowance for employers who undertake to hire job seekers receiving availability support and who have a Start Extra card and whose domicile, place of residence is located in one of the *47 most lagging behind sub regions*. After the expiry of the first year of the term of validity of the card, the employer will be exempt from the payment of lump sum health care contribution and social insurance contribution for another two years. Several more groups of job-seekers (registered unemployed for more then 3 months; those job-seekers, who have not had a job for a year prior to their employment; those, who have been affected by group-retrenchment; etc.) are affected by the modification of the Act on increasing the employment and making it more flexible. That guarantees 1 year exemption of paying the employer's

[1] Approx. 45% of the unemployed have been searching for a job for more than a year.
[2] The rate of employment of people with low level of schooling (8 classes of primary school or lower) just exceeds 27%.
[3] The success of the Start programme introduced in 2005 is supported by the fact that the APEH data assert that the number of cards applied for and payers who employ Start card has dynamically grown too. Until the end of Q3 2008 a total of 106,943 Start cards were issued, and the number of employers rose over 25,000. This means that employment of disadvantaged groups is getting increasingly typical.

contribution for companies with less then 250 people, if they undertake the increased employment for 2 years.

With a view to minimising the negative impact of the crisis on employment, in 2009 and 2010 the Government intends to provide businesses with financial resources amounting to a total of HUF 1400 billion through the banking system under the umbrella of an overall programme relying on European Union funds. The package intends to help preservation of jobs partly in indirect form, through promoting businesses' liquidity, staying on the market (for example by credit guarantee, interest support, micro credit facilities); on the other hand, it appropriates direct job preservation and job creating measures. They include the setting up of regional crisis management funds, and the contribution allowance serving to maintain jobs for the small and medium enterprises.

The employment impact of the shrinking of the demand in the next year might be moderated by the allocated package; however, in 2009, the aggregate rate of employment will probably decrease. More specifically, the headcount in the public sector will not change compared to 2008; the Government's priority aim is to preserve jobs. The rate of unemployment may be around 8%. According to the forecast, in 2010, the economy might regain momentum. Accordingly, external and internal demand will strengthen, which will increase demand for labour. This way, employment will presumably extend at a moderate rate in 2010, and at a somewhat higher rate in 2011. Simultaneously, unemployment will gradually decrease.

Employment annual percentage change

15-64 years	**2007**	**2008**	**2009**	**2010**	**2011**
Number of employed	-0.2	-1.1	-0.6	0.2	0.5
Increase of productivity	1.2	2.5	-0.3	1.4	2.0
Rate of unemployment,%	7.4	7.7	8.0	7.7	7.2
Rate of activity, %	61.9	61.5	61.6	61.8	61.9
GDP growth	**1.1**	**1.3**	**-0.9**	**1.6**	**2.5**

2.5. Incomes policy

Following the significant reduction in 2007, real wages again grow in 2008, they are expected to be higher by 1-1.5% than in the previous year. Nominal wage is expected to increase over 9% for the entire year in the business sector. In the government sector – including 13th month salary and one-off earnings supplements – gross average wages will presumably grow by approx. 7%. Together with interim supplements, the real value of pensions will somewhat rise. But family allowances will lose of their real value due to inflation higher than expected.

In Q1-Q3 households have become net borrowers. Growth of financial assets has fallen short of the growth in the same period in the previous year (in the first place, investment fund units have dropped), while liabilities have continued to rise.

So far, the slowing down of economy has affected household income primarily through layoffs and increasing unemployment. Due to the financial crisis the conditions of access to new credits became stricter. In 2008, household consumption expenditure might increase by approx. 1%.

In 2009, only moderate wage rise can be expected in the business sector, the National Interest Reconciliation Council proposed 3-5% nominal wage increase. In the government sector, due to income cut equal to the 13th month salary, earnings nominally will decrease. At the level of the national economy, real wage per employee may decrease by 2.5-3% and a fall in employment is projected. As the increase of social expenditures does not follow inflation, real income also falls in similar extent.

The forecast for 2009 reckons that stricter rules of borrowings will be presumably enforced during the whole year; so, consumption can be “smoothed” through credits only to a limited extent. On the whole, as a result of decrease in real wages and increase in the savings ratio, the volume of household consumption expenditure in 2009 might be lower by about 4% than the 2008 level.

In-cash social transfers will grow slower than the GDP even in 2010-2011. Therefore, consumption expenditures might grow only to a low extent, by yearly 1-1.5%.

2.6. Investments

Continuous expansion and renewal of the capital stock are crucial to catch up with developed economies. The rate of investment of Hungarian economy lags behind that of emerging countries; the contribution of investments to the growth of the GDP is rather low. Economic policy makes efforts to improve it. Pick-up in investment activity is served by Union development funds and the related co-financing. Infrastructural investments (motorway construction; building public roads) highly contribute to the implementation of large investments (e.g. Hankook, Mercedes) and thereby to creating jobs. The investments implemented by foreigners up to mid 2008 exceeded EUR 70 billion, which is outstanding among new member states. Improvement of the country’s investment attracting capacity continues to enjoy economic policy priority; investment incentives are set as key target.

Significant fall in the investment performance in 2006 was followed by a slight increase in 2007. As a result of large-scale investment in manufacturing, business investment in 2007 started to pick up again and household investment also rose. On the whole, these two sectors together counterbalanced the cut-back on public investment. At the same time, the first three quarters of 2008 saw decrease in investment again. This can be explained by the fact that business investment could no longer compensate the decreasing level of public investment. So, in the whole of 2008 investment is expected to drop slightly.

The financial market crisis will influence the willingness to invest in public and private sectors primarily in 2009. Global and domestic uncertainty, weakening domestic and foreign demand, as well as tightening lending standards has led to take a “wait and see” approach; companies postpone their investment decisions. On the other hand, the Government’s crisis management package might somewhat boost willingness to invest.

The credit guarantee program and the micro credit program, which offers conditions somewhat more favourable than before, as well as the easing of tender conditions for EU development tenders might, in spite of uncertain circumstances, be conducive to encouraging investments in the business sector. Since 2007 up to now, as part of the New Hungary Development Plan, incentives in the amount of approx. HUF 2000 billion have been granted; their impact on the investment market will materialise mainly between 2009 and 2011. In addition to large-scale road and railway construction projects, sewage system construction school infrastructure developments, industrial parks and logistics centres developments, as well as tourism-related projects might also constitute a significant part of national economy investments in the coming 2-3 years. The aforesaid measures and individual factors, however, can only partly counterbalance the impacts of the credit market crisis. In the changes in the gross fixed capital investments the business sector will see minor, the government sector major fall. Due to decrease of real wages, and primarily worsening chances to obtain credit, investment in dwellings will significantly decline; therefore household investment will contribute negatively to changes in the national economy investment. Against this background, next year, total investment in Hungary is expected to decrease by 1%.

Following shrink in the volume of investments in 2009, from 2010, investment activity will presumably start to pick up. With global economic uncertainties having lessened, external environment will improve and financing opportunities and income conditions will recover. In 2011 high growth of Hungarian investment can be forecast, to which all the three sectors can contribute positively.

2.7. Components of growth

Due to the fiscal consolidation started in the second half of 2006, the Hungarian economy came to a slower growth path also this year. According to former forecasts, after the negative impacts of adjustment measures affecting the GDP have ceased, the economic growth was projected to accelerate from 2009 on.

However, the world economic development experienced over the past period, the worsening turbulences in the money markets and their pass-through into the country and getting out of the global crisis will be a prolonged process, which will in the forthcoming two years withhold the Hungarian economy from returning to the potential growth path.

The negative effects of the turbulences arising from the U.S. sub-prime mortgage market, then developing into a global money market and real economy crisis pass through into the Hungarian real economy basically in two channels.

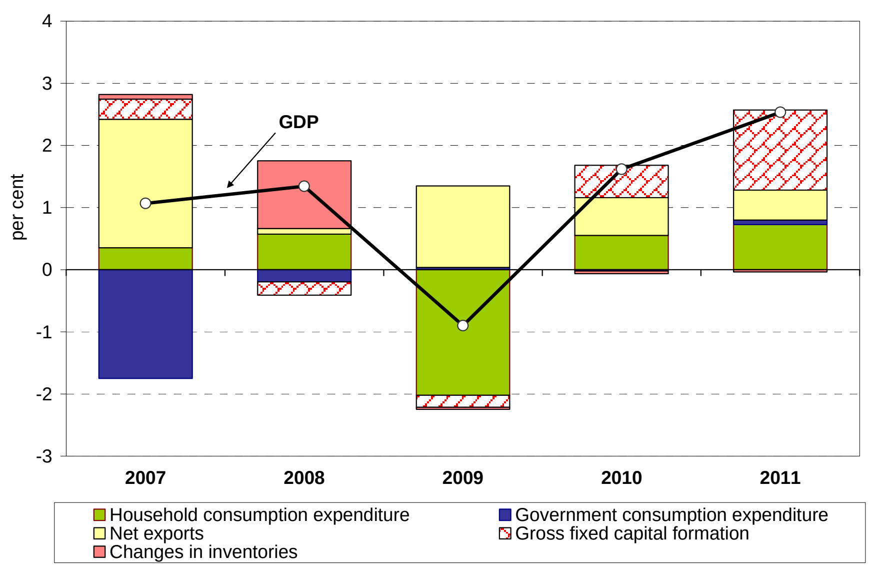
On the one hand, the weakening positions of economies absorbing Hungarian exports considerably worsen export sales prospects. As Hungarian exports to GDP ratio is rather high (more than 80%), the shrinking of export demand produced negative effect on the profitability of the business sector, which forces companies to adjust to a great extent. Adjustment will be identified in layoffs, cutting back on wage costs and investment decisions.

On the other hand, as a result of the financial crisis, the credit supply of the domestic banking system might be considerably narrowed. Reduced willingness of inventors to take risk will result in rise in costs of funds, increase in risk premium. Banks can obtain resources in a more difficult way and at a higher price, they lend money at stricter conditions and higher rates of interest, which will cut borrowings both of the private and corporate sectors.

Given the narrowed borrowing opportunities, and reduced employment arising from recession as well as decrease in real wages, households' consumption might drop by approx 3%. Government consumption with unchanged headcount in the public sector might somewhat decrease due to nominal costs cut. Due to unfavourable economic environment and shrinking financing opportunities, even with the positive role of increasing EU funds, investments will fall by approx. 1% in 2009. Export opportunities will considerably decrease, in a realistic calculation increase in export can merely come close to 4%, while the expansion of import will dramatically fall short of that of export due to fall in demand.

Based on the developments of the first three quarters of 2008, the economy will probably grow by 1.3% in 2008. Due to the world economy environment having become unfavourable, stricter credit terms having been introduced, and upon the effect of shrinking domestic demand caused by deficit reduction greater than planned, the GDP will decrease in 2009.

Contribution to real GDP growth



From 2010, provided that the global economic environment starts to improve, external demand might show slight pick-up and once money markets have calmed down, conditions of obtaining financing resources might become more favourable. Consequently, household expenditures will gradually rise and investment activity will pick up. Owing to growing domestic demand, the rate of expansion of import will come close to that of export; so, the contribution of net export to economic growth will slightly decrease. On the basis of all that, in 2011 economic growth might accelerate to 2.5%.

GDP components annual percentage change

	2007	2008	2009	2010	2011
Household consumption expenditure	0.7	1.1	-3.8	1.1	1.4
Social transfers in kind	-10.8	0.0	0.2	0.1	0.3
Household consumption	-1.8	0.9	-3.1	0.9	1.2
Government consumption	-2.2	-2.0	0.2	-0.3	0.3
Investment	1.5	-1.0	-0.9	2.5	6.2
Domestic consumption	**-1.0**	**1.3**	**-2.2**	**1.1**	**2.1**
Exports (goods and services)	15.9	6.1	3.9	5.8	8.5
Total demand	6.3	3.4	0.6	3.3	5.2
Imports (goods and services)	13.1	6.1	2.4	5.2	8.2
GDP	**1.1**	**1.3**	**-0.9**	**1.6**	**2.5**

2.8. External balance

The improvement of the current account balance due to real economic transactions will continue, similarly to previous years. Improvement of the balance in 2009 can be explained by lower import need arising from lower domestic demand. During 2010-2011, in spite of slowly picking up domestic demand, the real economy balance will continue to improve. The surplus might rise to 2.4% of GDP in 2009, and to approx. 3.5% in 2011.

As a result of already increased stock of external debts and worsening external financing conditions, in the balance of incomes in 2008-2009 the deficit of the income on debt will presumably rise. From 2010 the deficit of the income on debt might again improve. The deficit of the income on equity continuously grew in previous years, to a great extent, owing to the high profitability of direct investments implemented in Hungary in the former years. During 2008-2009, due to the financial crisis, the profitability of these investments will worsen; therefore, the extent of both reinvested earnings and profit outflow might be lower than the level in earlier years. With the gradual recovery of the economy, the deficit of the income on equity might again rise in 2010-2011.

As a result of real economic transactions and the balance of incomes, the current account deficit as a percentage of the GDP might decrease intensely by 1.6 percentage point in 2009, while by approx. 0.4-0.5 percentage point annually from 2010. Owing to growing EU transfers, external financing need will decrease faster in the second half of the forecast horizon than the current account deficit. The annual external financing need might decrease to 3.7% by 2009, while by 1 percentage point per annum during 2010-2011.

As a result of the financial crisis, during 2008-2009 net FDI will probably reach a lower level than the average of previous years[4]. Capital inflow might start to pick up again in 2010-2011, therefore, non-debt-creating financing might become determining at the end

[4] In 2007, the balance of direct investments was significantly deteriorated by one-off items such as change in ownership of the Budapest Airport and purchase of own shares by MOL.

of the forecast horizon. In spite of all these, the extent of debt-creating-financing will also continuously decrease, owing to the fall in external financing need.

External financing need in per cent of GDP

	2007	2008	2009	2010	2011
Balance of goods and services	1.4	0.9	2.4	3.1	3.5
Current account	-6.4	-6.8	-5.2	-4.8	-4.3
Capital account balance including EU transfers	1.1	1.7	1.5	2.3	2.8
External financing need	5.3	5.1	3.7	2.5	1.6
Debt-creating financing*	10.1**	4.6	3.5	1.4	0.5
Non-debt-creating financing	-4.8**	0.5	0.2	1.0	1.0
of which: net FDI	1.6	2.0	1.8	2.5	2.5
of which: net reinvested earnings	1.9	1.7	1.3	1.7	1.6

* without other capital

** due to considerable one-off items

Due to the rounding the sum data could differ from the sum of the detailed data

2.9. Inflation

The 2007 annual average consumer price index was 8.0%, which was determined by the 2006 autumn and early 2007 government measures aimed at improving the budget balance, and fast price rise of foodstuffs that can be traced back to domestic and international factors. The price index increasing impact of government measures terminated by 2007 autumn but given the permanently high foodstuff inflation and world economy energy prices dramatically rising in the meantime, the inflation rate has decreased only to a low extent in the first eight month of 2008. The agricultural prices steeply falling from September, the HUF rate reaching a definitely strong level at mid year as well as the aggregate weakening of household purchasing power in recent years together have now created a determining disinflation. In Q4 further price index decreasing impact may be attributed to quickly moderating international energy prices, yet now the first signs of the consequences of domestic recession due to slow-down in the world economy having developed due to the money market crisis can be clearly seen. As a result of all these, inflation will fall below 4.5% by the end of 2008, and its annual average value will be 6.2%.

To assess next year's inflation prospects is more difficult than usually. The HUF rate was highly volatile form in October 2008; for the time being, no reliable forecast can be made on its value expected from next year. International energy prices, including futures prices, dramatically fell during the autumn; currently, it is hard to estimate whether the low prices having developed will continue to be permanent. During the wage negotiation partners agreed on 3-5% as a recommended wage increase for 2009 in the business sector, so compared to the relatively high wage rises implemented in the past years, probably only small rise will be realised. Due to shrinking incomes and credit supply, household demand will significantly drop. Because of bad prospects in the overall economic climate the inflation risk will be basically downwards.

Against the background of the disinflation impact of the widening negative output gap, the commencement of rise in prosperity and international price developments, inflation will probably continue to slow down in 2010. After inflation has dramatically increased in recent years, fast recession triggered inflation might produce mitigation impact on inflationary expectations, and if boom beginning in the future will not be accompanied by e.g. exaggerated rise in wage claims or extreme expansion of household demand, then the inflation path will remain close to mid term target of the central bank permanently.

Inflation annual average changes, per cent

	2007	2008	2009	2010	2011
Consumer prices	8.0	6.2	4.5	3.2	3.0

The liberalisation of the energy market has been implemented in the midst of regional wave of prices getting higher due to insufficient supply in South-Eastern Europe. To mitigate further price pressures arising from insufficiency of domestic market competition, during the year the regulatory environment has been adjusted. In preparing the gas market liberalisation meant to be introduced at mid 2009, the lawmaker has already made use of this experience. It is favourable that the opening of the market will take place with presumably decreasing international prices.

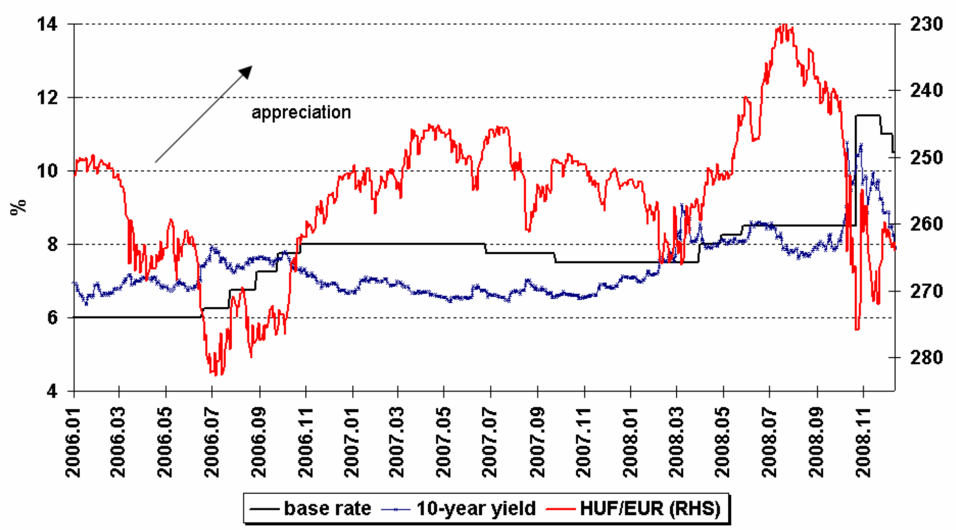
It is a mid term phenomenon that due to the fulfilment of environmental and service quality requirements and financing reasons municipalities make water, sewage and waste disposal services and local transport more expensive over the average inflation. On the other hand, from 2008 the Government has paid increased attention to the subject of municipalities' price authority regulation. This e.g. has embodied in the detailed elaboration of district heating price regulation where, with the help of the specialist assistance of the Energy Office, increased enforcement of cost based policy and efficiency constraints will presumably prevail.

2.10. Monetary and exchange rate policy

Pursuant to the central bank law, the central bank's primary objective is to achieve and maintain price stability. Since mid 2001, monetary policy has been operating within the inflation targeting framework, which has been supplemented by a free floating exchange rate regime since February 2008. The free floating exchange rate regime creates more favourable conditions for the central bank to achieve the inflation target, and thereby to meet the nominal Maastricht criterion on inflation, as well as for entering the ERM-II exchange rate system. In order to achieve the inflation targets, there is a continued need of a supporting fiscal policy. The monetary policy instruments are essentially harmonised with those of the Eurosystem, with the only difference that Magyar Nemzeti Bank (MNB) applies passive rather than active-side operation. In November 2008, the Monetary Council decreased the rate of mandatory reserves from 5% to 2%, which is equal to the level applied by the European Central Bank.

Since the widening of the fluctuation band in 2001, the exchange rate of the Hungarian currency (Forint) was stable apart from brief periods of volatility; with the exception of a few days until the termination of the fluctuation band in February 2008 the Forint stayed in the stronger side of the band. In the free floating exchange rate regime the Forint has developed steadfast along a strengthening trend up to early October 2008; then, given the deepening of the international financial crisis following the shock in the U.S. sub-prime mortgage markets, the exchange rate of the Forint weakened considerably.

Yields and exchange rate developments



Under the circumstances of general lack of confidence in money and capital markets, the market perception of Hungary – in spite of significant results of fiscal consolidation – has considerably worsened. Both short and long-term Forint/EUR spreads have significantly increased within a short time; ÁKK (Government Debt Management Agency) cancelled all remaining bond auctions previously scheduled in its 2008 issuance calendar; non-residents have reduced their stock of government securities denominated in Forint to a great extent. The base rate was raised by the Monetary Council by 300 basis points at its extraordinary meeting held in October. Early October, the country's default risk significantly increased; the CDS (credit default swap) spread rose. In order to temporarily substitute the dried-up market financing and restore confidence, the Government and the MNB concluded an agreement with the European Union, the International Monetary Fund and the World Bank on an approx. EUR 20 billion credit package. The credit facility is primarily aimed at restoring confidence and, if meeting determined conditions, can be drawn in several instalments. The agreement provides the proper background that should, upon the effect of the applied strict fiscal, incomes and monetary policy, strengthen confidence, stabilize the exchange rate of the forint, reduce short and long term yields, steer the government securities market to operate as usual, improve the conditions of financial service providers, especially banks, allow of better accessibility of financial resources from the markets necessary for the operation of the business sector. In terms of restoring market confidence and then forming the basis of continuous improvement, it is indispensable to cut the general government deficit below the Maastricht criteria and gradually attain the mid-term objective.

Once credit facility provided by international institutes have become available and following measures aimed at strengthening the stability of the financial intermediary system and the announcement of the steps that underpin the reduction of general government deficit to a greater extent than expected earlier, the Monetary Council decided to reduce the base rate by 50-50 basis points, on 24 November and on 8 December.

During 2008, through the appreciation of the real exchange rates and considerable rise in real interests, monetary conditions have become tighter. The one-year ex ante real interest rate – as the balance of rise in yield and inflationary expectations mitigated – is above its historic average. The real exchange rate – upon the effect of inflationary difference higher compared to our commercial partners but decreasing in its tendency, and because of the somewhat appreciated nominal effective exchange rate in terms of annual average – has strengthened.

During the reconsideration of the mid-term inflation target due in 2008, taking the structure of the Hungarian economy, future prospects and inflationary factors into consideration the 3% target remained unchanged. The next revision of the numeric value of price stability – in line with what was declared during the changeover to mid-term continuous target in August 2005 – will be carried out 3 years later, or when entering the ERM-II exchange rate system. The inflation target according to the forecast of the convergence programme might be achieved as early as in the first half of the programme period.

The Government consider the adoption of the euro as a priority. To facilitate the introduction of the common currency as soon as economic factors (fulfilment of the convergence criteria) allow, the Government has commenced preparation for practical changeover. As a first step therein, it has set up the National Euro Coordination Committee chaired by the Minister of Finance, co-chaired by the Governor of the MNB, which is responsible for the creation of the organisational frameworks for the introduction of the euro and the preparation of the National Changeover Plan. The first version of the National Changeover Plan was completed through an extensive cooperation of public, economic organisations and NGO's in mid 2008, which is to be updated yearly by the parties concerned.

3. Fiscal policy

3.1. Fiscal path; cyclical conditions

As a result of the fiscal consolidation programme started in the second half of 2006, the ESA95 general government deficit has decreased faster than planned. In 2007, the deficit declined to close to half of previous year's 9.3%, to 5% of GDP. Similarly to 2007, the deficit in 2008 will be lower than the target set in the former convergence programme and might be 3.4% of GDP instead of 4%.

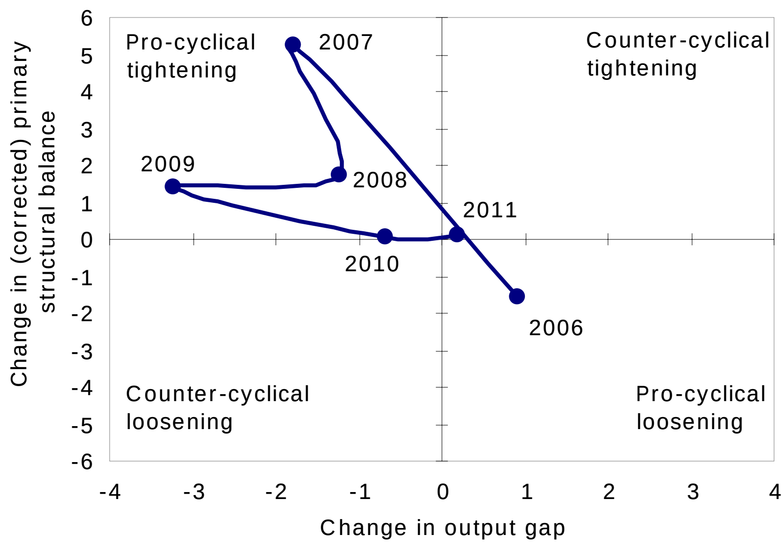
The financial market crisis seriously affecting also Hungary, the fast increase of risks have necessitated for the 2009 budget to aim at a higher than previously planned improvement in the budget balance, in order to strengthen market confidence and stability, and notwithstanding the deterioration in the economic outlook. Therefore, the budget deficit target was set at 2.6% of GDP. As a result of the expected economic downturn, the actual output of the economy will significantly fall short of the potential level; so, the deficit net of cyclical component and one-off items will decrease to 1.8% of GDP in 2009. Although, from 2010, growth is expected to return gradually, the cyclical position will continue to be unfavourable. Regarding cyclical conditions, slight improvement might commence only in 2011, but the output gap will still remain negative. In this context, faster reduction of the deficit than presented in the 2007 convergence programme might continue mainly at the beginning of the programme period, towards the medium-term budgetary objective determined in line with the Stability and Growth Pact (structural deficit around 0.5% of GDP). Between 2007 and 2011, according to the fiscal path of the updated convergence programme, the deficit will decrease by 2.8 percentage points (annual 0.7 percentage point on average). The structural balance will improve by 0.8 per annum on average; overall by 3.2 percentage points.

Medium-term fiscal path in per cent of GDP

	2007	2008	2009	2010	2011
General government deficit	5.0	3.4	2.6	2.5	2.2
of which: effect of the pension reform	1.3	1.4	1.4	1.4	1.4
Structural deficit	4.5	3.0	1.8	1.5	1.3
Output gap	1.4	0.1	-3.1	-3.8	-3.6

The need to improve the budget balance does not make it possible for the fiscal policy to use counter cyclical fiscal instruments in order to moderate the slow-down of the economy and the expected downturn. Change in the structural primary balance indicates considerable narrowing of aggregate demand until 2009; the fiscal stance can become practically neutral only from 2010. In the downswing of the economic cycle, the balance improvement implemented simultaneously with a widening negative output gap implies a strongly pro-cyclical fiscal stance.

Fiscal stance
(+: tightening, -: loosening)



3.2. Budgetary developments in 2008

In accordance with the target specified in the previous convergence programme, the Budget Act set out an ESA95 general government deficit of 4% of GDP in 2008. Interim data, however, similarly to 2007, showed again towards a better-than-planned balance; therefore, the Ministry of Finance reduced its annual forecast to 3.8% of GDP in July. In October, in the midst of increasing financial market turbulences, the Government announced expenditure reduction measures and again modified the forecast downwards, to 3.4% of GDP. In order to attain the new deficit target, still available chapter equilibrium reserves and central equilibrium reserves can be used only if and to the extent that it is made possible by other savings on expenditures or windfall revenues. Taking into account savings that can be attained in the expenditure of extra-budgetary funds and the fact that lagging behind in EU programmes will reduce expenditures spent on co-financing too, total savings will reach 0.4% of GDP.

The forecast is underpinned by monthly cash-flow and quarterly ESA data too. The ESA95 general government deficit was 2.4% of the seasonally adjusted quarterly GDP in Q1, and 2.1% in Q2 – lower quarterly deficit was attained in the past six and half years only on one occasion, in Q2 2007. For the whole of the half year, the deficit corresponded to 2.2% of GDP, which is the lowest value since the end of 2001. Compared to H1 2007, the general government sector deficit compared to GDP reduced just to its half. The improvement was attributable to the fact that the growth of expenditure was much lower than that of revenues. Among key expenditure items, it was only social transfers other than in kind that produced dynamics faster than the growth of GDP, which was related primarily to increase in pension expenditures. In 2008, the budget included rise in pension expenditure compared to GDP. This was justified by the expected growth in the number of retirees in the first half of the year due to changes in pension regulations (retiring in accordance with earlier rules was possible until that time) and by the pension correction programme. Expenditures were further increased by the fact that in May 1.1% supplementary pension rise retroactive until January was implemented – since the extent of pension rise is determined by each of the inflation and changes in net earnings by 50%. Otherwise, government expenditures, in particular investments, decreased compared to GDP.

Similarly to the ESA figures, monthly cash-flow data also indicate the improvement of the general government balance. In the first ten months, the aggregate deficit of the central government, the social security funds and the extra-budgetary funds did not reach the time-proportionate level even based on the annual forecast modified downwards. The deficit target can be attained even if in the last two months of the year – contrary to its tendency so far – the deficit would grow compared to November-December 2007. According to usual seasonality, the balance is expected to show considerable deficit in November, and surplus in December. In November, expenditures are increased by the payment of the second instalment of the 13th month pensions and by further supplementary pension rise necessary because of the development of wages and inflation. In December, however, owing to increasing tax payments[5], revenues will exceed expenditures.

The favourable development of the balance is owing to marked increase in revenues – especially from income related tax types, on the on hand; and, to the fact that the bulk of expenditures slightly lagged behind the time-proportionate level during the year.

The annual forecast reckons with expected revenue surplus based on the budget data and macroeconomic developments (slower disinflation and stronger wage growth than envisaged at late 2007/early 2008), but takes into account increased uncertainties too (growth and employment forecast modified downwards). After interim advance payments, revenues from corporate income taxes in December might be unfavourably influenced by the macroeconomic environment, additional revenues from social contribution might be less than expected earlier, and slight shortfall in taxes on consumption is presumable. Overall, the surplus from tax and contribution payments might reach 0.4% of GDP.

The balance of revenues, expenditures and budget contributions of central budgetary institutes and chapter managed appropriations (the deficit increasing impact of the system of budgetary institutes) has been systematically lower during the year than the time-proportionate level. Savings have been generated in chapter managed appropriations, mainly as a result of delay in the implementation of certain EU programmes.

Beside central subsystems, local governments have closed the first three quarters with a balance more favourable than expected; contrary to previous year's slight deficit they have closed the first three quarters with surplus; so, the annual deficit of the subsystem may be lower than it was forecast earlier. Balance improvement is related primarily to delay in investment expenditures.

ESA95 revenues and expenditures will be modified not only because of paying regard to interim information but due to methodological changes introduced by Hungarian statistical authorities in the autumn Notification to Eurostat on the Government sector deficit and debt:

- The company set up to manage passenger railway transportation (MÁV Start Zrt.) has been reclassified retroactively, as of the date of its establishment (1 July 2007), in the government sector. As a result of the reclassification, the company's market revenues increase the government's revenues. On the expenditure side, subsidies has been reduced by the sum allocated to MÁV Start, while compensation of employees, intermediate consumption and investment expenditures have increased;
- In accordance with the Eurostat recommendation, accounting for EU-transfers has changed to better ensure the neutrality of its impact on the balance. The reimbursement of costs of projects paid in advance from domestic sources to be realised in later years will be carried back in the accounts for the given year.

[5] According to the profit tax payment rules, over 40% of the profit tax is payable in December.

Upon the impact of macroeconomic and financial developments, accrual based expenditures will change at the following key points:

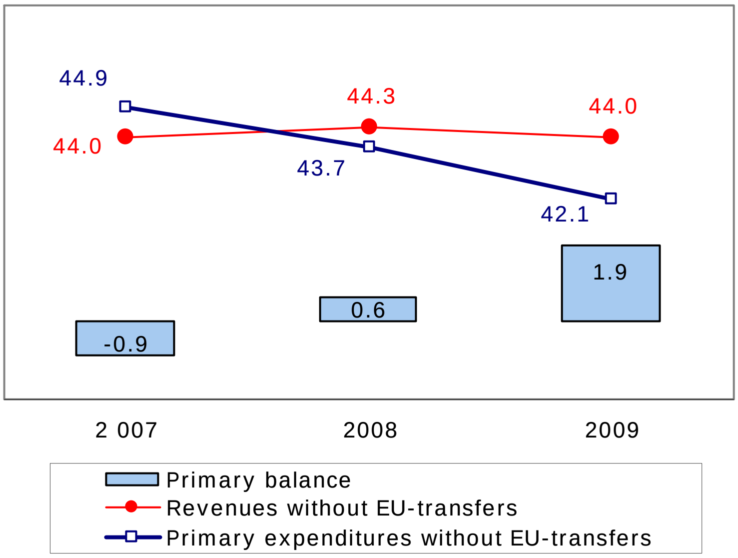
- In accordance with the wage agreement concluded in the public sector, real wages stay on the previous year level in 2008. Considering slower-than-expected disinflation at the time of budget preparation, this represents extra expenditures equal to 0.1% of GDP, in the form of wage supplement disbursed in two instalments;
- The supplementary pension rises at a rate of 1.1% (twice) payable in accordance with the law, in May and November, constitute extra expenditures equal to 0.2% of GDP. Regarding other elements of social transfers, changes in the contrary direction are expected. Savings might be generated in consumer price subsidies, in social benefits and sick pay disbursements. Expenditures of housing subsidies, however, will rise as a result of higher government security yields. The nominal GDP forecast modified downwards also plays role in the fact that overall social transfers compared to GDP will rise compared to 2007;
- Interim data justify downward modification of the investment expenditures forecast;
- The forecast assumes that the privatisation receipts from the sale of the company set up for freight railway forwarding (MÁV Cargo Zrt.) will remain at MÁV Zrt.; so, this transaction will increase ESA expenditures as capital transfer expenditure.

As a result of the afore-said changes and lower nominal GDP, lower-than-planned deficit can be achieved through attaining higher revenues and expenditures to GDP ratios.

3.3. The 2009 budget

Based on the 2009 budget, next year, the ESA95 deficit will be below the 3% threshold value. Contrary to the 3.2% target set out in the previous convergence programme, the deficit will decrease to 2.6% of GDP. Higher improvement in the balance and the offsetting of rising interest expenditures notwithstanding the lower deficit are possible by cutting back on primary expenditures. In accordance with the fiscal responsibility act adopted in November 2008, consolidated primary expenditures of the central government sector (excluding expenditures covered from EU-transfers and institutes' own revenues) will not rise even nominally; moreover, it will decrease compared to the previous year. Calculating without EU-transfers increasing both the revenue and expenditure side of the budget, primary expenditures of the general government compared to GDP will decrease by more than 1.5 percentage points.

Revenues, primary expenditures, primary balance
(in per cent of GDP)



The primary expenditures/GDP ratio will be lower than in 2008 even with growing EU-transfers taken into account. The expenditure cuts will be implemented mainly through reducing wage-related expenditures and central government chapters spending financed from subsidies (that is, not from own revenues and not from EU funds) and cutting back on rise in pension and social benefit expenditures.

- In 2009, the wage scale will remain unchanged in the public sector and overall wages will decrease to the extent of 13th month salaries. (Based on the earlier planned small real wage increase, the joint impact of the two measures will exceed 1% of GDP). The budget does not reckon with layoffs in the public sector but the Government intends to mitigate the expected fall in employment in the whole of the national economy by budgetary measures. The objective of the National Employment Programme is to multiply the number of persons participating in public work instead of living on social benefits. Increase in the amount re-allocated from social transfers other than in kind to public work will increase expenditures spent on wages and contributions compared to GDP by 0.1 percentage point; accordingly, overall the compensation of employees/GDP ratio will decrease by 0.5 percentage point compared to 2008;
- Regarding central government chapters' spending financed from subsidies, next year's budget reckons with much lower amounts than the 2008 appropriations. Appropriations set compared to GDP are more than 1 percentage point lower than in the previous year. Institutional measures supporting the "smaller and more efficient state" objective of the Government have been largely implemented. The achieved permanent savings and the disappearance of one-off tasks helped the reduction of the expenditure appropriations. Besides, the chapters have been allowed to plan 2009 appropriations on a basis reduced by approx. 0.4% of GDP. In order to achieve the deficit target modified downwards subsidy appropriations (excluding changes in expenditures spent on wages) were reduced further by 0.2% of GDP. Savings have been expanded by the fact that HUF 80 billion (0.3% of GDP) of the chapters' subsidies have been transferred to the so-called frozen chapter equilibrium reserve,

which will not be spent. Appropriations in the frozen chapter equilibrium reserve can only be spent if windfall revenues occur, but whatever is the amount of the windfall revenues, the increase in expenditures could not surpass the amount of the frozen reserve. Furthermore those windfall revenues to which an expenditure item is attached could not be spent;

- Pensions will increase by 1 January according to the relevant legislation, however, the so-called pension correction programme will continue only from 1 September. Payment rules of the 13th month pension change. The 13th month pension is capped to HUF 80,000, and it can only be paid above the official retirement age of 62 years, or to persons receiving disability pension. The measure will decrease expenditures by 0.3% of GDP;
- The annual valorisation of the family support to level of the inflation will take place from 1 September; social transfers attached to the minimum pension remain unchanged (savings are equal to 0.1% of GDP).
- Upon the effect of measures affecting pension and social benefit expenditures, social transfers other than in kind compared to GDP will not change compared to 2008. Social transfers in kind supplied via market producers, however, will slightly rise (by 0.1 percentage point) as a result of household subsidies related to the district heating service. (The source thereof is the temporarily introduced special tax on energy supplier enterprises.);
- Within expenditures the budget gives priority to projects partly financed by the EU. Restructuring of sources could help revitalising the economy and preserve jobs; therefore more emphasis will be given to projects supporting SMEs. Owing to increasing EU-transfers, investment expenditures can now rise compared to the reduced level in 2008;

The safe implementation of the budget is helped by reserves equal to 0.5% of GDP (general reserves, and the so-called stability reserves).

Given the worsening financial market and real economy conditions, it is not possible to put in place the earlier planned tax reduction – with a net impact of 0.5% of GDP; the tax code will change mainly in favour of simplification and further “whitening” of the economy:

- Administrative burden will decrease; companies’ book-keeping will become considerably simpler fore a determined scope of companies and up to a limeit in terms of sales revenue; private persons will have the opportunity to submit simplified tax returns with the tax authority’s assistance; the system of tax allowances in personal income tax will become simpler.

Key changes encouraging ”whitening” are as follows:

- Extension of mandatory invoicing (broadening the number of persons who can be fined for the failure of invoicing, extension of the mandatory invoice-keeping in case of enterprises);
- Restriction in cash transaction (cash limit prescription for taxpayers having bank account, limitation of the end-of-the-day cash stock);

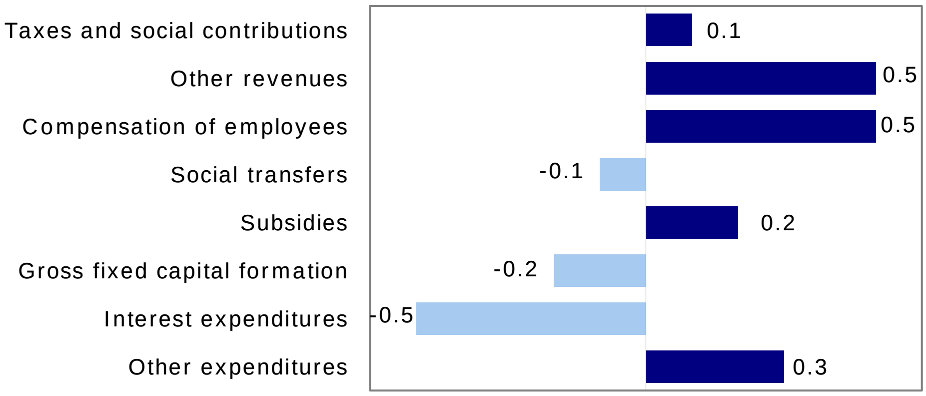
- Tightening the rules for suspension of tax register code (e.g. in case of failure of tax return and payment);
- Tightening the rules aiming at avoiding fictitious invoicing, extension of invoicing.

In addition to these measures, only a few minor changes in taxation having impact on revenues will be entered into force:

- The company car tax earlier regulated under the personal income tax, to be paid in relation to use for private purposes, will be replaced by a new type of company car tax projected on a wider tax base;
- The extension of companies' investment sources is served by making tax on dividends uniform at a rate of 25%; abolition of the 35% tax rate;
- In accordance with law harmonisation as of 1 January 2009 the act on energy tax is amended and as from 1 July 2009 the extent of excise tax on tobacco products will rise;
- Inheritance tax is abolished for a given scope, below a defined amount limit;
- A special tax on energy supplier enterprises is introduced temporarily. Revenues from this tax (0.1% of GDP per annum) will serve to provide sources of household subsidies related to district heating, and to encourage modernisation of heating.

Upon the joint impact of the only slightly changing taxation system and nominal GDP growing moderately, tax centralisation will roughly stagnate compared to 2008 (will increase marginally by 0.1 percentage point).

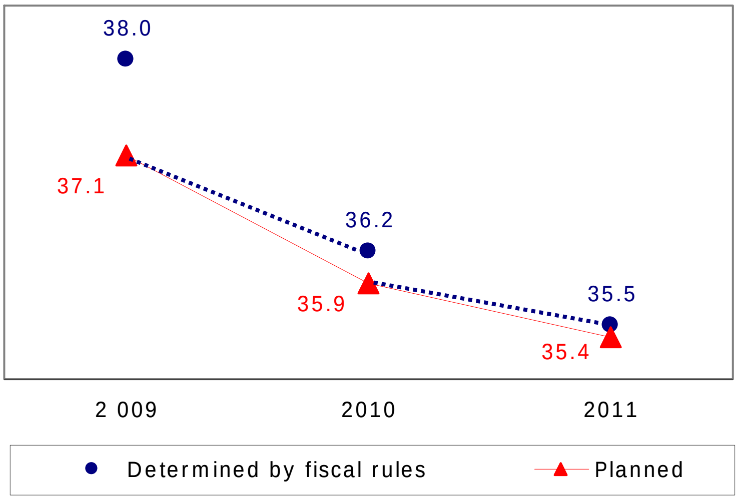
Composition of the 2009 deficit reduction
(in per cent of GDP, + / - : decrease/increase of the deficit)



3.4. 2010-2011 budgetary objectives

2010-2011 budgetary developments are determined by the deficit path set and the rule defining changes in primary expenditures stipulated in the fiscal responsibility act. In accordance with the rule, in 2010 and 2011 consolidated primary expenditures of the central government sector (excluding expenditures covered from EU-transfers and institutes' own revenues) shall increase, in real terms maximum by the half of the real GDP growth rate. Taking into account the expected development of revenues and interest expenditures, to achieve the deficit target calls for expenditure reduction somewhat larger than stipulated by law, according to the forecast.

Primary expenditures subject to fiscal rules
(in per cent of GDP)



Calculating without EU-transfers increasing both the revenue and expenditure side of the budget, deficit reduction might be ensured on the time horizon of the programme by cutting primary expenditures concerning the general government level, as well.

Main indicators of the general government in per cent of GDP

	2007	2008	2009	2010	2011
Taxes and social contributions	39.5	39.9	40.0	39.9	39.8
Revenues	44.9	45.2	45.8	46.0	45.8
Expenditures	49.8	48.6	48.4	48.5	48.0
Revenues without EU-transfers	44.0	44.3	44.0	43.7	43.4
Primary expenditures without EU-transfers	44.9	43.7	42.1	41.7	41.2
Balance	-5.0	-3.4	-2.6	-2.5	-2.2
Primary balance	-0.9	0.6	1.9	2.0	2.2

Differences are explained by the rounding.

Reduction in expenditures is underpinned by the following measures in the convergence programme forecast:

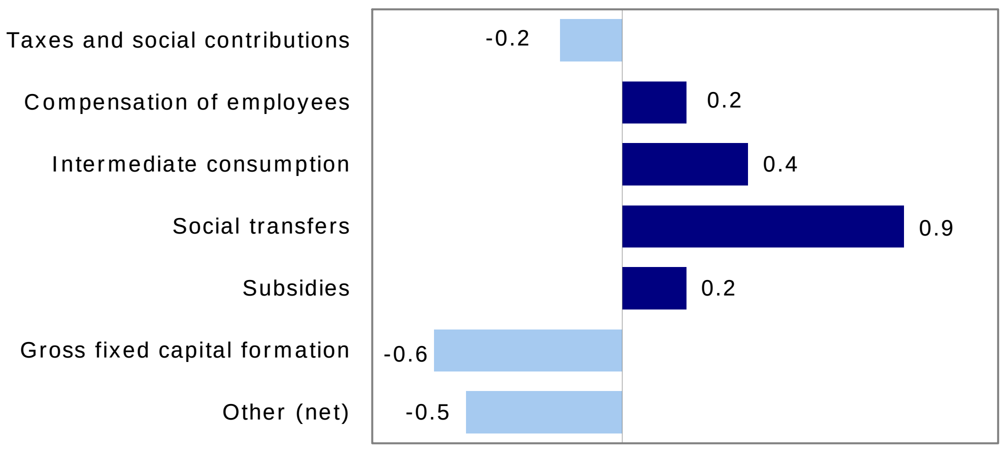
- Strict discipline continues to be maintained in the management of central budget chapters. Extra expenditures (e.g. increase in availability fees related to PPP-projects; disbursement of obligations assumed towards the NATO; surpluses arising from the Higher Education Act; one-off costs of EU Presidency related duties and the general elections in 2010; etc.) is offset by general basis reduction of necessary extent in the budget;

- Following the decrease in 2009, from 2010 real wages may moderately increase (approx. 0.5-1%) in the public sector. Compared to GDP, expenditures related to the compensation of employees will decrease slightly in 2010, and markedly in 2011;
- In spite of the increase in availability fees related to PPP-projects, the real value of intermediate consumption expenditures shall not increase;
- The programme foresees that upon the impact of structural changes the social transfers other than in kind to GDP ratio will decrease by 0.5 percentage point between 2009 and 2011. For price subsidies, measures introduced at the beginning of the fiscal consolidation programme will continue to be effective. The source of the district heating related household subsidies in 2009 and 2010 will be expanded by the temporarily introduced special tax on energy supplier enterprises. After its abolition, in 2011 social transfers in kind supplied via market producers may decrease nominally. Overall, between 2009 and 2011 social transfers may decrease by 1 percentage point compared to GDP.

Owing to savings and projects implemented through EU co-financing, investment expenditures during the programme period may grow faster than the GDP. The nominal level of investments do not differ significantly from the one projected in the previous convergence programme. The different dynamics of figures compared to GDP is explained basically by the impact of the GDP forecast modified downwards.

The calculations of the convergence programme have been made presuming unchanged taxation system after 2009, so the tax centralisation will stay basically unchanged during the programme period. The Government continues to deem it necessary to make the taxation system simpler, more transparent, more equitable with a view to boosting growth, extending employment and improving competitiveness; therefore, the internal proportions of tax revenues might be modified later on. Based on the macroeconomic forecast, reduction of tax and contribution revenues, without jeopardising deficit targets is only possible through even larger expenditure cuts than determined by rules.

Composition of the deficit reduction: 2011-2009
(in per cent of GDP, + / - : decrease/increase of the deficit)



3.5. Structural balance and one-off budget items

According to the calculations of the convergence programme, the sensitivity coefficient – taking the tax revenues expected in 2008 into account – is 0.265[6], that is, the budgetary balance will change by 0.265 percentage point as a result of 1% change of GDP (assuming no change in the composition of GDP).

During the period of the convergence programme, there are two key factors which determine changes in economic growth. One of them is the adjustment measures initiated in 2006; the other one is the financial crisis expanding from H2 2008. Upon the effect of the adjustment measures, current growth has significantly slowed down in 2007-2008; the level of output in 2009 will fall below the potential output. As a result of the budget consolidation carried on in the midst of the economic crisis, the economic growth will presumably stay below the potential level until 2010. Consequently, the output gap between 2007 and 2010 will gradually worsen and during the years 2009 and 2011 will show an extremely negative value. In 2011, economic growth will slightly exceed the potential rate; therefore, the output gap will start to narrow but will continue to remain quite wide. Due to the impact of all these, the cyclically adjusted balance will improve with significantly larger extent until 2010, and somewhat smaller extent in 2011 than the actual balance.

The budgetary expenditures have been increased by one-off items in 2007 and 2008. In 2007, the Gripen purchase, the cancellation of the Iraqi debt, additional flood protection expenditures, one-off costs related to staff cuts in the public sector and one-off expenditures related to MÁV can be considered expenditure increasing one-off items. In 2008, one-off items to increase expenditures and revenues also occurred but in view of their joint effect the items have increased expenditures. In 2008, expenditures were increased by one-off items related to MÁV and one-off costs related to layoffs in the public sector, and revenues were increased as a one-off item by the GSM concession revenues. The structural deficit was definitely less in 2007 and still less in 2008 than the cyclically adjusted deficit. From 2009 the programme does not contain one-off items.

In spite of the large negative output gap evolved in the extraordinary economic situation, the convergence programme plans to improve the structural balance continuously. The structural balance will improve by 1.5 percentage point in 2008, 1.2 percentage point in 2009, and 0.3 and 0.2 percentage point in the following two years respectively. Calculating with the sensitivity coefficient used by the European Commission (0.46), the structural deficit would be around the medium-term budget target by 2011.

[6] In the calculation of the sensitivity coefficient, the convergence programme follows the approach recommended by the European Central Bank and only the tax revenues from the private sector are taken into account to use them to weight the sensitivity of taxes and contributions.

Structural balance					in per cent of GDP
	2007	**2008**	**2009**	**2010**	**2011**
Output gap	**1.4**	**0.1**	**-3.1**	**-3.8**	**-3.6**
General government balance	-5	-3.4	-2.6	-2.5	-2.2
Cyclically adjusted balance	-5.4	-3.4	-1.8	-1.5	-1.3
One-offs*	-0.9	-0.4	0.0	0.0	0.0
Structural balance	-4.5	-3.0	-1.8	-1.5	-1.3

* A plus sign means deficit-reducing one-off items.
Due to the rounding the sum data could differ from the sum of the detailed data.

3.6. Public debt

The government debt to the GDP ratio in 2007 turned out to be slightly less favourable than it was projected in previous convergence programme. The somewhat higher rate developed in spite of the considerably lower deficit because the exchange rate became weaker than the technical assumption; other financing items (higher level of financial assets[7]) reduced the debt level less and the nominal GDP became lower than the path projected in the 2007 convergence programme.

The debt path assumption for 2008-2011 has been significantly modified, shifted upwards; in its dynamics with a rising path in the beginning of the period. Although the considerably lower forecast on the deficit path shifts the debt path downwards, the following factors work towards a higher debt rate:

- The growth dynamics of the GDP and also its nominal level have significantly decreased compared to the previous programme.
- The present programme calculates with a more depreciated technical exchange rate[8],
- The drawdown of the first instalment of the IMF credit, which served to expand foreign exchange reserves to a great extent, has increased gross government debt. HUF 600 billion of the credit can be the source of measures to strengthen the stability of the banking system. The rest will generate interest on the state's foreign exchange account kept in the MNB. In terms of economic processes it is more relevant to consider the net debt corrected by the latter item (table no 3, as a matter of fact, shows the ESA95 gross public debt of the government sector),
- Different path of the stock-flow adjustment[9].

[7] In the background of this process lies the significant involvement of municipality funds, which could be observed from late 2006. The involvement of funds is implemented through issuing bonds (mostly foreign exchange denominated bonds) and municipalities keep the funds in financial assets. Consequently, their net debt will not grow so intensively.

[8] The convergence programme has used a technical assumption regarding changes in the HUF/EUR exchange rate. The 2008 year-end HUF 260 exchange rate is the average value of the exchanges rates that actually prevailed in October 2008. The calculations regarding the rest of the period of the programme horizon have been made by fixing this rate.

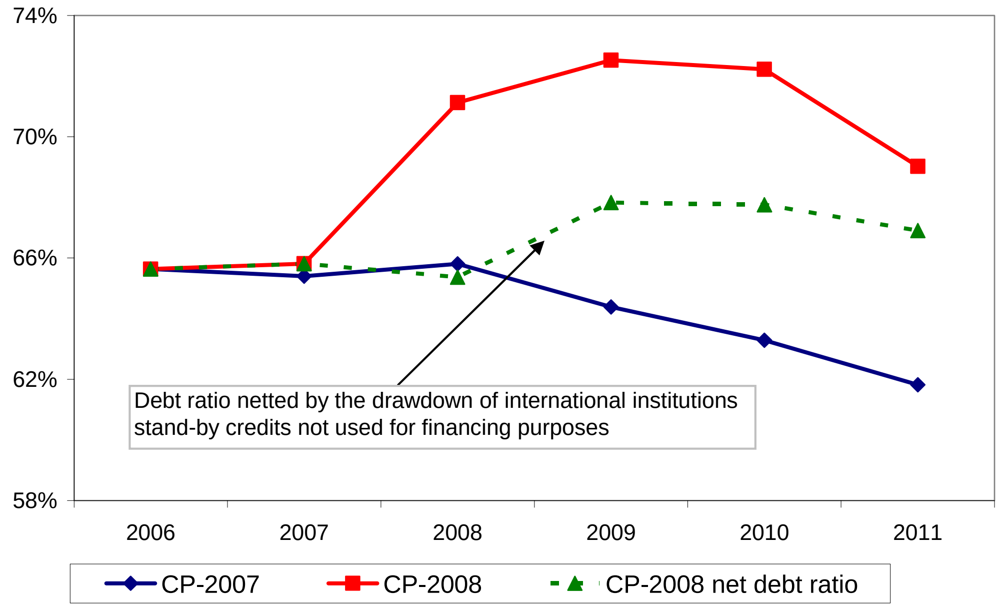
[9] Other items (stock-flow adjustment) represent the difference between the debt level increase and the deficit. The major items are as follows: privatisation proceeds; difference between cash and accrual based deficit elements; revaluation effect arising from changes in the exchange rate; changes in the financial assets.

Main assumptions in the convergence programmes

		2007	2008	2009	2010	2011
Nominal GDP growth (%)	*CP-2007*	8.2	6.8	7.2	7.2	7.1
	CP-2008	**6.9**	**6.6**	**2.2**	**5.0**	**5.5**
Deficit (in terms of GDP)	*CP-2007*	6.2	4.0	3.2	2.7	2.2
	CP-2008	**5.0**	**3.4**	**2.6**	**2.5**	**2.2**
Debt ratio (%)	*CP-2007*	65.4	65.8	64.4	63.3	61.8
	CP-2008	**65.8**	**71.1**	**72.5**	**72.2**	**69.0**
	CP-2008 net*		***65.4***	***67.8***	***67.8***	***66.9***

** Debt ratio netted by the credits drawn down from international institutions and put in the state's FX account hold at the MNB*

Debt ratio in the November 2007 and the actual convergence programme



In the medium run it is a definite aim of economic policy that after a temporary rise the debt ratio should start to decrease again. If medium-term budgetary plans and nominal GDP growth are to be in line with the forecast, the aim can be attained by 2010. Based on the present forecast, the debt ratio might turn from the 2009 peak, and the index will decrease to 69% by 2011.

In 2008 the debt ratio will rise significantly but the main reason for that is the drawdown of a part of the stand-by credit provided by IMF and the EU. According to the plans a significant part of the credits will not used for financing purposes in 2008. The planned drawdown of the credit line made available by international institutions will cover a part of the 2009 financing need. The rate netted by the credits not used for financing purposes, which measures the public sector's position more realistically, is lower compared to 2007 because of the much smaller deficit and the changes in the stock-flow adjustments. In 2009 due to lower nominal GDP growth the debt ratio will rise. The netted rate will decrease to 67% by the end of 2011.

The *primary balance* is much more favourable during the entire horizon of the programme period than the values forecasted in previous convergence programme.

On the contrary, *interest expenditures* will rise by 0.7-1.2 percentage points between 2009 and 2011 because of the higher gross debt, and the upward shifting yield curve. The forecast has used the technical assumption that initially the yield curve will develop in accordance with market expectations (based on the forward yield curve); then, it will converge gradually to the euro yield curve. In the present environment the forward interest curve has been derived from a relatively high yield curve. If upon the effect of national bank and debt management measures, the international environment improves and the government securities market starts to function orderly, t-bills and bonds might be sold at lower yield levels; as a consequence interest expenditures might be lower too.

In addition to the deficit, the stock-flow adjustment will influence future changes in the debt rate:

- The baseline scenario does not reckon with further significant privatisation revenues on the time horizon of the convergence programme – except for a low level of municipality property sale,
- The technical exchange rate is depreciated by 2.6% more than the 2007 year-end assumption resulting in a positive revaluation effect for 2008. From 2009 the programme calculates with unchanged exchange rate assumption,
- From 2008 MÁV Start Zrt. has been included in the public finance scope through amending the statistical ranking;
- Other items are affected by financing items not recorded in the deficit but influencing government debt (e.g., EU pre-financing; year-end change in the State Treasury Account and other HUF or foreign exchange accounts), the difference between the cash and accrual based accounting. Stock-flow adjustments for 2008 are dominated by the drawdown of the international institution's credits that are not used for financing purposes in 2008.

The future debt ratio is influenced by the following main factors (*ceteris paribus*[10]):

- Primary balance: the annual 1 percentage point permanent change of the primary balance prevailing from 2009 to the end of the path will induce 2.1 percentage point change in 2010, and 3.1 percentage point by 2011 in the debt ratio (which includes the accumulated interest expenditure as well).
- Exchange rate: the foreign exchange structure of the debt portfolio will significantly change due to the international institution's funds drawn and to be drawn down. Within the gross debt the foreign exchange ratio on the path is 36-44%; and within the debt netted by the international institutions credits not used for financing purposes 32-40%. Based on that, a 10% change in the exchange rate will – subject to the exact currency composition – have approx. 2.3-3.2; and 2.1-2.7 percentage point impact on the debt ratio.

[10] Examining the impact of changes in specific items influencing the debt ratio, under the assumption that the rest of the indices are unchanged.

- Yield curve: yield curve changes appear gradually in interest expenditures through renewed instruments. In specific years the cumulative effect of the altered interest expenditure on the debt ratio between 2009 and 2011 will be, in the event of 100 basis point HUF denominated government securities yield change, 0.1; 0.2; 0.4 percentage points respectively (change of interest expenditures in percentage of the GDP is 0.1; 0.2; 0.1 percentage points respectively).
- Economic growth: the steady 1 percentage point change of nominal GDP starting from 2009 lasting throughout the period would have an impact on the gross debt ratio of 0.7 percentage point in 2009, 1.4 in 2010, and 2.0 in 2011.

4. Alternative scenarios and sensitivity analyses

According to the baseline path of the convergence programme the Hungarian economy will shrink by approx. 1% in 2009 due to the significant drop in external demand, to the worsening of credit conditions and to the measures aimed at improving the general government balance; then, from 2010 it will again grow owing to the improving external conditions. However, compared to earlier years, the baseline path is more uncertain due to exogenous factors on the one hand; and to the uncertainty of the reaction of economic actors to the shock, on the other. Among the exogenous risks external demand, import prices and the exchange rate are most important, while among the endogenous risks the credit activity of the domestic banking system and the reaction of firms to the changing situation in terms of wages and employment deserve most attention.

The first part of this section introduces an alternative scenario, taking into account the above risks. The general government deficit to GDP ratio is higher on this path than on the baseline path between 2009-2011 but does not exceed 3% in either year. The sensitivity analyses in the second part of this section quantify these uncertainties and their macroeconomic and budgetary implications, separately.

4.1. Alternative scenario

The alternative scenario assumes a much weaker external demand, implying that exports growth in 2009-2010 falls short of the values on the baseline path by 2.5-3 percentage points. On the nominal side of the economy the main deviation from the baseline scenario is the lower inflation by 1.2-1.5 percentage point in 2009-2010, which is a consequence of the stronger technical exchange rate assumption and the lower price of raw materials. At the same time nominal wages of the private sector do not adjust fully to the smaller inflation, thus the path includes higher real wages compared to the baseline in 2009 and also in 2010. Weaker external demand implies a stronger reduction of employment, which is decreasing even in 2010.

Due to the lower dynamics of exports, and also to the stricter credit conditions for firms, investments in the alternative scenario suffer a substantial set-back in 2009 and display a more moderate growth in 2010-2011 than on the baseline path. At the same time, real consumption of households is reduced by a smaller amount because of higher real income. On the whole, GDP dynamics is lower by 0.7 percentage point in 2009 and by 0.2-0.4 percentage point in 2010-2011 than in the baseline scenario. Lower employment and nominal wages, together with the lower nominal consumption as a result of the smaller inflation reduce the revenues of the budget, and this is only partly offset from 2010 onwards by a reduction of transfers in cash. Therefore the general government deficit in the alternative scenario is around 3% of GDP between 2009 and 2011.

Alternative scenario* percentage point

	2009	2010	2011
Household consumption	-2.4	1.1	1.1
Gross fixed capital formation	-3.4	0.5	5.5
Exports (goods and services)	+0.8	+3.3	+7.0
Imports (goods and services)	-0.1	+2.8	+6.7
GDP	-1.6	+1.2	+2.3
Inflation	+3.0	+2.0	+3.0
Employment	-1.0	-0.3	+0.4
Budget balance (in per cent of GDP)	-2.9	-3.0	-2.8

* Growth rate of macroeconomic variables (except for the budget balance)

4.2. Sensitivity analyses

The following sensitivity analyses quantify the macroeconomic and budgetary impacts of a few risks separately.

External demand

If the growth rate of external demand is lower by one percentage point in 2009 than on the baseline path, export dynamics is reduced by approx. 1.3 percentage points because the short term external market elasticity of the Hungarian economy is greater than one. Due to the more moderate investment activity of exporting firms, gross fixed capital formation slows down by more than half percentage point in 2009 and 2010. In 2009 the GDP suffers a 0.7 percentage point setback compared to the baseline scenario. The slowdown affects employment, private sector wages and household consumption negatively in 2009 as well as in 2010. As a result of lower nominal household consumption and private sector wage bill, general government balance is worsening by 0.3 percentage point by 2011.

On the other hand, if external demand is increasing one percentage point faster in 2009 than in the baseline case, developments to the contrary effect take place, and the general government balance may be 0.3 percentage point more favourable.

Inflation

Uncertainty in inflation forecast is primarily a consequence of uncertainty in the development of the exchange rate and raw material prices. The following sensitivity analysis assumes that the price level – mainly as a result of the deviation of the exchange rate from the baseline – gets one percent below its baseline level in two years so that the inflation is 0.5 percentage point lower in 2009 as well as in 2010.[11] Lower inflation also pushes down wages in the business sector to a smaller extent in 2009, and to a greater extent in 2010. (As lower raw material prices temporarily improve the financial position of firms, and wages are not perfectly flexible anyway, total inflationary difference does not immediately appear in the slowdown of wage dynamics.) The stronger exchange rate and temporarily higher real wages, on the other hand, induce somewhat weaker exports dynamics; also, higher real wages lead to a lower growth of employment in the business sector in 2010. As a result of higher household real consumption and lower exports, the real GDP growth rate and imports do not substantially deviate from the baseline scenario. Because of the lower nominal path, the level of purchased consumption of households will be 0.6% and the wage bill of the business sector more than 1% less than under the baseline scenario by 2011. The definitely lower tax and contribution revenues cannot be offset by the 0.6% drop in transfers in cash and by the somewhat falling interest expenditures because of the stronger exchange rate. Consequently, through the indirect effects, the scenario represents a 0.2 percentage point higher general government deficit to GDP ratio by 2011.

On the other hand, a higher than expected inflation, as a result of the indirect effects (mainly of the faster growth of nominal wages), would decrease deficit by around the same magnitude (about 0.2 percentage point).

Wage adjustment in the private sector

If wages in the private sector react more swiftly to the economic downturn than expected and their growth in 2009 is one percentage point lower than assumed in the baseline scenario, then the budget deficit will increase by 0.2% of GDP due to lower revenues from PIT and VAT. At the same time, such a development involves a smaller adjustment in the number of employees, implying higher private sector employment. Lower wage dynamics also imply a slight decrease in inflation for 2009 and 2010. Conversely, if the growth rate of private sector wages is one percentage point higher than in the baseline scenario, that improves general government balance by 0.2% of GDP.

Credit restrictions

According to the baseline scenario, due to worsening credit conditions and precautionary behaviour, the household consumption ratio[12] will drop by approx. 1 percentage point from 2008 to 2009, and stay basically unchanged after that. Nevertheless, uncertainty in the extent of credit restrictions and consumption smoothing introduce high risks into the development of the consumption ratio. This sensitivity test assumes that the consumption rate falls only slightly in 2009 (that is, it is almost a full percentage point higher than in the baseline scenario), which means additional household consumption in the magnitude of 0.5% of GDP. An easing of credit restrictions also implies a similar increase in investment, spread over two years.

[11] The reason for choosing a shock spread out for two years is that the indirect effects of the exchange rate – and partly also of raw material prices – do not materialise immediately in consumer prices.
[12] The ratio of household consumption expenditure to disposable income

Under such circumstances the volume index of household consumption is 0.8 percentage point higher for 2009 than in the baseline scenario, while the volume index of gross fixed capital accumulation is 1.0-1.3 percentage point higher for 2009 and 2010. More favourable domestic demand slightly increases employment and wages in the business sector, too. Owing to increased tax and contribution revenues the budget deficit is then 0.3 percentage point lower by 2011 compared to the baseline scenario.

Difference from the baseline scenario* percentage point

	2009	2010	2011
1a. One percentage point less favourable external demand			
Household consumption	-0.1	-0.2	-0.1
Gross fixed capital formation	-0.6	-0.6	0.0
Exports (goods and services)	-1.3	0.0	0.0
Imports (goods and services)	-0.8	-0.2	0.0
GDP	-0.7	-0.1	0.0
Inflation	0.0	0.0	-0.1
Employment in the private sector	-0.1	-0.2	-0.1
Budget balance (in per cent of GDP)	-0.1	-0.2	-0.3
1b. One percentage point more favourable external demand			
Household consumption	+0.1	+0.2	+0.1
Gross fixed capital formation	+0.6	+0.6	0.0
Exports (goods and services)	+1.3	0.0	0.0
Imports (goods and services)	+0.8	+0.2	0.0
GDP	+0.7	+0.1	0.0
Inflation	0.0	0.0	+0.1
Employment in the private sector	+0.1	+0.2	+0.1
Budget balance (in per cent of GDP)	+0.1	+0.2	+0.3
2. One percent lower price level and – as a consequence – a lower wage level			
Household consumption	+0.2	+0.2	0.0
Gross fixed capital formation	0.0	0.0	0.0
Exports (goods and services)	-0.1	-0.2	+0.1
Imports (goods and services)	0.0	0.0	+0.1
GDP	0.0	0.0	+0.1
Inflation	-0.5	-0.5	0.0
Employment in the private sector	0.0	-0.1	0.0
Budget balance (in per cent of GDP)	0.0	-0.1	-0.2
3. One percentage point lower wage growth in the private sector			
Household consumption	-0.2	+0.1	+0.1
Gross fixed capital formation	0.0	0.0	+0.1
Exports (goods and services)	0.0	+0.1	0.0
Imports (goods and services)	0.0	+0.1	+0.1
GDP	0.0	0.0	+0.1
Inflation	-0.2	-0.2	-0.1
Employment in the private sector	+0.1	+0.1	+0.1
Budget balance (in per cent of GDP)	-0.2	-0.2	-0.2
4. Easing credit restrictions			
Household consumption	+0.8	+0.2	0.0
Gross fixed capital formation	+1.3	+1.0	0.0
Exports (goods and services)	0.0	0.0	0.0
Imports (goods and services)	+0.5	+0.2	0.0
GDP	+0.3	+0.1	0.0
Inflation	0.0	0.0	+0.1
Employment in the private sector	0.0	+0.1	0.0
Budget balance (in per cent of GDP)	+0.2	+0.2	+0.3

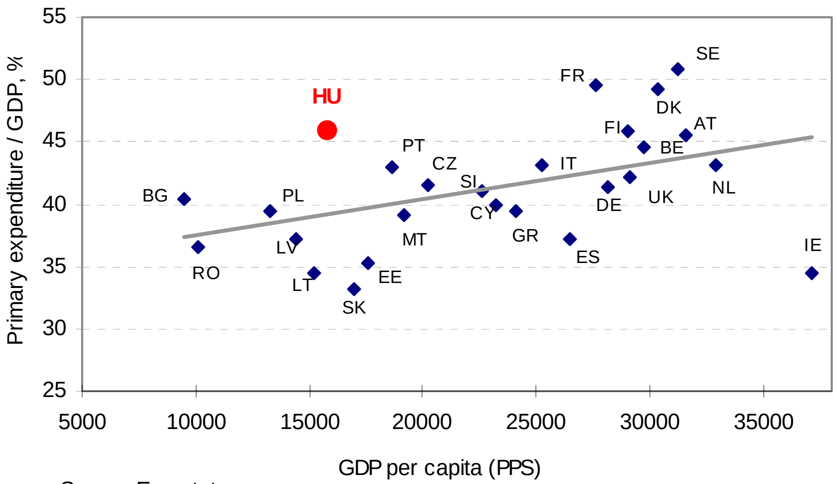
* Percentage point deviation of macroeconomic variables from the baseline path

5. Quality of public finances

5.1. Expenditure side

The primary expenditures/GDP ratio, following the salient figure of 2006, decreased by more than 2 percentage points (to 45.8%) in 2007. Nevertheless, by European standards, the Hungarian general government sector is still larger than medium-sized, last year's primary expenditure/GDP ratio was some 2.5 percentage points higher than the EU average. Compared to the Member States most similar to Hungary in terms of GDP per capita, the difference is more significant (about 5-10 percentage points, in some cases even larger).

Primary expenditures in per cent of GDP and GDP per capita (2007)



Source:Eurostat

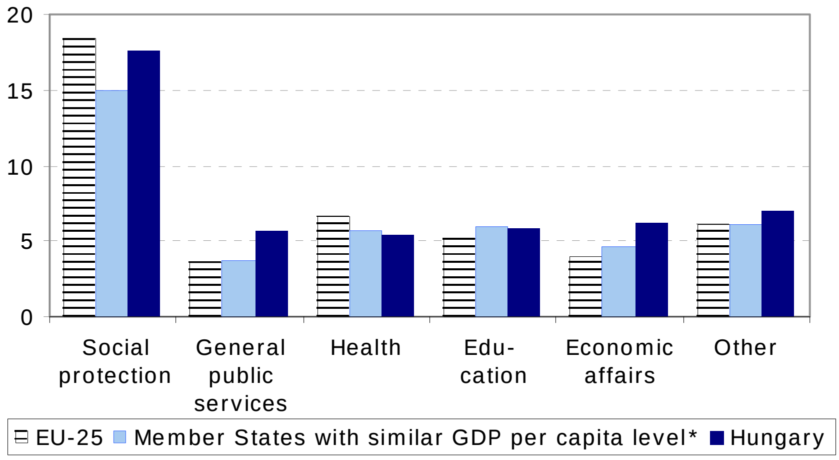
Luxembourg is not recorded due to the high GDP per capita indicator.

Hungarian figures differ, however, from that of Member States at a similar level of economic development, not only concerning the size of re-distribution, but also the internal proportions of expenditures. In 2006[13], at the beginning of the fiscal consolidation, the functional decomposition of expenditures showed, that quite more than average is spent on tasks related to social protection[14], general public services and economic affairs, while the level of education and health care expenditures is essentially average, compared to the country's level of development.

[13] Expenditure data classified by functions of the government are currently available till 2006.

[14] The comparison can be distorted by the differences between tax systems (whether social allowances are subject to taxation, and if so, to what extent) or by the differences of subsidy systems (different proportions of tax allowances and/or subsidies via cash benefits).

Primary expenditures by function in 2006
(in per cent of GDP)



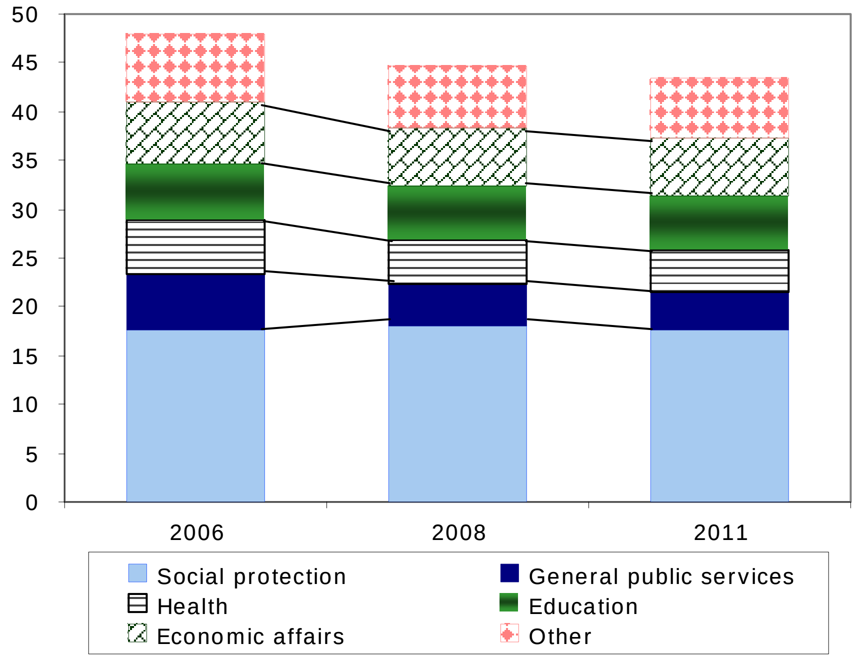
Source: Eurostat
*: GDP per capita (PPS): 10000-20000

The objective of the fiscal consolidation programme launched in the second half of 2006, beside the deficit reduction, is to curtail expenditures of the general government, as a result of the structural reforms launched, to perform public tasks more efficiently, at lower cost and in higher quality, to restructure expenditures.

- The ratio of expenditures on general public services (excluding interest expenditures) was high in 2006 both as compared to primary expenditures and to GDP, and not only compared to the level of development, but also to EU average. Reflecting changes implemented in public administration, expenditures/GDP ratio may have decreased markedly (according to estimations, by more than 1 percentage point). Expenditures in the category can only grow slower than the GDP, during the entire programme period;
- The rate compared to GDP of expenditures relating to social protection increased by some 3 percentage points between 2001 and 2006; although it still lagged somewhat behind the EU average, it exceeded significantly (mainly by 4-8 percentage points) the level observable in Member States with a similar level of development. These expenditures grew also faster than the GDP in 2007 and 2008, but the tendency will be altered by the measures concerning pension and social expenditures, included in the 2009 Budget. According to the programme, as a result of the structural changes, expenditures on social protection, in the last two years of the programme period, will decrease both as compared to primary expenditures and to GDP;
- The expenditures on economic affairs to GDP ratio, following the salient figure of 2006, will be some decimal percentage points lower, but significant reduction is not expected. The relative stability of the expenditures is explained by several factors with offsetting effects. The "phasing out" of motorway projects reduces, while the classification to the general government sector of the railway company (MÁV Sart Zrt.) increases the expenditures/GDP ratio. It is also attributable to EU co-financed developments that the proportion of the these expenditures can gradually grow within the decreasing total expenditures;

- The expenditures on education to GDP ratio, as a result of the emphasis on economies of scale, has decreased by some decimal percentage points, but in view of the outstanding importance of the area, according to the programme, expenditures on education will grow in line with the GDP in the coming years;
- In health care, initial reform measures halted, then reversed the increase of expenditures/GDP ratio. The overhaul of the subsidy system helped the reduction of unjustified demand for pharmaceuticals, and induced a permanently lower expenditure level. As a result of the improvement of economies of scale and cost efficiency in curative-preventative care, expenditures/GDP ratio could also decrease in this area. In the coming years, proportions of expenditures are expected to remain at their current levels;
- Regarding other, smaller expenditure items, environment protection spending is expected to increase somewhat.

Primary expenditures by function
(in per cent of GDP)

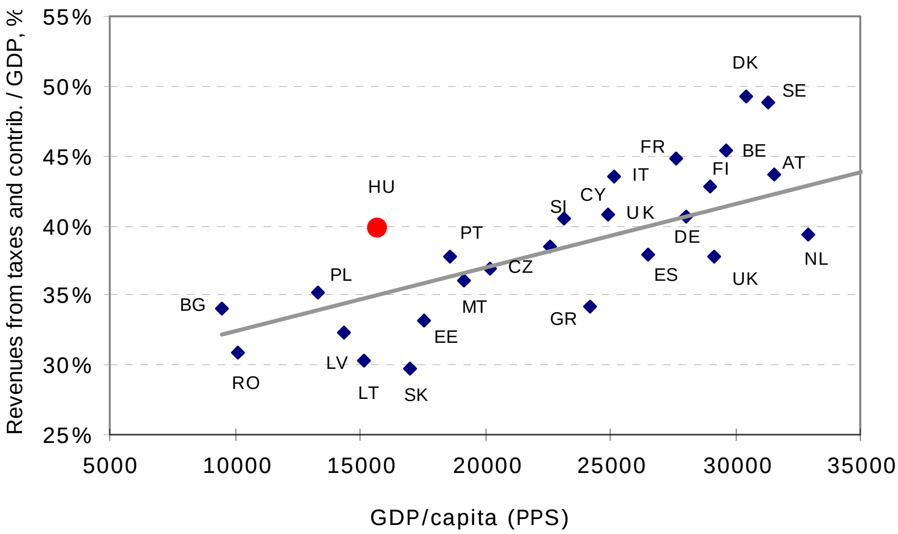


5.2. Revenue side

In Hungary tax centralisation was 37.0% of GDP in 2006, which rose to 39.5% by 2007 as a result of the adjustment. It will be around 40% in 2009, and is projected to drop to 39.8% by 2011. The 2007 value falls short by one percentage point of the EU-27 average.

Data for the EU Member States show that there is a positive correlation between the ratio of tax revenues and per capita GDP. Figures for 2007 reveal that tax centralisation in Hungary is somewhat higher than in Member States at a similar level of development.

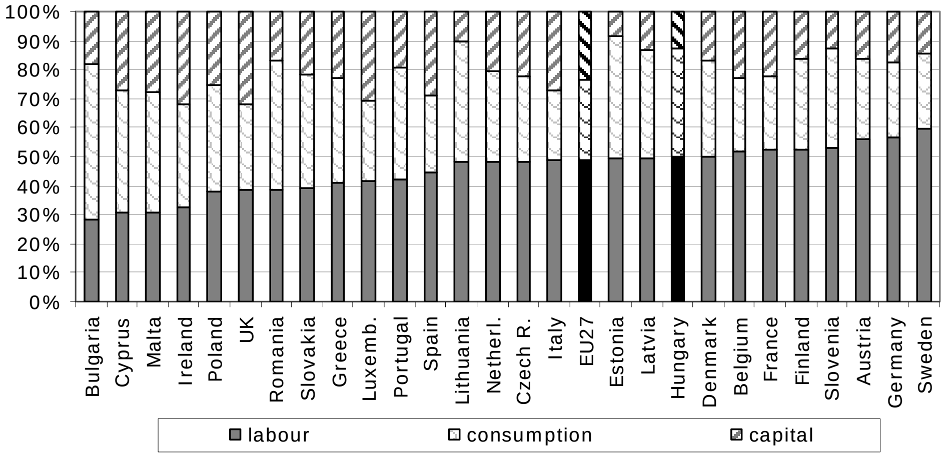
Tax centralisation and GDP per capita (2007)



Source: Eurostat AMECO database
Luxembourg is not included due to the high GDP per capita indicator.

Regarding tax burdens by economic functions (taxes on labour, consumption and capital income), 2006 data show that in Hungary the ratio of taxes on capital is substantially below the EU average, while taxes on consumption have an above-average share, and the taxes on labour income (including social security contributions) are around average.[15]

Tax revenues on labour, consumption and capital in the EU, as a percentage of total tax revenues, 2006



Source: European Commission

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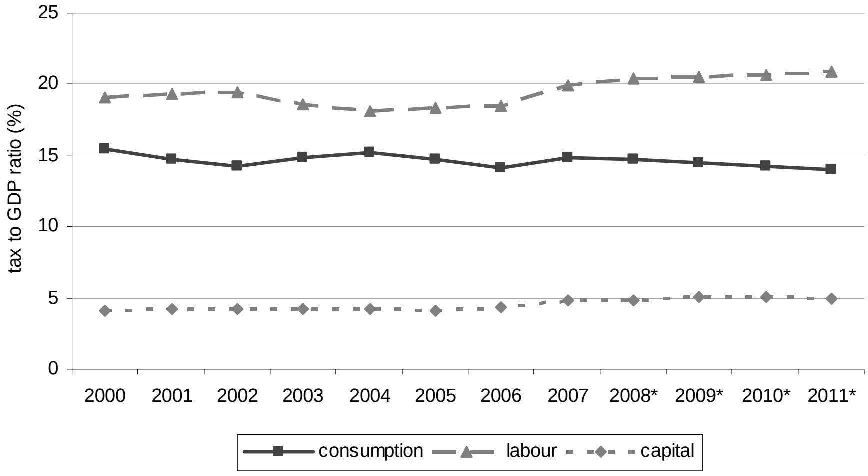
[15] Taxes are classified by their economic function in accordance with the methodology of the European Commission's publication "Taxation trends in the European Union" (2007). The key items of taxes on consumption are as follows: VAT, consumption taxes, local business tax, simplified business tax, gambling tax, the part of the vehicle tax that falls on the households, as well as customs and import duties. Taxes on labour income are the personal income tax (SZJA) and most of the social security contributions, the training levy, the rehabilitation contribution and other minor items. Taxes on capital income include the corporate income tax, a minor part of the personal income tax, the social security contribution of the self-employed, the duty on the transfer of property, wealth taxes, a part of the vehicle tax and some other items. When splitting the personal income tax to taxes on labour and taxes on capital, the programme uses the weight disclosed by the Commission on the entire horizon, while the calculation of the social security contribution of the self-employed is based on MoF estimate.

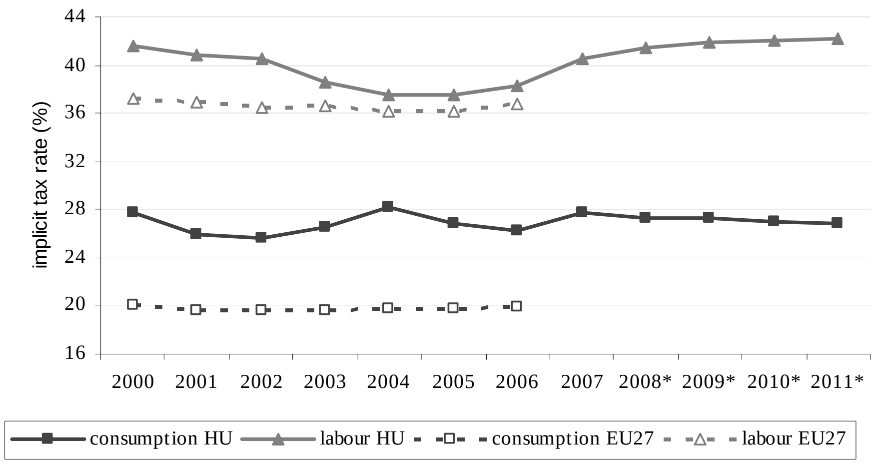
Taxes on consumption amounted to 14.8% of GDP in 2007; their proportion is expected to drop to 14.0% by 2011. The labour tax to GDP ratio will grow from 18.5% in 2006 to 20.4% in 2008; and then it will reach 20.9% by 2011. Taxes on capital income will be around 4.8-5.1% of GDP in the period 2007-2011.

Tax revenues on labour, consumption and capital in Hungary, in per cent of GDP, 2000-2011



The examination of implicit tax rates shows a picture similar to the above. The implicit tax rate on labour income[16] was 38.2% in 2006 (which is approx. 2 percentage points higher than the EU-27 average); as a result of the adjustment it will grow to 41.4% in 2008, and to 42.2% by 2011. The implicit tax rate on consumption is also high; it was 6 percentage points above the EU-27 average. Its value will presumably decrease from the 27.7% peak in 2007 to 26.8% by 2011.

Evolution of implicit tax rate on labour and consumption in EU27 and Hungary



Source: European Commission and MoF calculation

[16] To ensure international comparability, the implicit tax rate on labour is defined as the ratio of collected tax revenues and the compensation of employees, while in the case of tax on consumption it is determined as the proportion between tax revenues and household consumption expenditures.

The rise in the labour tax to GDP ratio and in the implicit tax rates on labour income in the period 2006-2009 can be explained by the fact that no valorisation of personal income tax brackets was implemented and by the rise in employee's contribution rates in 2006-2007, on the one hand; and by the impact of whitening measures, on the other. Estimates reveal that whitening measures generated extra budget revenues of HUF 80-100 billion in 2007, and HUF 30-40 billion in 2008,[17] and upon their effect both the number of contribution payers and the contribution base have grown. Although labour surveys have found that employment has decreased, tax authority data assert that the number of registered employees in the business sector was higher by 230 thousand persons in the first half of 2008 compared to the same period in the previous year.[18] The effect of measures to increase the contribution base is clearly manifested by the example that after the introduction of the contribution payment rule on double minimum wage in 2007 more than 80 thousand employees – formerly earning much less than this amount – and approx. 60 thousand individual entrepreneurs or entrepreneurs in partnerships – one-fourth of entrepreneurs – were registered in 2007 at a rate close to twice the minimum wage.[19]

Due to the restricted elbow room of the budget, in 2009 there will be no changes in the personal income tax system similar in magnitude to the changes in the tax credits in 2008 (as a result of which the marginal tax rate of persons earning close to average has decreased by nine percentage points). Nevertheless, cutting back on the administration costs of private persons and businesses (e.g. making bookkeeping of limited partnerships and unlimited partnerships with sales revenues below HUF 100 million simpler) will decrease distortions in the tax system, increase transparency and will advance further whitening of the economy.

5.3. Structural measures

Central public administration

The reform measures started in 2006 (reorganisations, staff cuts and the introduction of the performance measurement system) have all contributed to cutting costs and raising the efficiency of public administration. The main thrust of the organisational measures adopted early in the term of the government was to regionalise large networks; these have been implemented between 2006 and 2008. The remaining measures and objectives, mostly attained by now, all aimed to improve the efficiency and effectiveness of operations. These include the following: the reduction of the size and internal segmentation of the institution system; the close-down of institutions and business associations where the performance of functions by the public sector is not justified; the elimination of duplications; merger of financial services supporting professional activities,

[17] Source: The report of the committee examining the whitening of the economy, 22 Sept 2008, http://www.feheredes.org/docs/feheredes_2_0809.pdf
[18] Source: ibid
[19] Source: Calculation by the Ministry of Finance based on the data of the Central Administration of National Pension Insurance

of professional functions and physical support organisations, and the performance of functions with concentrated and more limited capacities. Actual figures indicated that in 2006-2007, the measures brought about a net reduction(i.e., taking into account any staff increases in some fields) of 13,604 in the number of persons employed, representing some 5% of the total authorized employee numbers for 2006. The sustainable annual savings for the budget amounted to HUF 47 billion, which thus serves to improve the equilibrium.

- The number of employees of the central government fell to 5787 by the end of 2007, corresponding to an approximately 27% reduction from the staff numbers at the beginning of 2006 (7936 persons);

- in the framework of the centralisation of parallel functional areas, in order to make the performance of tasks more effective and economical, the management of public assets was integrated in a single entity (Hungarian National Asset Management Zrt.) as of 1 January 2008. Central service providers have gradually taken over support functions in the course of 2007-2008;

- in the course of the consolidation and regional reorganisation of the central administration and its regional (decentralised) bodies, a number of large networks were reorganised with a regional focus mostly as of 1 January 2007, or later in the year. As a result of the reorganisation, instead of the 430 central budgetary institutions affected, only 184 have continued their operation.

The quality improvement of public services has been promoted by the introduction of the definition and measurement of performance requirements across the board in the entire public administration (establishment of a new type of performance assessment procedure (TÉR)).

In order to gradually reduce the administrative burdens of market and non-market actors alike, the assessment of the administrative burdens imposed by the effective legal regulations has started based on the Standard Cost Model method. The aim is to reduce burdens by at least 25% by 2012.

In order to prevent the regeneration of the aforementioned administrative burdens, it will be necessary to introduce the prior measurement of expected administrative burdens imposed by proposed draft regulations, as well as to carry out prior impact analysis according to common methodology. Accordingly, the preparation for the systematic use of the SCM method and for its inclusion in the government’s decision making mechanism is ongoing, with the deadline on 31 December 2008.

To eliminate procedural law obstacles to maintaining electronic contacts between clients and authorities and between various authorities and to promote such electronic contacts, it is necessary to amend the act on the rules governing the regulatory administrative procedure and service provision; the draft of the legislation has been completed and submitted to the Parliament.

The purpose of the review of the role of specialised authorities in every regulatory procedure is to reduce the participation of specialised authorities in the various procedures, applying a notification obligation instead of a licensing procedure while introducing strict controls. The review of procedures has made progress and the proposals for the relevant laws are prepared, the Government will deliver its decision in December. As a result, the contribution of specialised authorities will be reduced by about 25%.

With a view to reducing the administrative burdens of market and non-market actors and of public administration and to assure faster and electronic case administration, progress has started on making the forms used in public authority and regulatory procedures electronically available for downloading or completion. The technical tool is available for the conversion of forms into electronic format, and the guidelines for their required content have been completed. The preparation of the electronic versions of the various forms is under way, with the final deadline on 31 March 2009.

<u>Act on the legal status and management of budgetary institutes:</u>

In December 2008, the Parliament adopted the Act on the legal status and management of budgetary institutes. The expected key results of the Act are that through the general re-regulation of the budgetary institutional, and chapter level operational and financial management system, it helps fiscal requirements to be respected, on the one hand; and supports efficient provision of public services, and the execution of public functions (public administration; defence; jurisdiction; etc.) in line with modern challenges, on the other.

The key objectives and principles of the new regulation are as follows:

- sizes of appropriations and services based on identifying requirements and conditions, output-linked resource measurement (sustainability);
- instead of the present universal one, tailored, differentiated regulation primarily regarding institutional planning/financial management/reporting;
- enforce the principle of performance;
- reinforce chapter and municipality control; exact setting of their duties and responsibilities, making them principle based: these agencies should effectively become the operators of and parties that order the fulfilment of public services. Regarding ministries, it is a special requirement for them to be interested in achieving overall government objectives;
- exact setting of the tasks and responsibilities of institute management, the various methods thereof;
- application of business solutions in fields, where needed: through ensuring market opportunities and providing flexible rules (e.g., as to modifying appropriations);
- creation of a budget organisation form performing partly market activities and financial management, for a narrow field (for some organs of higher education, research and health care sectors)
- creation of criteria relying on public interest for selecting proper form of institutions (business organisation; or central budgetary agencies);
- creation of a state and municipality organisation system operating efficiently and transparently, moderating public expenditures overall;

- helping the elaboration of a budget, that can be financed (adaptation to fiscal framework);
- organisation and guarantee of the implementation.

The Act provides a framework, that is, the lawmaker's shall enforce general rules paying regard to special provisions set forth in various special acts and other rules of law.

Local governments

The increase in subsidies for funding the performance of tasks in micro-regions has a positive effect in the direction of a more efficient local government system. For such subsidies the 2008 Budget contained HUF 28.1 billion, as opposed to HUF 15.4 billion in 2006. The main areas of cooperation continue to be public education and social functions. As an indication of the intensity of cooperation, the number of associations maintaining public education institutions and the number of local governments participating in such increased considerably in the 2007/2008 school year.

In addition to multifunctional micro-regional associations, the increase in the number of district town clerk offices also indicates a move towards a more rational allocation of functions.

In order to improve cooperation between municipalities and to promote the joint performance of functions subsidies are available for small settlements to implement some minor investments for which there is a real need but which, due to their size, are not eligible for EU funding. Based on 342 successful applications, 905 settlements and 38 micro-regions received funds to achieve the aforesaid objectives.

Subsidies for the infrastructure development and capacity expansion of nurseries and kindergartens and the infrastructure development of primary schools serve the infrastructure development of settlements in the 47 most disadvantaged micro-regions. The objective is to ensure that care for and education of children and students in these micro-regions is the highest possible quality, with particular attention to providing equal opportunities to children with multiple disadvantages.

The amendment of the act on public finance altered the system of on-site inspection of requesting and accounting for the funds received by local governments from the central budget, in the framework of the Treasury review, as well as the terms of the mandatory on-site inspection:

- In respect of the application for grants and contributions at the beginning of or during the year, by default, the Treasury conducts an on-site inspection if the difference between the aggregate amount indicated in the local government reporting on the one hand and shown in the Treasury records on the other hand exceeds 2% and is not less than HUF 1 million. In respect of the review of the year-end accounts, the Treasury conducts on-site inspections at every local government at least once every four years.

- By way of exception, stricter rules apply to local governments with budgets in excess of HUF 400 million. In that case, on-site inspection is performed annually in respect of at least 50% of the titles of revenues from the central budget.

Public education

The new performance indicator based financing, introduced on 1 September 2007, has been extended, as of 1 September 2008, pursuant to the budget act, to basic art education, education and care in dormitories and hostels, day school and study room activities and boarding school education as well. The basis of calculation for these functions is also the education organisation parameters specified in the act on public education. Essentially, as a result of this funding system, maintainers (mostly local governments) will have to face the consequences if they employ more teachers than justified by these parameters (mandatory classroom hours of teachers, average student group sizes, weekly time allocated to study).

In respect of kindergarten education, school instruction and theoretical studies in vocational training, the parameters defined for the 2007/2008 school year will become more stringent in the new school year as we move up in grades. The provisions of the public education act will be fully applicable in financing in the 2010/2011 school year.

The rules governing transfers to promote the association of local governments maintaining institutions have been fine-tuned; the obligation of planning public education tasks in micro-regions has been set forth. From 1 September 2008 on, funding to micro-regional public education functions has been conditional on the multifunctional micro-regional association possessing an approved micro-regional action plan setting out, in respect of the settlements participating in performing the public education functions, all the requirements that need to be included in the action plans of local governments as well.

The amendment of the Act on public education aims at broadening the scope of local governments for efficient and professional organisation of public education services. In this context, the organisation in mutual institutions of tasks closely related to child rearing, provided by several sectors is possible. A new type of multi-purpose institution was introduced, called uniformly kindergarten-crèche.

The objectives of the Government’s programme ‘New Knowledge – Education for Everyone’ include, inter alia, that every child should start school with equal opportunities and that the school system should not increase social differences but rather it should allow persons in disadvantageous positions to improve their plight; furthermore, the teaching profession should be made more attractive and the work of teachers should receive more recognition.

Higher education

The key objective of the higher education reform is to improve the quality of education, and make it more capable of adapting the changing structure and level of labour market demand.

Under the reform the following steps have been and will be taken:

- Through the amendment to the 2007 act on higher education, the Government programme for the quality principle based development of higher education offers universities, colleges, as a new opportunity to adjust, to conclude a three year maintainer agreement between higher education institutions and the ministry fulfilling maintainer's tasks, which provides them with greater independence, vests them with greater liability, helps institutional financial management. The agreement formulates quality performance requirements to be met by the institutions in fields such as training, R&D, financial management, regional economic, social embeddedness and cooperation.
- As from 2007 a new admission procedure, based on student's choice, is in force; the administrative allocation of state-financed student ceilings was terminated. The measure forces institutions to adapt and the smaller number of institutions is conducive to the evolution of a more efficient and competitive higher education system. The admission results of 2007 and 2008 show that the competition is keen, and the concentration of institutions has started. While in 2007 the majority of students applied to larger universities in large cities and institutions in Budapest, in the 2008 admission procedure, compared to the first year of the new admission system, the number of applications and those admitted was more evenly spread between the capital city and the provinces. Nevertheless, due to demographic decline the number of those applying to higher education institutions decreased by approx. ten thousand persons. Further concentration of applications, which can be limited only by the maximum capacity of institutions, will presumably result in forced reduction of the number of institutions, thus advancing the development of a more efficient, competitive higher education structure.
- On 1 January 2008, the number of institutions decreased by one state-run and one church-financed institution; and the process of regional integration of institutions, network type universities (operating in several towns) continues; consequently, the number of institutions deceases further.
- The maximum state-financed student numbers have been reduced and their structure changed. In accordance with the Government's decision and as a result of the new admission procedure, in September 2008 and 2009 the quota of students that can be admitted to state-financed BA education was identical with the figure in 2007, 56,000 persons. In view of the fact that within this figure the number of applicants to post-secondary vocational training, in spite of increased labour market needs, fell short of the quota, the number of state-financed first-year students actually admitted declined even further. The ceilings for lawyers, liberal arts students, teachers and economists have been reduced, while natural sciences, IT and technical student numbers have been increased.
- In the 2008/2009 academic year the transformation of the training structure has become full-scope and students attend the old type university, college training

programmes only in courses being phased out. 35% of students admitted three years earlier to state-financed BA education may continue their studies in the master courses of the second cycle. Students attending old type training programmes will complete their studies until 2013, and from then on multi-cycle training will become general, and the numbers will be presumably rearranged.

- Through the amendment to the act on higher education adopted on 8 December 2008, a regulation to advance higher education institutions' adapting to the market will enter into force regarding the property management of and participation in business organisations by state-run institutions.

Transforming regular social allowance under the "Pathway to Work" programme

Under the "Pathway to Work" programme it has been formulated as a priority objective that persons capable of working, permanently unemployed, receiving social allowance should participate to a greater extent than before in some form of public work to enable them to obtain regular labour income and get closer to the world of labour.

Pursuant to the programme the persons in active age on the labour market may obtain entitlement to *benefit for persons in active age* instead of regular social allowance. In accordance with the new rule, there will be two groups of persons entitled to benefit for persons in active age:

1. Persons capable of performing work, who can be involved in public work, or in case of lack of work, are entitled to availability support. Persons who belong to this scope are obliged to report to the Public Employment Service (hereinafter referred to as ÁFSZ) for registration, under cooperation with the ÁFSZ enter into a job-seeking agreement, and complete such agreement as well as to take part in public work. Special cooperation rule will be stipulated for young people under 35 who have not completed the 8th class of the primary school. In their case, with a view to preventing the form of life as beneficiary of aids from becoming permanent, the key form of fulfilling the obligation to cooperate is not public work, but attending training. The monthly amount of the availability support is fixed, its extent, irrespective of the number of members and composition of the family, is equal to the current smallest monthly old-age pension.

2. Persons incapable of performing work, therefore, cannot be compelled to perform work; due to their social standing they are entitled to social allowance. It is this group that the programme ranks among persons who qualify disabled due to their health condition confirmed by expert opinion of medical specialist institution, or receive blind people's allowance, support for the handicapped and are therefore illegible for performing work as well as persons who bring up child under 14, and the attendance of the child at an institution providing care is not ensured. Furthermore, the correspondent municipality may set further conditions of exemption in its local decree.

The calculation of regular social allowance does not change: it continues to be determined on the grounds of the composition and income of the family; its monthly extent shall not exceed the amount of the net minimum wage.

Organising public work is the responsibility of the correspondent municipality, which task municipalities may provide through partnership, or other organisation founded for this purpose. In order to ensure public work, municipalities shall make a public work plan having consulted with labour agencies. The plan shall contain the composition of the persons entitled to public work benefit split per qualification, the description and time schedule of public works that the municipality intends to perform either in part or in whole through public work, and the headcount necessary for performing them as well as resources available for financing the public work.

Performing black work results in termination of the benefit regarding both groups of persons. A further element of the programme is to ensure the possibility for reviewing the certification of employability. If a person entitled to benefit for persons in active age is qualified ineligible by the employment health service, the regulation provides opportunities for the employer to initiate revision of the opinion at the body that provides employment health care special service.

The system will be transformed by re-allocating the resources available. As an incentive to put in place public work schemes, pursuant to the programme, the proportion of central and municipality resources will change. For persons exempted by law, receiving social allowance, the financing system will not change (that is, the rate of central resources remains 90%). For persons exempted by the correspondent municipality from participating in public work, receiving social allowance, and for the availability support to be introduced the rate of central resources will be 80%. The adjustment of the financing system of public work applied so far to actual costs will be implemented: municipalities may claim 95% of personnel expenses actually incurred regarding employment (wages and contributions) from the central budget.

Pension system

The measures implemented in the 2006-2008 period partly already presented in the 2007 convergence programme will, in the medium and long term, considerably reduce the expenditures to be incurred in the pension system till 2050, thereby continuously improving the position of the central budget as well as the sustainability indicators of the mandatory pension system.

- Persons going into early retirement after 1 January 2008 will be allowed to take up regular employment with earnings above minimum wage only if they simultaneously suspend their pensioner status. The new rule is applicable to persons retiring after 1 January 2008, while from 2010 onwards it will also be extended to all persons in early retirement.
- After 1 April 2007, pension contributions in accordance with the general contribution rules must be paid also in respect of income earning activities pursued by pensioners. This contribution gives rise to eligibility for additional pension: pensioners receive a pension increase corresponding to 0.4% of their annual income (0.5% after 2008) for each year of contribution payment.
- From 2008 on, for incomes earned in previous years, instead of the current partial valorisation, full valorisation will be applicable in pension calculation (to the level of

the year directly preceding retirement); furthermore, the calculated tax must be deducted from the earnings reduced by the contributions payable by the individual. As a combined effect, the replacement ratio of initial old-age pensions may decline from 82% to around 76%.

- From 2007, businesses employing persons in jobs with potential health hazards have had to pay a special contribution to cover eligibility for early retirement. Between 2007 and 2010, the central budget will assume the related burdens from the employers, on a regressive scale, while from 2011, the 13% contribution will be payable fully by employers.
- In case of men, the earliest date of early old age retirement will not be reduced to 59 years of age between 2009 and 2012; instead, it will remain at 60 years. The adjustment is estimated to result in expenditure savings of HUF 120 billion between 2009 and 2012;
- From 2009 on, the criteria of early retirement will become considerably more stringent: instead of the previous 38 years of service, or 33 years for a reduced benefit, 40 and 37 years, respectively, will be required from next year, which is expected to significantly increase the mean age.
- As of 2013, the early retirement age will increase to a uniform 60 years of age, and at least 37 years of service will be required for a reduced pension benefit.
- From 2013 on, the rules governing the reduction of old age pension in case of early retirement will be modified. The rate of reduction, depending on the time remaining until retirement age, will be 0.3% per month for the 61-62 age group and 0.4% per month below the age of 61.

Furthermore, the Parliament has adopted the amendment to the act that sets a ceiling for the 13th month pension as from 2009. For pensioners under 62 the 13th month pension will be terminated; nonetheless, persons receiving disability allowance and survivors' benefit remain to be entitled to 13th month pension with no age limitation (except for transitory widow's pension beneficiaries). In 2009, the ceiling of the amount of 13th month pension will be HUF 80,000.00 (this is almost equal to the amount of current average pension); the expected savings by the measure will be HUF 60 billion. These measures will reduce increase in expenditures related to ageing population in the long run, and improve the long term financing of the public finances.

The amount of the pension minimum and the related family allowance and social benefits will not change in 2009. This measure, as a matter of fact, will produce impact not only on pension expenditures but on the expenditures of the family allowance and social benefit systems too. The expected savings yield of the measure is HUF 14 billion.

The 2009 pension correction will be implemented in September instead of January. These measures will moderate pension expenditures in 2009 by HUF 18 billion.

Early retirement

From 2007, businesses employing persons in jobs with potential health hazards have to pay a social contribution to cover eligibility for early retirement. Between 2007 and 2010 the central budget will assume the related burdens from the employers, on a regressive scale; while from 2011 the full amount of the contribution will be payable completely by the employers.

The data of the ONYF /Central Administration of National Pension Insurance/ reveal that as of 18 September 2007 in almost 400 spheres of work more than 55,000 persons were engaged in jobs giving title to early retirement (the 2008 data are not yet available). The new contribution introduced on persons engaged in jobs giving title to early retirement was fully financed by the central budget in 2007, where both the appropriation and actual completion amounted to HUF 17 billion. In 2008, 25% of the necessary funds are provided by the employer and 75% by the central budget.

Rehabilitation benefits

In order to reinforce the rehabilitation nature of the benefit systems for persons with altered working capacity, the present three-group disability pension system has been extended to include a new group receiving benefits: the group of persons granted rehabilitation benefit from 2008. Persons are entitled to rehabilitation benefit who have significant, 50-79% health impairment and are incapable of performing work in their sphere of work, or in jobs in line with their qualification without rehabilitation. In terms of the assessment of eligibility for rehabilitation, the new system takes into consideration, in addition to the person's health and functional condition, several individual and environmental background conditions too, such as age, highest level of schooling, qualifications, opportunities for being employed. The amount of the rehabilitation benefit is equal to 120% of the disability pension in group III. The higher gross amount is justified by the fact that pension contribution shall be paid of the rehabilitation benefit – in order to maintain the years of service.

It is a peculiar feature of the system that the person entitled to the benefit is obliged to use the care services determined by the employment service in the rehabilitation plan. The person will enter into an agreement with the labour agency on completion of the programme. In addition to introducing the system, the new order of enforcing claims and specialist procedure has been also developed; consequently, the assessment has become more objective and well-grounded. It is reasonable to ensure gradually uploading of the system taking into account changes in the conditions; it is expedient to involve as many persons in the benefits as the rehabilitation system or the labour market can integrate, with a good chance.

Estimates suggest that in the initial year the headcount will be lower; then, later on after gradual increase, approx. 10,000 persons will be granted benefits. The National Rehabilitation and Social Expert Institute asserts that in H1 2008 1021, until late August 2429, until late November a total of 5066 persons went through the procedure of the assessment of their eligibility for rehabilitation benefit.

Health care

Curative-preventive care

The declining trend of the expenditures on curative-preventive care to GDP in recent years in line wit the September 2006 convergence programme lays the foundations for the sustainable funding of health care in the long term. Expenditures on curative-preventive care decreased from 3% to 2.7% in terms of GDP from 2006 to 2008.

The reforms of 2006 and 2007, the introduction of the new capacity regulation and financing systems facilitated the equilibrium of the Health Insurance Fund. In 2007, the Health Insurance Fund closed with a surplus of HUF 27.4 billion, and in 2008, a balanced budget is expected.

The revenue side of the Health Insurance Fund has been strengthened mainly through the verification of insured status, which continues to be an important reform element. Persons not paying contributions continue to receive any required health care, but the Tax Authority, based on the data supplied by the NHIF and the aliens policing authority, has paid special attention to controlling residents and foreigners failing to sort out their legal relationship. Failure to submit a notification triggers a default fine, and failure to pay contributions results in the imposition of a penalty. In order to assist with controls, the scope of data exchange between the NHIF, the aliens policing authority and the Tax Authority is being broadened.

Health care service providers are obliged to verify the existence of an ensured status in advance. The NHIF will withdraw 10% of the financing of service providers failing to perform the verification. In order to improve the efficiency of the insured status check, under the system introduced in 2008, if the family doctor or the service provider offering dental, outpatient or in-patient services verifies the insured status of a patient, he receives HUF 50 remuneration per case to recognise the additional effort required.

The insurance principle of the social security system is also reinforced by the fact that there is actual contribution payment in respect of persons entitled to health care services on a solidarity basis (e.g., pensioners, recipients of maternal benefits, full time students, homeless persons) as the central budget pays a health service contribution of HUF 4350 per month and per person into the Health Insurance Fund. In 2008, the funds thus remitted from the central budget amounted to HUF 307 billion, in contrast with HUF 289 billion in 2007.

In the rationalisation of the curative-preventive care, the account statement plays a major role, serving to curb the financing of reported but unjustified output. Under the threat of sanctions, all health service providers must issue account statements to insured persons if they make use of in-patient care, specialised outpatient care or basic dental care. In the account statement, the insured person is informed about the services or treatments the health service provider intends to charge to the insurer as well as the amount charged.

Following the abolition of the visit fee/daily hospital charge payment obligation, there was a slight increase in the number of patient-doctor meetings, but this does not endanger compliance with the curative-preventive care appropriation.

The standards of care can be maintained also among the tighter fiscal boundary conditions considering that

- •as a result of the relevant measures (account statement), invalid, fictitious procedures no longer burden the benefit system, thus capacities can be used to satisfy real needs;
- the monitoring of care has become more efficient through the institutional background (Health Insurance Supervision) and the new legal instruments introduced (waiting list, scheduled appointment system);
- continued promotion of forms of care that create less burden for the budget but that are better for patients (day surgery, day hospital).

The savings in expenditures facilitated increasing the financing of providers of basic health care services, the improvement of forms of day surgery and the shortening of waiting lists that evolved in certain specialisations.

The objective of further changes is to reinforce the insurer role of mandatory health insurance. This is conditional upon extending the liability and freedom of managing health insurance resources and service purchase. To ensure efficient, client oriented operation, a decentralised, regional structure will develop in health insurance.

The insurer's system level, central tasks will continue to be fulfilled uniformly, centrally; contracting, supervisions, maintenance of professional relations with service providers will be transferred to regional level; in the region, customer service for the population for each county, micro region, and extension of the electronic administration will make the operation of the insurer client-oriented.

It is an important and continuous task of health insurance system to make the content of the mandatory insurance more accurate and update it. This is conditional upon accelerating the development of financing protocols and unambiguous determining the order of recourse (referral; selection of physician and institution; and the consequences thereof).

The modern determination of the care package is helped by creating uniform and transparent rules of admitting health care technologies, analogous with the admission of medicines and price negotiations. The tasks of admitting policy are to determine, in line with health care policy objectives and economic opportunities, health care technologies taken in/out of public financing, the character and extent of subsidy, as well as the public and uniform order of procedure of all the above. It is a basic criterion that in each case decision shall be made only on the grounds of systematic analyses carried out in medical profession and health economic aspects and public documents drafted as a result thereof, under public procedure.

The admitting system will allow continuous supervision and maintenance of the scope of already admitted services too.

Pharmaceutical subsidies

As the November 2007 convergence programme presented, the substantial changes were introduced in the field of the pharmaceutical subsidy system at the beginning of 2007. The key elements are as follows:

- the free supply of indication-related pharmaceuticals in priority subsidy groups has been abolished;
- subsidy rates have been lowered;
- in order to accelerate generic competition and to assure transparency, the rules of "fixing" of the subsidy have changed (formation of fixed subsidy groups and announcement of price cuts continuously, fixing on a quarterly basis);
- the criteria for remaining in the subsidised pharmaceutical category will become more stringent;
- in line with regulations promoting efficient prescription, physicists receive regular feedback about how their prescription practice relates to the average;
- the payment obligations of pharmaceutical producers and traders is set in an act (payment obligation of 12% of the producer-price-proportionate part of the subsidy, 2.5% of the wholesale margin of subsidised pharmaceuticals, HUF 5 million per year after medical representatives, tiered payment in the event of the over-run of the appropriation for pharmaceutical sales in pharmacies);
- the restraints on the opening of pharmacies have been eased and the sale of certain non-prescription drugs outside pharmacies has been allowed;
- a visit fee has been introduced to encourage a more rational behaviour of patients. (after the termination of the obligation to pay visit fee and daily hospital charge in 2008, only low increase has started in the number of physician/patient appointments).

The reduction of the subsidy levels triggered a considerable increase in the co-payment early in the year. As a result of the price competition on the generic market, however, prices declined continuously during the year.

As a consequence of the measures affecting the pharmaceutical subsidy system and the pharmaceutical market, in 2007 the long-standing growth trend of pharmaceutical subsidy expenditures was interrupted, and there is a realistic chance that pharmaceutical subsidies do not exceed the relevant budget appropriation.

As a result of the above measures, the ratio of gross and net pharmaceutical subsidies to GDP has declined by 0.3-0.4 percentage points compared to previous year.

The key objective for 2008 has been to stabilise the results attained in medicine expenditures, to maintain lower expenditure level.

Based on the 2007 results of the Act on Economy in Pharmaceuticals and the measures introduced by its implementing decrees, a general revision of the regulation was not justified.

In order to retain the achievements in the long term, the following tasks continue to be important:

- Maintenance of competition between producers based on the lump-sum subsidy regime. The terms of the public bidding procedure should be clarified to assure efficient implementation;
- Promotion of high-quality and effective prescription practices. Based on the analysis of the experience gained, the fine-tuning of the system is called for;
- Maintenance and enforcement of the rules concerning the joint risk bearing of pharmaceutical producers (beneficiaries of the marketing pharmaceuticals marketing licence) and wholesalers;
- In the course of assessing the eligibility of new drugs for subsidies, the consistent application of the techniques of technological assessments. Framework rules for the eligibility of high specific cost technologies for financing from the Health Insurance Fund should be developed and enforced;
- The review of the subsidisation of drugs already admitted in order to achieve a balance in funding and rational use; increasing the efficiency of the control system, roll-out of the control system for the on-line monitoring of prescription and eligibility.

As overrun in pharmaceutical expenditures is not expected in 2008 either, producers do not need to make tiered payments either this year. Producers', wholesalers' payments are expected to amount to HUF 38.7 billion, the pharmaceutical-related balance of the Health Insurance Fund to around HUF 289.6 billion. Gross and net pharmaceutical subsidies decreases by approx. 0.1 percentage point in terms of GDP compared to previous year.

In 2009, it will be a further aim to comply with the appropriation of pharmaceutical expenditures of the Health Insurance Fund through enhanced control of measures introduced in 2007, to this end, the verification of medicines already admitted for subsidy is continued, and the generic programme is strengthened.

The following measures planned as from 2009 are also meant to ensure the ability to comply with the appropriation.

- International comparison of the producer price of preparations with the highest turnover and price by the health insurer;
- In the event of applying considerably higher price on the Hungarian market, initiating consultation and correction by the health insurer concerning the price of the given preparation that forms the basis of public financing, in order to continuously comply with statutory provisions that determine the conditions of providing subsidy;
- Conditions will be presumably also created for enforcing fixed amount subsidy also in prioritised medicine groups, and for charges determined on a differentiated basis;
- As to new technologies and therapies with high specific cost, expert work to determine the top threshold value of financing has commenced. The financing threshold value might be suitable in the future for designating the top limit of assuming burdens by the social insurance regarding therapies with extremely high costs;
- Simultaneously with admitting new, innovative medicines in the social insurance subsidy, in accordance with the conditions of ordering medicines, the procedure of disclosing algorithms for checking financing in laws was developed, where strict conditions may ensure to patients access to these preparations at minimum charges, and prevention of unjustified outflow of subsidies;

- A further objective is to monitor the application and subsidy based ordering of medicines concerning medicines recently admitted, and to implement the related IT system.

Gas and district heating subsidy

As a result of the transformation of the subsidy system, expenditures are expected to decrease from 0.4% in 2007 to 0.3% of GDP in 2008. In 2009, there will be no change in the subsidy system. The source of the district heating related household subsidy will be created partly by the temporarily introduced special tax on energy supplier enterprises.

Public transport

In 2008, the Government provides HUF 160 billion for MÁV-Start Zrt in the context of passenger transportation as public service. This meets the conditions assumed under the public service contract entered into by and between the passenger transport railway company and the Hungarian State, which set forth that the company's costs not covered by income will be reimbursed by the contracting party ordering the passenger transportation public service.

The organisational and activity modernisation carried out at the MÁV Zrt. that operates the major part of Hungarian railway track network has resulted in greater transparency at the company. The efficiency improving processes having commenced at the company (nil base planning, BPR) will presumably make the management of the coming years more balanced and successful.

6. Sustainability of public finances

Expenditures related to long term sustainability are determined by pension, health care, long term care and education systems as well as unemployment benefit, and long term demographic trends. As a result of the demographic developments, without reforming the pension and health care systems, expenditures are certain to increase with the aging society, which induce the growth of the government debt in long term. The level of the government debt calculated for 2050 is determined by the current position of general government (budget balance; current government debt) and the size of age-related budgetary expenditures, which will grow in the future. The medium-term reduction budgetary deficit as provided for in the convergence programme also improves sustainability, but the growth rate of age-related expenditures must also be curbed so that the debt do not increase by 2050.

Growth of expenditures related to the population aging is caused primarily by the growth of expenditures spent on pensions and health care. The pension measures introduced in the years 2006, 2007 and 2008 have decreased the age-related expenditures incurred in the long run a significant extent, approx. by 1% of GDP, and improved the sustainability of the public finance. According to the projection of the Ministry of Finance pension expenditures to GDP between 2007 and 2050 will grow about by 2 percentage points, while health care expenditures to GDP by 1 percentage point, as stated in the Sustainability Report issued by the Economic Policy Committee in February 2006.

Projection for the long-term expenditures of the public finance

in percentage of GDP	2000	2005	2010	2020	2030	2050
Pension expenditures (net)[1]	9.1	10.4	11.3	10.7	10.6	12.6
Old age and early pensions[2]	6.7	8.3	9.5	9.5	9.2	11.1
Other pensions (disability, survivor)	2.4	2.1	1.8	1.2	1.3	1.5
Health care, education and other age-related expenditures[3]		10.1	9.8	9.7	10.0	10.5
Pension contribution revenue[4]	6.9	6.4	8.9	8.6	8.6	8.6

[1] Including pension payments from other funds than Social Security Fund. The figures for the pension expenditures (old age and other) are from the pension projection model 2008 of the Ministry of Finance. It includes the projection for the old age allowances as well.

[2] Including survivor pension paid after the retirement age and other pension–type benefits.

[3] Data from the 2006 EPC (Economic Policy Committee) projection.

[4] Data from the 2008 long term pension projection model of the Ministry of Finance.

7. Institutional features of public finances

7.1. Public finance statistical governance

The Hungarian Central Statistical Office (CSO) and the central bank (Magyar Nemzeti Bank, MNB) compile the statistics on the government sector. In the current division of labour, the CSO is responsible for non-financial accounts, the MNB for financial accounts. The above mentioned division of labour applies to the compilation of data up to the (t-1) period within the Excessive Deficit Procedure (EDP Notification), while the expected deficit and debt of the current (t) period are calculated by the Ministry of Finance (MoF). Previously, the deficit for the (t-1) period was also calculated by the MoF, but since 2006, when the Notification deadlines were changed, the CSO has been able to take on this task, which assures consistency with the national accounts. The statistical working group comprised of the representatives of the CSO, the MNB and MoF operates on the management and expert levels, and a co-operation agreement regulates procedural issues of data flow, division of labour and methodological assessment.

Key data sources of the statistics of the government sector include the general government information system, the annual and interim reports of the units of legal government (including 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. The Notification submitted under the Excessive Deficit Procedure, its time series and the detailed description of its compilation methodology (“EDP Inventory”) are published and updated on the homepages of the CSO and the MoF, simultaneously with the press release of Eurostat. Since the autumn of 2007, the CSO has published brief press releases together with the Notification. According to the current practice, the MoF dedicates an individual chapter to the explanation of the difference between the official national and the Maastricht deficit and debt indicators, as part of the general explanation attached to the annual budget and the final accounts submitted to Parliament. The temporary possibility for the accounting of private pension funds as part of the government sector has ended; since April 2007, private pension funds have been classified in statistical reports within the sector of financial corporations. As from 2008, the CSO discloses quarterly data of the general government sector in its publications on national account statistics.

In July 2008, the Eurostat examined and it raised no objection to the institutional background of data supplies related to the Excessive Deficit Procedure, the cooperation of co-authorities, the data sources, the applied methodology and procedure as well as the disclosing policy.

7.2. Fiscal rules

After extensive political consultations, in November 2008 the Parliament adopted the act on fiscal responsibility. The act sets out new fiscal rules regarding the central subsystem of the legal government; establishes the Fiscal Council, and introduces guarantee elements, prevailing in the planning of the budget, which ensure that compared to the accepted medium term expenditure ceilings additional expenditure claims could only be planned in the event that their balance deteriorating effect can be offset by the decrease of other expenditure elements or increase in revenues.

The act determines expenditure caps and balance limitations too; both for the coming years and in the long run.
Pursuant to the act

- in 2009, the corrected, consolidated primary expenditure total of the central government sector shall not grow, not even nominally, compared to 2008.
- in the years 2010 and 2011, the Government will be obliged to submit a budget bill that ensures that the above mentioned expenditure total grows in real terms maximum by the half of the real GDP growth rate.
- from 2012, for each budget year, the growth of the above mentioned expenditure total compared to the previous year shall be determined in the Budget three years in advance.
- in the years 2010 and 2011, the Government shall submit a budget bill that assures that the value of the Maastricht deficit indicator decreases as compared to the prior year's budgeted value.
- In accordance with the real debt rule, as from 2012, the central budget balance goals shall be determined on the grounds of the requirement that the public debt shall not increase in real terms. The medium term planning framework is reinforced by the fact that pursuant to the act, approaching the given budget year the Parliament sets increasingly accurate details, which shall be complied with:
    - it sets primary balance targets three years in advance (which shall not be deficit);

- it sets the balance requirement of discretionary items two years in advance;
    - mandatory items: primary budgetary items, the development of which is clearly defined by the substantive legislation and the trends in the private economy and in demography
    - discretionary items: non-mandatory primary budgetary items
- it provides for the detailed distribution of discretionary items one year in advance.

The Fiscal Council to be set up pursuant to the act is meant to ensure the transparency and professional, methodological support of fiscal planning. The Council is an institute that consists of three members, assists the work of the Parliament, whose members are elected by the Parliament by simple majority, for a period of nine years at the proposal of the President of the Republic, the Governor of the National Bank, and the President of the Sate Audit Office. The Council is assisted in fulfilling its key tasks by the Secretariat of the Fiscal Council, which tasks are as follows:

- preparing and disclosing macroeconomic forecasts;
- preparing and disclosing baseline projections for the budget figures;
- preparing and disclosing methodological recommendations related to fiscal planning and forecasting;
- preparing independent estimates concerning budgetary impacts of draft bills and amendatory motions negotiated by the Parliament.

The mandatory requirement set forth in the act stipulates that after the primary balance target has been set no law shall be enacted that results in the worsening of the balance: simultaneously with proposals on measures that bring along additional expenditures or reduce revenues, measures shall be proposed that offset the fiscal effects of the former.

TABLES

Table 1

Macroeconomic prospects

	ESA code	2007 HUF bn	2007	2008	2009	2010	2011
			percentage change				
1. Real GDP at 2005 prices	B1g	24 039.5	1.1	1.3	-0.9	1.6	2.5
2. Nominal GDP	B1g	25 419.2	6.9	6.6	2.2	5.0	5.5
Components of real GDP							
3. Private consumption expenditure	P.3	12 468.6	0.7	1.1	-3.8	1.1	1.4
4. Government consumption expenditure	P.3	5 373.2	-7.2	-0.9	0.2	-0.1	0.3
5. Gross fixed capital formation	P.51	5 207.8	1.5	-1.0	-0.9	2.5	6.2
6. Changes in inventories and net acquisition of valuables (per cent of GDP)	P.52 + P.53	663.5	2.8	3.7	3.7	3.6	3.5
7. Exports of goods and services	P.6	21 244.2	15.9	6.1	3.9	5.8	8.5
8. Imports of goods and services	P.7	20 917.7	13.1	6.1	2.4	5.2	8.2
Contribution to real GDP growth							
9. Final domestic demand		-	-1.1	0.1	-2.2	1.0	2.1
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	-	0.1	1.1	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	2.1	0.1	1.3	0.6	0.5
Price developments							
12. GDP deflator		-	5.7	5.2	3.1	3.3	2.9
13. Private consumption deflator		-	6.4	6.2	4.5	3.2	3.0
14. HICP		-	7.9	6.2	4.5	3.2	3.0
15. Public consumption deflator		-	7.0	4.8	-0.1	3.9	3.2
16. Investment deflator		-	2.6	4.2	3.9	2.7	2.5
17. Export price deflator (goods and services)		-	-4.0	2.4	4.8	1.5	1.5
18. Import price deflator (goods and services)		-	-4.3	2.5	5.1	1.4	1.4
Labour market developments							
19. Employment ('000)		3 926.2	-0.2	-1.1	-0.6	0.2	0.5
20. Unemployment rate (%)			7.4	7.7	8.0	7.7	7.2
21. Labour productivity, persons			1.2	2.5	-0.3	1.4	2.0
22. Compensation of employees (HUF bn)	D.1	11 826.1	8.0	7.1	1.5	5.7	6.0
22a. Compensation per employee (HUF million)		3.4	9.2	8.2	2.1	5.5	5.5
Sectoral balances (per cent of GDP)							
23. Net lending/borrowing vis-à-vis the rest of the world	B.9		-5.3	-5.1	-3.7	-2.5	-1.6
of which:							
- Balance of goods and services			1.4	0.9	2.4	3.1	3.5
- Balance of primary incomes and transfers			-7.8	-7.7	-7.6	-7.9	-7.9
- Capital account	B.9/ EDP B.9		1.1	1.7	1.5	2.3	2.8
24. Net lending/borrowing of the private sector	B.9		-0.3	-1.7	-1.1	0.0	0.6
25. Net lending/borrowing of general government	EDP B.9		-5.0	-3.4	-2.6	-2.5	-2.2

Table 2

General government budgetary prospects

	ESA code	2007 HUF bn	2007	2008	2009	2010	2011
			per cent of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-1 260.8	-5.0	-3.4	-2.6	-2.5	-2.2
2. Central government	S.1311	-1 306.7	-5.1	-3.1	-2.2	-2.0	-1.9
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-0.4	0.0	-0.3	-0.5	-0.6	-0.4
5. Social security funds	S.1314	46.4	0.2	0.0	0.1	0.1	0.2
General government (S13)							
6. Total revenue	TR	11 410.5	44.9	45.2	45.8	46.0	45.8
7. Total expenditure	TE[1]	12 671.3	49.8	48.6	48.4	48.5	48.0
8. Net lending/borrowing	EDP B.9	-1 260.8	-5.0	-3.4	-2.6	-2.5	-2.2
9. Interest expenditure	EDP D.41	1 033.3	4.1	4.0	4.5	4.5	4.5
10. Primary balance		-227.4	-0.9	0.6	1.9	2.0	2.2
11. One-off and other temporary items[1]			-0.9	-0.4	0.0	0.0	0.0
Selected components of revenues							
12. Total taxes (12=12a+12b+12c)		6 577.5	25.9	26.1	26.2	26.1	25.9
12a. Taxes on production and imports	D.2	3 975.6	15.6	15.6	15.4	15.2	14.9
12b. Current taxes on income, wealth, etc	D.5	2 584.8	10.2	10.5	10.7	10.9	11.0
12c. Capital taxes	D.91	17.1	0.1	0.1	0.0	0.0	0.0
13. Social contributions	D.61	3 465.4	13.6	13.8	13.7	13.8	13.8
14. Property income	D.4	230.7	0.9	1.0	0.9	0.7	0.6
15. Others		1 137.0	4.5	4.3	5.0	5.4	5.4
16.=6. Total revenue	TR	11 410.5	44.9	45.2	45.8	46.0	45.8
Tax burden (D.2.+D.5.+D.61.+D.91.-D.995.)		10 042.9	39.5	39.9	40.0	39.9	39.8
Selected components of expenditures							
17. Compensation of employees + intermediate consumption	D.1+P.2	4 608.6	18.1	17.9	17.5	17.2	16.9
17a. Compensation of employees	D.1	2 917.9	11.5	11.4	10.9	10.9	10.7
17b. Intermediate consumption	P.2	1 690.7	6.7	6.6	6.6	6.4	6.2
18. Social payments (18=18a+18b)		4 599.2	18.1	18.4	18.5	18.1	17.6
18a. Social payments in kind via market producers	D.6311, D.63121, D.63131	726.9	2.9	2.9	3.0	2.9	2.6
18b. Social transfers other than in kind	D.62	3 872.4	15.2	15.5	15.5	15.3	15.0
19.=9. Interest expenditure	EDP D.41	1 033.3	4.1	4.0	4.5	4.5	4.5
20. Subsidies	D.3	358.7	1.4	1.2	1.0	0.9	0.8
21. Gross fixed capital formation	P.51	903.4	3.6	2.8	3.0	3.4	3.6
22. Other		1 168.1	4.6	4.3	3.9	4.2	4.5
23.=7. Total expenditure	TE[2]	12671.3	49.8	48.6	48.4	48.5	48.0
Government consumption	P.3.	5369.7	21.1	20.8	20.5	20.1	19.6

/*: in 2007, without the assumption of debt of HUF 130.8 bn of the social security funds by the central government, which in the notification according to Eurostat rules worsened the balance of the central government and improved that of the social security funds

[1] A plus sign means deficit-reducing one-off item.

[2] Corrected with the net effect of the swap transactions TR-TE=EDP B.9.

Due to the rounding the sum data could differ from the sum of the detailed data.

Table 3

General government debt developments

per cent of GDP	ESA code	2007	2008	2009	2010	2011
1. Gross debt		65.8	71.1	72.5	72.2	69.0
2. Change in gross debt		0.3	5.3	1.4	-0.3	-3.2
Contributions to changes in gross debt						
3. Primary balance		0.9	-0.6	-1.9	-2.0	-2.2
4. Interest expenditure	EDP D.41	4.1	4.0	4.5	4.5	4.5
5. Stock-flow adjustment		-0.5	6.0	0.3	0.8	-1.6
of which: privatisation receipts		-0.4	-0.1	-0.1	-0.1	-0.1
international institutions stand-by credits not used for financing purpose			5.8			-2.1
Implicit interest rate on debt (%)		6.4	6.0	6.3	6.4	6.5

Table 4

Cyclical developments

per cent of GDP	ESA code	2007	2008	2009	2010	2011
1. Real GDP growth at 2005 prices (%)		1.1	1.3	-0.9	1.6	2.5
2. Net lending of general government	B.9	-5.0	-3.4	-2.6	-2.5	-2.2
3. Interest expenditure	D.41	4.1	4.0	4.5	4.5	4.5
4. One-off and other temporary items[1]		-0.9	-0.4	0.0	0.0	0.0
5. Potential GDP growth (%)		2.9	2.6	2.4	2.3	2.3
contributions:						
- labour		0.1	0.1	0.1	0.1	0.1
- capital		1.4	1.3	1.2	1.2	1.2
- total factor productivity		1.3	1.2	1.1	1.1	1.1
6. Output gap		1.4	0.1	-3.1	-3.8	-3.6
7. Cyclical budgetary component		0.4	0.0	-0.8	-1.0	-0.9
8. Cyclically-adjusted balance (2-7)		-5.4	-3.4	-1.8	-1.5	-1.3
9. Cyclically-adjusted primary balance (8+3)		-1.3	0.6	2.7	3.0	3.2
10. Structural balance (8-4)		-4.5	-3.0	-1.8	-1.5	-1.3

[1] A plus sign means deficit-reducing one-off item.
Due to the rounding the sum data could differ from the sum of the detailed data.

Table 5

Divergence from the 2007 Convergence Programme

		2007	2008	2009	2010	2011
Real GDP growth (%)						
2007 Convergence Programme		1.7	2.8	4.0	4.1	4.2
2008 Convergence Programme		1.1	1.3	-0.9	1.6	2.5
Difference		-0.6	-1.5	-4.9	-2.5	-1.7
General government net lending (per cent of GDP)						
2007 Convergence Programme		6.2	4.0	3.2	2.7	2.2
2008 Convergence Programme		5.0	3.4	2.6	2.5	2.2
Difference		-1.2	-0.6	-0.6	-0.2	0.0
General government gross debt (per cent of GDP)						
2007 Convergence Programme		65.4	65.8	64.4	63.3	61.8
2008 Convergence Programme		65.8	71.1	72.5	72.2	69.0
Difference		0.4	5.3	8.1	8.9	7.2

Table 6

Long-term sustainability of public finances

per cent of GDP	2000	2005	2010	2020	2030	2050
Pension expenditure (net)[1]	9.1	10.4	11.3	10.7	10.6	12.6
Old-age and early pensions[2]	6.7	8.3	9.5	9.5	9.2	11.1
Other pensions (disability, survivors)	2.4	2.1	1.8	1.1	1.2	1.2
Health care, education and other age-related expenditure[3]		10.1	9.8	9.7	10.0	10.5
Pension contribution revenue[4]	6.9	6.4	8.9	8.6	8.6	8.6
Assumptions[5]						
Labour productivity growth	4.2	4.0	2.5	2.6	2.7	1.7
Real GDP growth	5.2	4.1	3,3	2.4	2.1	0.8
Participation rate, males (15-64)	67.5	67.9	69.5	72.1	70.7	69.3
Participation rate, females (15-64)	52.6	55.1	57.5	61.2	61.1	60.5
Total participation rate (15-64)	59.9	61.4	63.4	66.6	65.9	64.9
Unemployment rate	6.4	7.2	7.7	6.2	6.2	6.2
Population aged 65 +over / total population	15.0	15.6	16.6	19.8	22.0	29.4

[1] Including pension payments from other funds than Social Security Fund. Pension expenditure (old-age and other) data from the 2008 long term pension projection model of the Ministry of Finance. It includes the projection for the old age allowances as well.

[2] Including survivor pension paid after the retirement age and other pension-type benefits.

[3] Data from the 2006 EPC (Economic Policy Committee) projection.

[4] Contribution revenue data from the 2008 long term pension projection model of the Ministry of Finance.

[5] Table contains projection used by the 2008 long term pension projection model of the Ministry of Finance.

Table 7

Basic assumptions

	2007	2008	2009	2010	2011
Hungary: short-term interest rate (annual average)	7.6	9.0	9.7	8.7	7.9
Hungary: long-term interest rate (annual average)	6.8	8.8	9.9	8.9	7.8
World excluding EU, GDP growth	5.6	4.3	2.9	3.8	4.3
EU GDP growth	2.9	1.4	0.2	1.1	1.8
Growth of foreign markets of Hungary	7.9	5.2	2.6	4.2	6.2
World import volumes, excluding EU	7.2	6.0	3.1	4.7	6.7
Oil prices (Brent, USD/barrel)	72.4	100.0	85.0	85.0	85.0