



Government of the Republic of Hungary

**CONVERGENCE PROGRAMME OF
HUNGARY
2004**

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1. ECONOMIC SITUATION

In 2001-2002, the Hungarian economy diverted from the investment and export driven growth path. This was the result of unfavourable external conditions and an economic policy leading to a much higher increase of domestic demand than that of GDP. Though Hungary managed to maintain its growth surplus of around 2 percentage points over the average of the euro area in this period, but it could only be achieved with increasing domestic consumption offsetting missing export growth. These trends, in turn, led to problems in external and internal balances. Consumption growth over that of GDP, and real wage growth exceeding that of productivity created a situation, which definitely called for a change in economic policy. From 2003, the focus has been shifted from the stimulation of domestic demand to the improvement of competitiveness, and to the reduction of the increased budget deficit. In the 2003 budget, the government set up the conditions for a stricter fiscal policy than before, which, beside the improvement of the internal balance, aimed to promote a more favourable environment for enterprises.

In 2003, economic developments showed a mixed picture. As the world economy, including the EU region, did not show the growth forecasted by international organisations, the growth potential of the Hungarian economy did not increase significantly either. Data for 2003 as a whole showed an unfavourable picture at some points, including GDP growth lower than in 2002, increasing current account deficit and public debt. Nevertheless, primarily since the middle of 2003, clearly positive changes have unfolded, and these positive changes have continued in 2004 as well.

The most important macro-economic developments - compared to the projections contained in the Pre Accession Economic Programme of 2003 (PEP 2003) - are summarised in the table below:

Economic indicators	<i>annual percentage change</i>				
	2002	2003		2004	
		PEP 2003	Preliminary Fact	PEP 2003	Expected
GDP	3.5	cca. 3.5	2.9	cca. 3.5	3.3-3.5
Household consumption	9.3	cca. 8	6.5	1.5-2	1-2
Gross fixed capital formation	8.0	cca. 4	3.0	6-8	6-8
Exports	3.7	3-5	7.2	6-8	8-10
Imports	6.2	5-7	10.3	6-8	7-9
Consumer prices	5.3	4.8-5	4.7	cca. 5	cca. 6.5
Number of employed	0.1	cca. 0.5	1.0	cca. 0	0-0.5
Unemployment rate	5.8	5.8-6	5.9	5.8-6	5.8-6
Real wages	13.6	10-12	9.2	cca. 0	0-1
General government deficit (% of GDP)	9.3	cca. 4.8	5.9	cca. 3.8	4.6

GDP growth in Hungary – in line with that in the EU - was lower in 2003 than in the previous year, but it began to accelerate in the second quarter of 2003 and reached 3.6 % in the last quarter. Taking into account the improving external environment and favourable impacts of the economic policy on strengthening competitiveness, in 2004 the growth rate may be close or even reach 3.5 % again for the whole year. The lower than planned growth rate in 2003 was primarily related to an accelerated increase in imports. The **export** volume has strongly increased since last July, due to external conditions turning more favourable and improved competitiveness. However, due to significantly increasing imports, the contribution of net exports to GDP was slightly lower (-2.8 %) than projected (-2.3 %). **Import growth** was primarily related to the import of

consumer goods (cars and pharmaceutical products) and increasing imports of machinery for investment and production purposes.

The **deficit of the trade balance** amounted to EUR 4.3 billion, EUR 0.8 billion higher than in 2002. Nevertheless, the gap between the growth of exports and that of imports has begun to narrow since July 2003.

The dynamic growth of exports was maintained in the first quarter of 2004, too, while imports increased slower than exports, primarily due to the lower growth of household consumption.

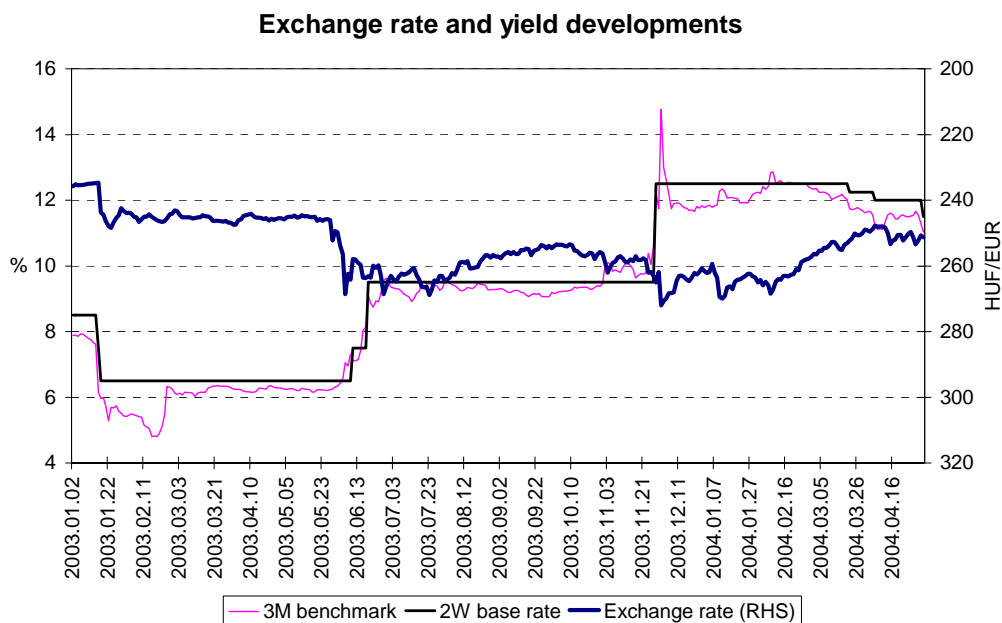
Investments continued to expand and achieved a 4.7 % growth rate in the last quarter of 2003. Within this, manufacturing investments, which are vital for future growth, increased by 27 % and 14 % in the third and fourth quarter of 2003, respectively. The investments of the national economy are projected to grow by 6–8 % in 2004, which will also be accompanied by further improvement of the investment structure. The increase will primarily be related to the investments of the corporate sector- in line with an improvement of exports outlook and increasing capacity utilisation – and to those in housing and motorway construction, which began last year and will accelerate this year.

Household **consumption** grew by 6.5 % in 2003. Although this increase was below the rate forecasted in PEP 2003, it was still higher than the GDP growth rate. The deceleration was primarily due to the lower growth rate prevailing in the fourth quarter. One of the potential reasons for that may be the increase of households' financing capacity in the last quarter of 2003. For 2004, we expect much lower growth in consumption than that of last year, which is also in line with the economic policy objectives related to the return to a more balanced growth path.

Industrial output kept increasing quarter-by-quarter in 2003, and achieved a nearly 10 % growth rate in the last quarter. The same dynamism continued in the first quarter 2004, too, with a growth rate of 10.8%. At the same time, an extremely important structural change also took place in the demand side of GDP. As a result of some deceleration in household consumption growth and an increase in investments and exports parallel, the former consumption-oriented growth is increasingly dominated by export and investment activities.

In 2003, the **HUF exchange rate** - following the changes in market confidence - fluctuated more intensively than in previous years. Yet the exchange rate remained in the stronger side of the ± 15 % exchange rate band in the course of 2003.

In January 2003, a considerable amount of speculative capital came into Hungary with the purpose of shifting the exchange rate band to the strong direction. In order to protect the exchange rate band, the NBH reduced the base rate in two steps from 8.5 % to 6.5 %. In the middle of January, the exchange rate depreciated by approximately 4 % and then, during the consolidation period after the attack, it stabilised again.



Following the short period of consolidation, market sentiments changed unfavourably and doubts concerning macro-economic prospects were intensifying. The loss of market confidence led to depreciation of the market exchange rate, and uncertainties concerning future exchange rate developments strengthened. To counterbalance these developments, the central bank raised, in two steps, altogether by 3 percentage point, to 9.5 %, its policy rate. With this move, the central bank tried to curb the impact of a weaker exchange rate on inflation. Despite this, both by the end of 2003 and by 2004, the risk of higher than targeted inflation has increased significantly. The raise of indirect taxes has also contributed to the increase of inflation in 2004 by at least 1.5 percentage points.

However, as the year-end became closer, the market began to focus more and more on the unfavourable internal and external balance, which led to further deterioration in market confidence. At the end of October 2003, the exchange rate began to weaken again, and yields started to rise. The Monetary Council raised the base rate by 3 percentage points to 12.5 % at the end of November in order to offset the increase in the risk premium, and to prevent further weakening of the HUF, which would have threatened the fulfilment of inflation targets. As a result of this, the ex-ante real interest rate reached an extremely high level (more than 5 %). During the rest of the year, there were small corrections in the money market: the exchange rate strengthened again, and short yields, following a sudden overshooting, stabilised at a lower level.

The improvement in macroeconomic fundamentals, the increased credibility of fiscal policy, and coordinated central bank and government measures were gradually reflected in strengthening exchange rate and declining yields.

The NBH considers that declining risk premium, improvement in market confidence, as well as favourable inflationary outlook can create the opportunity of a gradual reduction in interest rates. In line with these considerations, in 2004 the base rate was reduced by 25 basis points twice, and by 50 basis points last time in May; thus currently the base rate is 11.5 %.

The 2003 **inflation target** outlined in PEP 2003 was achieved. The annual average inflation rate turned out to be even more favourable than forecasted (4.7 %), primarily because of the rapid disinflation of the first half of the year, which can be explained by seasonal factors. In line with the projections made then, the annualised inflation rate

increased at the end of the year, primarily because of an increase of food prices. The fast increase of food prices continued at the end of 2003 and beginning of 2004, and, furthermore the impacts of the increase of preferential VAT rate from 12 % to 15 %, and the price increase of numerous services with regulated prices also appeared. Thus, in the first four months, compared to the same period of the previous year, inflation accelerated to 6.8 %. This is below the majority of projections. Consequently, the first signs indicate that as a result of the decline in demand relating to the deceleration of household consumption, and increasing competition in our markets, the one-off effect of tax increases may not be fully turn up in consumer prices. Due to the same reasons, we expect the deceleration of inflation in the second half of the year.

2003 was a turning point in the **competitiveness** of the economy. In 2001-2002, there was a sharp price and cost-based deterioration in competitiveness as a result of the nominal appreciation of the Forint and wage increases significantly outpacing moderate productivity growth. This deterioration came to halt from the second half of 2003. In 2004, cost competitiveness may improve. Parallel with the acceleration of production, the increase of domestic unit labour cost – with productivity growth and wage increases becoming more and more in line – may further decelerate, and may be more favourable than that in our main trading partners. Because of the temporarily accelerating inflation, price-based competitiveness is expected to deteriorate in 2004.

The **current account** deteriorated until September 2003, but in the last quarter the deficit decreased compared to the base period, as the trade balance improved and the deterioration of the services balance came to halt. In total, the deficit was EUR 4.5 billion in 2003 (6.2 % of GDP). Together with re-invested earnings, the deficit amounted to EUR 6.5 billion (8.9% of the GDP). The much higher deficit than projected in PEP 2003 was caused by several factors. While pick-up in exports growth had earlier been expected to start at the end of 2002, this materialised only in the second half of 2003, due to the protracted slowdown in the global economy. Because of a robust increase in consumption, imports went up significantly, therefore the trade deficit turned out to be much higher than expected. In the case of services - due to the terrorist attacks- the surplus of tourism continued to decline, and fell by approximately EUR 1 billion in 2002, and EUR 0.4 billion in 2003 compared to the base period. Based on improving external conditions, exports are expected to increase again in 2004, and, as a result of moderating domestic consumption, the import growth is expected to be lower than that of exports. Thus, the trade deficit is projected to narrow further. This is expected to offset increasing interest expenditures. Altogether, the current account deficit is expected to be close to the level in 2003, while declining as a percentage of GDP. The financing structure of the current account will improve, and non-debt-generating financing will increase.

In 2003, the **general government deficit** reached 5.9 % of GDP. This was a significant decline over the previous year (9.3 %), but it was still higher than the figure projected in PEP 2003 (4.8 %). Though GDP growth turned out to be lower than projected, tax revenues were higher than originally anticipated in the budget, Thus, the higher deficit was caused by expenditures increasing much faster than revenues. However, the higher deficit was not the result of government decisions, but that of market processes, including rising yields and interest rates, and the impact of higher-than-expected growth in housing loans. In 2004 to date, the deficit figure practically corresponds to our projections, and thus, with the implementation of the savings measures introduced at the beginning of the year, the projected 4.6 % deficit is expected to be realised.

2. ECONOMIC POLICY FRAMEWORK AND OBJECTIVES

In the present situation, economic policy should concentrate on strengthening the favourable changes started in 2003, contributing to the return to an export-driven and balanced growth path. In order to regain investors' confidence, the government must follow a programme with realistic objectives, and fully implement it in order to retain

credibility. The budget deficit has to be further reduced and the widening of the current account deficit has to be prevented. Furthermore, the build-up of inflation expectations upon temporarily increasing inflation has to be avoided and the longer-term disinflation process has to be maintained.

Modernisation and catching up to the EU-15 average remain the longer-term objectives of the economic strategy. The Hungarian economy should grow, in a sustainable manner, faster than the EU average. In this context, the most important task now is to utilise our growth opportunities originating from the improvement of external conditions, since this would contribute to realise our most important immediate objective, i.e., the increase in employment.

The economic policy focuses on the following tasks:

- improving competitiveness,
- strengthening investment attraction capability,
- establishing the infrastructure for sustainable growth,
- improving education and training, concentrating on skills adaptable to ongoing structural changes in the economy,
- promoting domestic R&D activities,
- implementing the privatisation process in order to increase efficiency,
- improving environmental conditions.

2.1 Fiscal policy

The most important fiscal policy objective is to gradually reduce both the deficit – which remained high despite the consolidation started in 2003 - and the scope of the general government. Smaller government deficit is conducive to the improvement of the external position of the economy, supports the disinflation, and allows for the reduction of the public debt to GDP ratio. The reduction of the centralisation and redistribution ratios (i.e., revenues/GDP and expenditures/GDP) creates more room for the private sector and also contributes to the improvement of the competitiveness of the economy.

From 2004, the borrowing requirement of the corporate sector is increasing, as economic conditions improve and investments pick-up. Since household savings are expected to increase only slowly in the next few years, the financing requirement of enterprises must be met by the reduction of the government net borrowing, in order to improve the external balance. From 2005, the general government deficit will be reduced annually by 0.5 percentage point of GDP, therefore, it will be below 3 % in a durable manner from 2008. The targeted deficit path also supports sustainable economic growth and can also be credibly implemented.

In 2004, the deficit will be cut by more than 1 percentage point, and the primary balance will improve by 1.5 percentage points, thus there will be a strong demand restricting effect. The primary balance will continue to improve in the next few years, therefore a moderate demand restricting effect will remain on a medium term. By reducing aggregate demand, fiscal policy contributes to disinflation.

In 2002, the declining trend of the general government gross debt to GDP ratio was reversed; the ratio has been higher than 59% for the period of 2003-2004. Due to the reduction of deficit and the improvement of primary balance, the declining trend of debt ratio will be resumed from 2005. By 2008, the general government gross debt will be below 54 % of GDP and interest expenditures in per cent of GDP will gradually decrease.

General government

in % of GDP

	2003	2004	2005	2006	2007	2008
Deficit	5.9	4.6	4.1	3.6	3.1	2.7
Primary balance	-2.0	-0.5	-0.2	0.1	0.3	0.4
Government gross debt	59.1	59.4	57.9	56.8	55.6	53.7

In terms of the demand effect, the indicator adjusted by the revenue losses owing to the pension reform shows the fiscal stance more accurately. The revenue loss due to the contributions paid into the fully funded private pension funds, instead of into the pay-as-you-go social security system, will cause a temporary extra deficit during the years of transition. However, the accumulated savings in private pension funds automatically offset this deficit, therefore, it will not generate additional demand in the economy. The deficit adjusted by the impact of the pension reform will be below 3 % of GDP already from 2006, and the adjusted primary balance shows a surplus as early as in 2004.

Indicators adjusted for pension reform effect	in % of GDP					
	2003	2004	2005	2006	2007	2008
Pension reform revenue loss	0.7	0.7	0.8	0.9	0.9	0.9
Deficit adjusted for pension reform loss	5.2	3.9	3.3	2.7	2.2	1.8
Primary balance adjusted for pension reform loss	-1.3	0.2	0.6	1.0	1.2	1.3

The adjustment of the unfavourable structure of growth, which developed at the beginning of the 2000s, will become stronger in 2004, and household consumption will grow much below GDP growth. As a result of the income policy ensuring wage increases in line with productivity growth, wages and salaries will only increase moderately. By holding back the increase of the tax base, this would result in a reduction of the share of tax and tax type revenues of the general government compared to GDP. However, the changes of the tax system in 2004 will mostly offset this impact and the revenues/GDP ratio will only drop slightly compared to 2003. Thus, the improvement of the balance is the result of the more than 1.5 percentage points fall in the expenditures/GDP ratio. The reduction of the redistribution ratio includes the impact of the Government decision, taken at the beginning of 2004, on expenditure cuts amounting to approximately 1 % of GDP.

The objective of the fiscal policy is to improve the balance and simultaneously reduce the extent of income centralisation during the next few years. The ratio of tax and tax type revenues of the general governments will decrease on average by 0.5 percentage points from 2005, falling to 37 % in 2008 from the present 39 %. Taking into account the EU transfers, which increase both the revenue and expenditure side of the budget, the revenue/GDP ratio will essentially not change, but without the EU transfers, the centralisation ratio will be reduced by more than 2 percentage points by 2008. The balance will improve through reducing the expenditures/GDP ratio, including mainly current expenditures. Comprehensive reform measures will be carried out, aiming at a smaller and more efficient public sector. The restructuring of expenditures will allow for approximately 2 percentage points cut in the expenditures/GDP ratio by 2008 (more than 4 percentage points without the EU transfers).

2.2 Incomes policy

In 2001-2003, household incomes increased significantly, much faster than economic growth. Per capita real wages increased by 32 % in three years. In order to restore the equilibrium of the economy, and improve competitiveness, there is a need to establish a set of conditions, whereby the unfavourable impact of rapid wage growth, though justified in many aspects, can be slightly corrected in 2004 and 2005, and which allows only for an increase in real wages in line with productivity from 2006. In this way, real wages can increase by 2-3 % annually during the next few years, as a result of which the catching-up in income levels can be ensured.

Increasing competition arising from the accession to the European Union will probably force enterprises to increase wages only in accordance with productivity growth.

Pensions increase as defined in the legislation being in effect and the 13th month pension will gradually be introduced in this period. Targeted benefits need to be applied more widely in the case of social benefits.

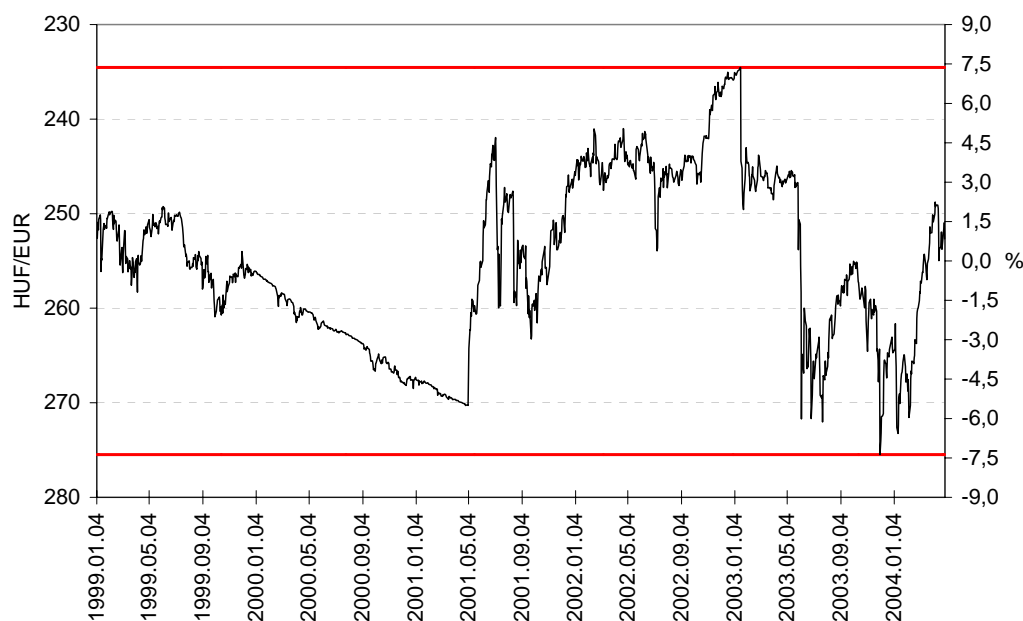
2.3 Monetary and exchange rate policy

The Act on the Central Bank defines the achievement and maintenance of price stability as the primary objective of monetary policy.

Since the middle of 2001, the Hungarian monetary policy has defined its objectives and instruments, and made its decisions within the inflation-targeting framework. The main elements of the monetary instruments are harmonised with the instruments of ECB, but in contrast with the ECB operating on the active side, the NBH operates on the passive side. The reason for this is that the significant capital inflows caused by the monetary and exchange rate policy applied from the mid-1990s created a still existing, although gradually falling, structural liquidity surplus in the Hungarian financial markets.

The central parity of HUF is fixed against the Euro with a $\pm 15\%$ fluctuation band. This system is expected to remain until the entry into ERM II. Since the widening of the fluctuation band, the Forint has always been on the strong side of the band. During the last few years, the exchange rate fluctuated between 235-271 HUF/EUR, which means that compared to the average of this range, maximum fluctuation was $\pm 7.5\%$. Though there was considerable exchange rate volatility in the HUF market during a significant part of last year, this represents a lower fluctuation than the exchange rate movements of numerous currencies having a significant role in financial markets (e.g., USD, JPY and GBP vis-à-vis EUR), or the exchange rate changes of some freely floating currencies.

Exchange rate development



In theory, this exchange rate system provides limited independence for monetary policy. At present, however, barriers, theoretically arising from the current exchange rate regime, do not hinder the interest rate policy being in line with the inflation target. The stricter fiscal policy, incomes policies aiming at wage increases that are in line with productivity growth, and the decline of the interest rate differential provide more room to manoeuvre for interest rate policy. Within the exchange rate band, the monetary policy is

not subordinated to the requirement of exchange rate stability. The wide band creates an opportunity for the central bank to promote disinflation in order to achieve price stability as soon as possible and to support the sustainable growth of the economy by changing the monetary conditions. The direct impact of the interest rate channel is relatively weak because of the low indebtedness of the corporate and household sector, and their increasing demand for foreign currency loans. Thus, the impact of monetary policy measures works through mainly the exchange rate channel and – to an increasing extent – via influencing inflationary expectations.

In 2004, the December/December inflation rate will be around 5.5-6 %. The inflationary targets for the next few years are defined together by the Government and Monetary Council, taking into account the envisaged fiscal path. The inflation target for 2005 is 4 % (with a tolerance band of ± 1 %), which will be reduced to 3.5% in 2006 and to 3 % subsequently.

Joining ERM II will represent an important stage of the convergence path. Entry into the common exchange rate mechanism will most probably not require changes in the present monetary regime of inflation targeting. Before achieving nominal convergence, an explicit exchange rate management should be avoided, and even in ERM II, the monetary policy will primarily aim to achieve the inflation targets. A higher degree of exchange rate stability within the band can be ensured by the increasing credibility of the convergence process and the stabilisation of long-term exchange rate expectations.

As the present monetary regime is very similar to that operating within the framework of ERM II, it is of utmost importance to change the exchange rate system as smoothly as possible. It is a prerequisite for joining ERM II smoothly that markets consider the announced convergence programme credible. On the other hand, a significant pressure on the exchange rate should be avoided at the time of the entry into ERM-II. This requires the actual market exchange rate to be on a level which can be seen as optimal before the entry, i.e. close to equilibrium rate, which is considered sustainable by the markets on a long term. Without threatening the statutory objectives of the NBH or the inflation targets, it can only be achieved, if in relation to joining ERM II, the fiscal policy takes into account explicitly the tasks which will be its responsibility deriving from the inflationary path in order to retain stability within the system. A prerequisite for joining ERM II is therefore that markets consider the fiscal path credible and sustainable.

2.4 Anti-inflationary policy

The macro-economic policy of the next few years concerning inflation must focus on gradual reduction of inflation as well as achieving it on a sustainable path, without causing any output loss.

In the medium term the equilibrium inflation rate is slightly higher in Hungary than the average of the Member States. This relates to the change in the consumption structure and to the typical feature of the catching-up process, namely, in the service sector, which has slower productivity growth than the manufacturing sector, wage increases will probably correspond to wage hikes observed in the manufacturing industry, therefore, the rate of inflation will be higher than average in the case of services.

Disinflation will take place autonomously, through market mechanisms. In the next period, inflation will decelerate as a result of the following factors:

- demand contracting fiscal policy;
- incomes policy allowing for wage increases in line with productivity;
- monetary policy applying the system of inflation targeting, and reducing inflationary expectations.

As a consequence of liberalisation and market conform regulatory practice, the ability of the government to directly influence prices (and influencing the market in general) will

gradually diminish in the future. No forced price decrease, achieved with artificial tools can be preferred on the budget side either.

2.5 Competitiveness

Indispensable conditions of convergence include simultaneous increase of employment and productivity, which continuously require improvement in competitiveness. The Government intends to enhance competitiveness with the use of numerous economic policy instruments. Of these, modification of the proportions of income redistribution in favour of the entrepreneurs, easing of the tax burden, and reduction of the financing needs of the public sector are of fundamental importance.

Increased efficiency and productivity is one of the main sources of competitiveness, requiring continuous innovation, development and investments from the corporate sector. In order to promote this, the Government provides support to R & D activities, and, in the framework of SMART Hungary and Economic Competitiveness Operational Programme, which provides access to financial sources from the EU, it allocates funds for various development and capital investment projects. The Government promotes the development of network infrastructures providing quick access (logistics, telecommunication, etc.)

In relation to this, it is a priority to improve the FDI attracting capability of the economy and to increase the integration level of already completed foreign investments. Favourable environment is created for foreign investments through the introduction of a 'single window administration system', the low corporate income tax rate, the tax allowances relating to development expenses and the indispensable infrastructure investments (for example, motorway network). Tenders promoting the establishment of integrated production lines connected to large companies and clusters of suppliers aim to deepen the domestic economic relationships of foreign affiliates and to facilitate the technology transfer.

With increased flexibility in the labour market, competitiveness is also increased by those employment policy measures that create conditions for part-time employment and telecommuting and are aimed at the improvement of adapting capabilities of employees through the development of the education system, adult training and the conditions of lifetime learning. The objective is a reform of education, which parallel with lexical knowledge, also provides adequate training for the requirements set by the market economy (good adaptation and problem-solving capability). The wage policy objectives of the Government are also related to the labour market, as they are aimed to prevent long-term deterioration of cost-competitiveness. Accordingly, a public sector wage policy has been developed which is in line with the productivity increase of the national economy and the economic policy of the Government also intends to orient the wage developments of the business sector into the same direction through the mechanisms of interest reconciliation. Changes in the social benefit system, which provide more encouragement for work intend to increase the adjustment capabilities of the labour market and employment, too.

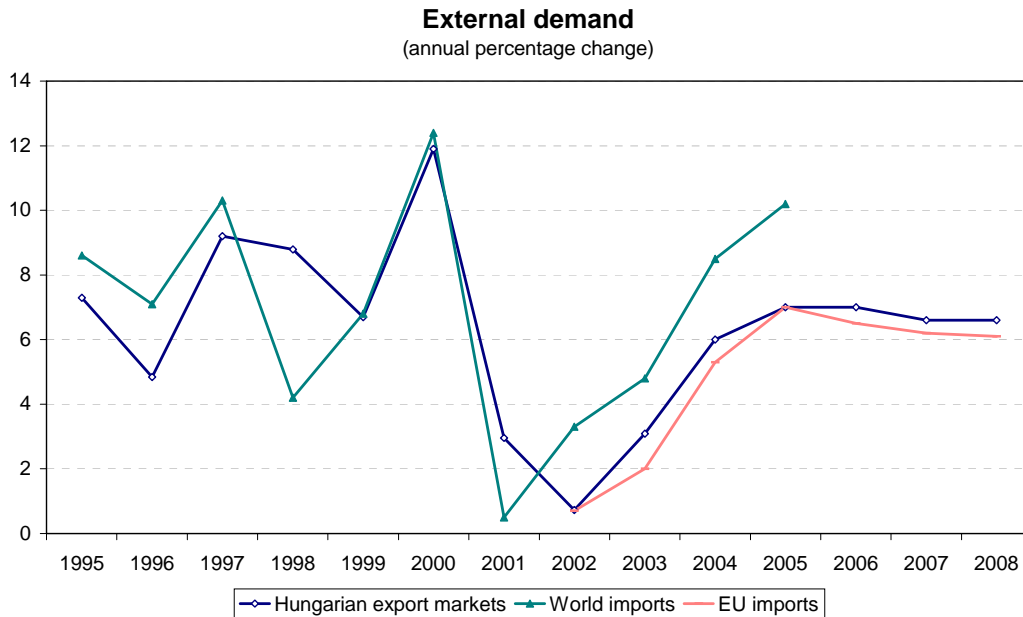
The reduction of the deficit and the scope of the general government is expected to encourage investments by the private sector, and promote more effective capital allocation. A lower tax burden (primarily in relation to labour) contributes to an increase of competitiveness through cost reduction and release of additional resources.

3. MACRO-ECONOMIC FORECAST 2004-2008

The assumptions of global economic trends were used for outlining the macro-economic trends for the next 4-5 years in the case of the open Hungarian economy. The forecasts prepared by the European Commission and OECD in Spring 2004 indicate favourable

external conditions, although both international organisations point out that the extension and durability of the recovery are still uncertain.

According to the latest projections of the European Commission for 2004-2005, the import demand of ten developed countries and the five most important East European partners, which determine Hungarian exports, will increase. On this basis, the Hungarian export markets will strongly grow in 2004-2005, while the growth will slightly decelerate in the subsequent three years.



3.1 Employment

Accelerating growth since the second half of 2003 and the active employment policy of the Government have supported the improvement of the labour market: a considerable, 1-2 % employment increase is estimated in the business sector each year. With these conditions, the participation rate of those aged 15-64 may increase from 60.7 % in 2003 to 63.5 % by 2008. The increase of the number of employees is an outstanding objective for the general government equilibrium, too, because a higher employment ratio increases the revenues of the budget, even if the average tax burden is reduced. However, this requires an active employment policy, which increases not only the number of jobs but also the willingness of the population to seek employment, and it also changes the structure of qualifications in accordance with the labour demand of the economy.

The willingness to seek employment may be improved by increasing employment opportunities. This requires support for types of employment, which suit more the requirements of both employees and employers. Alternative, distant and part-time employment forms should be increased. Wherever it is justified, targeted subsidies and allowances need to be attached to such employment options for both employers and employees.

The participation rate can also be increased by making the education system more target-oriented, and reforming the secondary and high-level vocational system, too. Some of the Hungarian employees are unable to enter the labour market for a long time, because they do not have qualifications that suit the market demand. The training of skilled workers has decreased, or completely disappeared in certain professions, at the same time pointless excessive training in higher education needs to be eliminated.

With a gradual expansion of employment and assuming a stable, approximately 3 % annual labour productivity improvement, the GDP growth rate may increase from 3.3-3.5 % in 2004 to 4.5-5 % by 2008.

Employment	annual percentage change				
	2004	2005	2006	2007	2008
Number of employed	0 - 0.5	0.5 - 1	cca. 1	cca. 1	cca. 1.5
Labour productivity	cca. 3	cca. 3	cca. 3	3 - 3.5	3 - 3.5
Unemployment rate, %	5.8 - 6	5.8 - 6	5.7 - 5.9	5.6 - 5.8	5.5 - 5.7
Participation rate, %	cca. 61	61 -61.5	cca. 62	62 - 63	63 - 64
GDP growth rate	3.3 - 3.5	3.5 - 4	cca. 4	4 - 4.5	4.5 - 5

3.2 Income and consumption

During the last 2-3 years, the increase of real wages and consumption was significantly higher than the increase of labour productivity, therefore, competitiveness deteriorated, which contributed significantly to both external and internal imbalances. The structure of household income expenditures has changed unfavourable: the propensity to save has considerably decreased. Especially financial savings (net financing capacity) have dropped due to increased demand for subsidised mortgage loans. From 2004, growth of household incomes will decelerate with an income policy that is aimed to coordinate productivity and the increase of income on a medium term. The National Interest Reconciliation Council has returned to a wage bargain on nominal wages and an agreement was reached on 7-8 % gross average wage increase in the business sector for this year. There will be no central wage increase in the government sector this year, and the carry-over effect of last year's measures guarantee that the real wages will not decrease. As a result of various changes introduced in the tax system, including the decrease of personal income tax rates, elimination of tax preferences and increase of individual health care contribution, the growth of net wages will be slower than that of gross wages. Slightly accelerating inflation, caused by changes in the value added tax rates, has also contributed to deceleration of real income growth. More stringent conditions introduced in relation to housing loans have also put the brakes on the expenditure of households. Thus, in 2004, real wages and real income will increase by 0-1 %, and household consumption will go up by 1-2 % compared to 2003.

On a medium term basis, gross average wages will increase by 6-7 % a year, and real wages will gradually increase, annually by 1-3 %. The number of retired people will not rise in this period as the retirement age has been lifted for women; pension expenditures will increase because of the annual regular increase (indexation), the gradual introduction of the 13th month pension and higher widow pension. In summary, the pension expenditures will rise by 26-27 %, and in real terms by 9-10 % in four years.

The volume of household consumption is expected to grow annually by 2-3 %, lower than GDP growth. Within this, consumption expenditures will grow faster, and transfers in kind will increase slower. In relation to a decline in the role of the budget, government consumption expenditures will also decrease and thus, the share of final consumption compared to GDP will drop by approximately 1-1.5 percentage points a year, which gives an opportunity to increase capital formation.

3.3 Investments

As a result of better external conditions, the profitability of companies is also improving, increasing the own resources available for investment purposes. Due to the increasing EU transfers, which will more than double from this year, external resources will have an increasing role in the financing of investments. Hungary also expects that the volume of foreign direct investments will rise again, partly as a result of EU accession, and partly as a consequence of global recovery, thus in the business sector the investment increase

may even reach 8-10 %. However, it also requires an active role of the Government beside the significant fall in short-term interest rates during the next period.

In order to increase corporate investments to the desired extent, apart from favourable external conditions, there is a need to have an investment-friendly economic environment, too. The present high interest rates may hold back investments, although they fall parallel with the strengthening of the credibility of the economic policy. The Government intends to reduce labour costs, primarily employer's contribution, which causes a loss in budget revenues directly, but it has a long-term favourable effect indirectly as a result of higher employment and economic growth. The Government also contributes to an increase in investment intentions of entrepreneurs by accelerating and simplifying regulatory proceedings, and reducing local business tax.

An important source of the increase of corporate investments is the influx of more direct investments for purposes other than privatisation. In order to reduce regional differences, the Government will extensively develop the roads leading to underdeveloped regions of the country, including not only motorways, so foreign investments may be expanded by using the cheap and available labour in those areas. This can be supplemented with support to targeted vocational training programmes, which are in line with the requirements of enterprises, settling down in the region. It also requires a change in strategy, targeting not only at large multinationals, but at smaller investors, too.

From 2004, the general government investment expenditures will be determined by infrastructure development (motorways and metro), and no other increase is expected in this sector in the next one-two years. In total, the investment ratio will gradually rise, and by 2008 it will reach 25 %, which is typical in the cohesion countries.

Investment	in % of GDP				
	2004	2005	2006	2007	2008
Investment ratio	cca. 22.5	cca. 23	cca. 23.5	cca. 24	cca. 25
of which: business sector	cca. 12.5	cca. 13	13.5 - 14	14 - 14.5	cca. 15

3.4 Foreign trade

As a result of the adjustment of income and fiscal policy, growth will be driven again by exports, in addition to investments. The Hungarian export markets will expand substantially in 2004-2005, although the pace is expected to slightly decelerate after 2006. This is also reflected in export projections, which are cautious and conservative estimates concerning the baseline scenario. Caution is justified because the recovery is still volatile, and the growth prospects of the German economy, which has a major influence on the Hungarian economy, are still uncertain.

Exports and external demand	annual percentage change				
	2004	2005	2006	2007	2008
External demand	6.0	7.0	7.0	6.6	6.6
Exports of goods and services	9.1	10.2	9.4	8.8	8.8
<i>Difference:</i>	<i>3.1</i>	<i>3.2</i>	<i>2.4</i>	<i>2.2</i>	<i>2.2</i>

A basic requirement for making use of the improving external circumstances is the continuous improvement of competitiveness, which began at the end of last year, encouragement of direct investments, and deliberate support to tourism.

Projections for external demand contain moderate growth. Although the risk cannot be denied that the increase of import demand of our main trading partners will not reach 5 % even in the long term, the possibility of a higher export demand than projected may also exist. Russia and the CIS countries, countries of the Balkan area, and rapidly

developing Asian countries, primarily China, may have an important role in export market growth. As a more intensive export market, the countries listed above may contribute to growth and improvement of the external balance.

The increase of tourism balance depends primarily on the external development, but with regard to overseas tourists it also depends on the strengthening of security in the world and success of the fight against terrorism, too. At the same time, if Hungary can remain a relatively safe area, we can still benefit from the regional restriction of tourism. There is still a need for programmes in tourism, for a wider use of possibilities in medicinal tourism in order to utilise the favourable external conditions and regional opportunities. These programmes also need infrastructure investments. Education can contribute to an increase in tourism revenues mainly by developing the language skills of young people.

As a result of a fast expansion of exports and increase in domestic demand, the import demand of the economy will continue to go up in the next period, too. In addition, balanced economic growth also requires infrastructure development and higher corporate investment, which also increase import demand. Consequently, the raise of import demand will be higher than the increase of total demand in future, too. However, the differences between the growth rate of exports and imports are expected to be small.

3.5 Components of growth

The expenditure structure of GDP will change favourably in the next few years, investment and export may become the main driving force of growth again. At the same time, following temporary deceleration, the increase of consumption may also be in line with the increase in labour productivity.

GDP components	annual percentage change				
	2004	2005	2006	2007	2008
Household consumption	1 - 2	2 - 3	2 - 3	cca. 3	3 - 4
Government consumption	-(3 - 4)	cca. -2	cca. 0	0 - 1	0 - 1
Gross fixed capital formation	6 - 8	6 - 8	6 - 8	7 - 9	8 - 10
<i>Domestic demand</i>	<i>cca. 3</i>	<i>3.5 - 4</i>	<i>4 - 4.5</i>	<i>4 - 4.5</i>	<i>4.5 - 5</i>
Exports of goods and services	8 - 10	9 - 11	8 - 10	8 - 10	8 - 10
<i>Total demand</i>	<i>cca. 5.5</i>	<i>6 - 7</i>	<i>6 - 7</i>	<i>cca. 6.5</i>	<i>cca. 6.5</i>
Imports of goods and services	7 - 9	9 - 11	8 - 10	8 - 10	8 - 10
<i>GDP</i>	<i>3.3 - 3.5</i>	<i>3.5 - 4</i>	<i>cca. 4</i>	<i>4 - 4.5</i>	<i>4.5 - 5</i>

According to the latest calculations, the potential GDP growth is around 3.5-4.5 % on a medium term. Thus, for the next few years the output gap will still remain negative, and it will only turn into a positive figure at the end of the period, by 2008.

Output gap	annual percentage change				
	2004	2005	2006	2007	2008
Potential GDP at market prices	3.6	3.7	3.9	4.1	4.2
Output gap	-0.4	-0.5	-0.5	-0.3	0.1

3.6 General government, financing positions

The macro-economic path defined in the above economic policy framework and envisaged tax reduction will allow for an annual, approximately 0.5 percentage point cut in ESA95 general government deficit, starting from 4.6 % in 2004. By 2008, the deficit will fall below 3 %, with a significant drop in centralisation and redistribution ratios.

General government

in % of GDP

	2004	2005	2006	2007	2008
Income centralisation	44.2	cca. 43.5	cca. 43	43 - 43.5	cca. 44
Without EU transfers	43.6	cca. 42.5	41.5 - 42	cca. 41.5	41 - 41.5
Redistribution	48.8	cca. 47.5	cca. 46.5	46 - 46.5	46.5 - 47
Without EU transfers	48.2	cca. 46.5	45 - 45.5	cca. 44.5	cca. 44
General government deficit	4.6	cca. 4	cca. 3.5	cca. 3	2.5 - 3

The significant reduction in the budget deficit and in the scope of the general government sector will allocate more resources to enterprises, and increase competitiveness. There will only be a slight increase in household savings, and thus the annual 0.5 percentage point decrease in the financing demand of the budget can give room for meeting business sector financing requirements. The current account deficit to GDP ratio will continuously improve. Although this improvement cannot be spectacular, on a medium term it still provides an opportunity for balanced growth. Increasing EU transfers will also reduce the external financing demand of the economy.

Net lending / Net borrowing

in % of GDP

	2004	2005	2006	2007	2008
<i>Total economy</i>	cca. -8	cca. -7	cca. -6.5	-(5.5-6)	-(4.5-5)
Households	cca. 0.4	0.5 - 1	0.5 - 1	cca. 1	cca. 1
Corporations	-(3.5-4)	-(3.5-4)	-(3.5-4)	-(3.5-4)	-(3-3.5)
General government	-4.6	cca. -4	cca. -3.5	cca. -3	-(2.5-3)
Current account deficit	cca. 8.5	cca. 8	7.5 - 8	7 - 7.5	6.5 - 7

In the course of the capital-intensive catching-up process, the external debt to GDP ratio will decline from 2004. The external financing demand can fall from 9 % of GDP in 2003 to 4.5-5 % by the end of the period, in view of the fact that the capital transfers from the EU, which will increase from less than 1 % of GDP at the beginning of the period to almost 2 % by 2008, will significantly reduce the financing demand generated by the current account. There will be changes in the financing structure too: debt-creating financing will drop parallel with the reduced financing demand of the public sector, giving room to the corporate sector. At the same time, the share of non-debt creating financing will increase and in 2008 this type of financing will exceed the external financing demand. Net foreign direct investments will be over 4 % of GDP by the end of the period.

In the recent past foreign investors financed approximately 45 % of the general government deficit in Hungary. Taking the above projection for non-debt creating financing and EU-transfers and assuming an unchanged ratio of foreign investors in deficit financing, the additional external financing need of the business sector will be less than 1 % of GDP in 2004 and 2005. Subsequently, debt-creating financing need of this sector will be negative, their foreign debt will fall.

External financing need

in % of GDP

	2004	2005	2006	2007	2008
Current account deficit	cca. 8.5	cca. 8	7.5-8	7-7.5	6.5-7
Capital account with EU transfers	cca. 0.5	cca. 1	1-1.5	cca. 1.5	cca. 2
Of which: EU transfers	cca. 0.5	0.5-1	0.5-1	cca. 1	1.5-2
External financing need	cca. 8	cca. 7	cca. 6.5	5.5-6	4.5-5
Debt creating financing	cca. 3	2-2.5	1.5-2	0.5-1	cca. -0.5
Non debt creating financing	cca. 5	cca. 5	cca. 5	cca. 5	5-5.5
of which: reinvested earnings	2.5-3	2.5-3	2.5-3	2.5-3	cca. 3

3.7 Inflation

This year, due to tax changes related to EU harmonisation, increase in preferential VAT rates and energy prices, the disinflation of the last few years will temporarily come to a halt, but in the second half of the year, we expect a marked decline in inflation. On a medium term, inflation will start to gradually decelerate again in line with the macro-economic framework outlined above.

	annual percentage change				
	2004	2005	2006	2007	2008
Annual average	cca. 6.5	cca. 4.5	cca. 4	cca. 3.5	cca. 3
Dec/Dec	5.5 - 6	4 - 4.5	3.5 - 4	3 - 3.5	2.5 - 3

In the baseline scenario, the fiscal criteria for joining the euro area can be fulfilled by 2008, and the inflation criterion can be met at the same time, i.e., based on macro-economic conditions, Hungary can adopt the euro relatively safely in 2010. If conditions turn out to be more favourable, and inflation falls more rapidly, the adoption of the euro can take place already in 2009 under the baseline scenario.

3.8 Alternative scenario

It is reasonable to base the Convergence Programme on the relatively cautious scenario outlined above which can be used as the basis for government measures to improve equilibrium and economic structures. The economic policy must aim at a faster growth than this, but projections should only be adjusted if acceleration actually takes place. Below, we shall describe one of such variations of the baseline scenario.

Faster export – faster growth

The baseline scenario relied on a relatively conservative export projection, because we assumed that the difference between export and external demand would diminish. In the alternative scenario we do not assume better external conditions either, since the external environment is very volatile and still fragile. However, we do assume that as a result of the economic policy measures of the Government to improve competitiveness and investment attracting capabilities, export growth will durably be higher than the projection in the baseline scenario.

	annual percentage change				
	2004	2005	2006	2007	2008
External demand	6.0	7.0	7.0	6.6	6.6
Export of goods and services	10.1	11.3	10.1	9.1	9.0
<i>Difference:</i>	<i>4.1</i>	<i>4.3</i>	<i>4.1</i>	<i>2.5</i>	<i>2.4</i>

Higher export growth and the expected more vigorous economic development will not loosen the fiscal objectives of the Government, and expenditures will be reduced as they are outlined in the baseline scenario. However, as a result of higher employment and increasing consumption, the revenues of the budget may slightly increase, with which the deficit can be reduced more. As a result of a more favourable economic environment and higher export increase, the external equilibrium will also improve. There will be a stronger improvement in corporate profitability, and the number of employees in the business sector will increase more rapidly, too. Unemployment drops, and the participation rate will exceed 64 % in 2008.

Employment	annual percentage change				
	2004	2005	2006	2007	2008
Number of employed	0 - 0.5	cca. 1	1 - 1.5	cca. 1.5	1.5 - 2
Labour productivity	3 - 3.5	cca. 3	cca. 3	3 - 3.5	3 - 3.5
Participation rate, %	cca. 61	cca. 61.5	62 - 62.5	cca. 63	64 - 64.5
Unemployment rate, %	5.8 - 6	5.8 - 6	5.6 - 5.8	5.5 - 5.7	cca. 5.5
GDP growth rate	cca. 3.5	cca. 4	4 - 4.5	4.5 - 5	5 - 5.5

Increased economic activity, representing the basis of higher exports will not cause inflation pressure neither on cost, nor on demand side, if Hungarian and foreign resources are available for growth and the income and demand are in line with actual performance. Assuming tight income policy, the consumption of the population will increase slightly more than in the baseline scenario only due to higher employment increase. The share of final consumption is slightly lower in the more rapidly increasing GDP by 2008 than in the baseline scenario, and the savings available for accumulation in the national economy are slightly higher. Although investment growth is slightly stronger than it is assumed in the baseline scenario, the accumulation ratio will not change significantly, because a higher contribution of exports is the key factor in GDP growth. As a result of these factors, consumption and accumulation takes place with lower external financing demand, which may drop by nearly 1 percentage point compared to the baseline scenario on a medium term.

Growth and equilibrium	annual percentage change				
	2004	2005	2006	2007	2008
<i>GDP</i>	cca. 3.5	cca. 4	4- 4.5	4.5 - 5	5 - 5.5
Household consumption	1 - 2	2 - 3	cca. 3	cca. 3.5	3.5 - 4
Gross fixed capital formation	6 - 8	6 - 8	7 - 9	7 - 9	9 - 11
Exports of goods and services	cca. 10	10 - 12	cca. 10	8 - 10	8 - 10
Imports of goods and services	cca. 9	10 - 12	cca. 10	8 - 10	8 - 10
General government deficit *	4.6	cca. 4	cca. 3.5	2.5 -3	cca. 2.5
External financing need*	7.5 - 8	6.5 -7	cca. 6	cca. 5	cca. 4
Current account deficit*	cca. 8.5	7.5 - 8	7 - 7.5	cca. 6.5	cca. 6

* / in % of GDP

If this scenario is realised, the criteria of joining the euro area can be fulfilled already in 2007, and the adoption of the euro can take place in 2009.

4. PUBLIC FINANCE

4.1 Fiscal developments in 2003

In 2003, the general government deficit amounted to 5.9 % of GDP. Although the deficit declined significantly compared to the extremely high 9.3 % measured in the previous year, it was still higher than both the target in the 2003 Budget Act (4.5 %) and the projection in PEP 2003 (4.8 %). The developments were greatly influenced by the fact that the risks already indicated in PEP 2003, and affecting primarily the expenditure side, not only occurred but also increased.

The difference from projections was reflected mainly in the primary balance, but as a result of the higher than expected deficit, increasing yields and the exchange rate effect, interest expenditures also exceeded the projection. The yields turned out to be higher than assumed in PEP 2003 mainly as a result of the unfavourable financial market events. Because of the fluctuation of exchange rate, the entire yield curve moved up. In order to ensure financing and exchange rate stability, the central bank increased the base rate, as a result of which short-term yields rose. All this already influenced the

interest expenditures in 2003, but it will also have carry-over effects in 2004, significantly changing the interest expenditure projections in PEP 2003. In consequence of the unfavourable financial market developments, in the second half of 2003 the exchange rate was weaker than expected, which increased the HUF amount of interest paid in foreign currencies. In sum, the increase in accrual-based net interest expenditures worsened the deficit by 0.3 % of GDP. The primary deficit was 0.8 percentage point higher than forecasted in PEP 2003 and amounted to 2 % of GDP.

Despite the fact that economic growth was lower than it was forecasted in the budget and expected in PEP 2003, the higher deficit was not primarily caused by the loss of revenues. Although tax revenues fell behind the projections amended upward during the year, the original budget appropriations were exceeded. Some losses in certain tax revenues (personal income tax, corporate profit tax) were offset by a surplus in other tax revenues (VAT, simplified business tax which was much successful than expected, etc.). Total revenues of the general government reached 44.5 % of GDP compared to the planned 43 %.

However, expenditures increased much faster than revenues, and exceeded the figure projected in PEP 2003 by nearly 2.5 percentage points, amounting to 50.4 % of GDP. Contrary to the previous two years though, the extra expenditures were not caused by Government decisions made during the year, but by market processes.

In the primary expenditures of the central budget an excess of approximately 0.3 % of GDP occurred in housing subsidies. This was mainly due to increased interest subsidies on mortgage loans, which grew rapidly in 2003. The corrective measures of the Government introduced in June 2003 were primarily related to this item, yet the strong increase of housing loans continued in the second half of the year, too. Raising interest rates at the end of the year exacerbated the pressure on budgetary expenditures. Therefore, further restrictions in the housing subsidy system were introduced last December. However, the impact of these modifications will only occur in later years. The increase in expenditures was unavoidable as the stock of housing loans expanded faster than projected and the yields on government securities, constituting the reference yield for the subsidies, increased sharply.

The three major elements of the housing subsidy system are as follows:

- interest subsidies to loans extended on the construction or purchase of new dwellings, as well as on the purchase of second-hand dwellings;
- tax credit in the personal income tax related to the repayment of housing loans;
- direct subsidies to construction or purchase of dwellings.

* The two-stage measures implemented **in the housing loan system** in 2003 made the system more equitable and sustainable.

In June the Government

- eliminated the possibility to simultaneously raise several subsidised loans;
- reduced the maximum of subsidised mortgage loans from HUF 30 million to HUF 15 million.

In December

- the ceiling on subsidised mortgage loans to buy second-hand dwellings was reduced to HUF 5 million;
- the Government linked the rate of interest subsidies to the yields of government securities with maturities equalling those of mortgage bonds; the rate of interest subsidies is 60 percent of the yields on the corresponding government security in the case of constructing or purchasing new dwellings, and 40 percent in the case of buying second-hand dwellings or modernising and extending existing dwellings.

* As of January 1, 2004 the maximum of **tax credit in personal income tax** was reduced from HUF 240 thousand to HUF 120 thousand; the tax credit is applicable only to 30% of the repayments (instead of 40%); and the eligibility for the tax credit is linked to the level of income.

* Together with the stricter conditions, however, **the direct supports** were raised:
 - the Government twice raised the amount of direct support to construct or purchase dwellings and introduced the payment of the support in advance for young married couples;
 - as of 1st of January 2003 the eligible amount for subsidies on savings in home savings banks was raised to HUF 72 thousand from HUF 36 thousand.

Some other unplanned obligations also increased the expenditures: for example, the extra expenditures in family and social support were the results of a decision by the Supreme Court on the income supplement to be paid to mothers on maternity leave

Social benefits and pensions increased according to the legal regulations. Pensions increased by 8.4 % in January, and in November another 2.2 % increase took place as a supplementary pension with a retroactive effect in accordance with the projected increase of inflation and net wages. The 53rd week pensions were paid out, and widow pensions were raised from 20 % to 25 % in November, too. The deficit of the social security funds exceeded the budgeted figure by 0.4 % of the GDP, and by 0.3 % the figure projected in PEP 2003. This was mainly due to overrun in pension payments and the higher than planned expenditures on pharmaceuticals.

On the basis of risks inherent on the expenditure side, the Government decided to implement savings measures amounting to 0.4 % of GDP at the beginning of June 2003. Restrictions were introduced in the housing subsidy system and 2.5 % of the expenditure appropriations of central budgetary institutions were frozen. However, the interim adjustments were not enough to achieve the targeted deficit, and the decisions taken in December 2003 affected mostly developments in 2004.

The major deviations from the original appropriations is summarised in the following table:

Major deviations from the appropriation	in % of GDP		
	2003 original appropriation	2003 preliminary fact	The impact of the deviation on the balance
Primary revenues	42.7	44.3	+1.6
Primary expenditures	43.6	46.3	-2.7
Deviation in the primary balance			-1.1
<i>of which:</i>			
<i>tax and contribution revenues</i>	38.8	39.2	+0.4
<i>housing subsidies</i>	0.4	0.7	-0.3
<i>family and social subsidies</i>	2.3	2.5	-0.2
<i>pensions</i>	9.1	9.3	-0.2
<i>pharmaceutical subsidies</i>	1.2	1.4	-0.2
<i>budgetary institutions, chapter-administered appropriations, other</i>			-0.6
<i>State Privatisation and Asset Management Holding (ÁPV Rt), NMw Co. (NA Rt), other organisations</i>			-0.2
<i>local governments</i>			+0.2
Net interest expenditures	3,6	3,9	-0.3
Deviation in the balance			-1.4

4.2 Fiscal objectives for 2004

In the 2004 Budget Act, in line with the objectives in PEP 2003, ESA95 deficit of the general government was defined as 3.8 % of GDP, and the primary deficit as 0.3 % of GDP. However, due to an increase in both yields and interest rates, significant extra expenditures could be projected not only in the interest expenditures on the debt service, but also in housing loan subsidies. In addition, the fiscal outcome in 2004 is also influenced by the fact that the 2003 actual data on certain revenue and expenditure items were different from the expectations used as a basis of budgetary planning for 2004.

In 2003, the actual amount of tax revenues was below the projections, which were adjusted upwards during the year. The impact of the corrected base implies that in some major tax types planned revenues will not be realised in 2004. Revenues from personal income tax, corporate profit tax, value-added tax, and social security contributions are now expected to be lower than the appropriations in the 2004 budget. In total, approximately 1 percentage point loss is expected compared to appropriations in tax and tax-type revenues, expressed as a percentage of GDP.

In order to offset the impact of the interest rate increase on interest expenditures, the Government decided already in December 2003 to freeze some part of the 2004 expenditure appropriations. Against the background of the actual data on 2003 and reviewing the expected developments in 2004, the Government decided on further cuts in expenditures in February and April 2004. Approximately 50-50 % of the savings measures relate to current and capital expenditures, respectively. Altogether they improve the balance of the general government by nearly 1 % of GDP. The savings must be achieved in chapter-administered appropriations, in government investment projects and in institutional expenditures. In addition, more than 100 foundations, public foundations and non-profit companies operated from budget funds will be terminated.

In 2004, the remuneration base and coefficients of public sector employees will not increase, and wage expenditures can only increase in budget appropriations as a result of a raise in minimum wages and carry over impacts. In its resolution adopted in October 2003, the Government decided on 10 % and 6 % mandatory staff reduction in ministries and background institutions, respectively. Local governments must find a solution to increase wages by reallocating their funds. The Government has also indicated reforms in public administration, in the social and health systems and in higher education.

Taking also into account the effect of these measures, the ESA95 target deficit was raised from 3.8 % to 4.6 % of GDP. The primary deficit will increase from 0.3 % of GDP to 0.5 %. Compared to the 5.9 % and 2 % deficit and primary deficit in 2003, there will be a 1.3 percentage points adjustment in the deficit and a 1.5 percentage points adjustment in the primary balance. As a result of the negative output gap, the cyclically adjusted deficit and primary deficit will be 0.1 percentage point lower. Thus, the cyclically adjusted primary balance indicates an adjustment of 1.6 percentage points.

The revenues/GDP ratio will drop by 0.3 percentage point of GDP, from 44.5 % in 2003 to 44.2 % in 2004. The reduction of deficit is the result of cuts in expenditures, which is expected to amount to 48.8 % of GDP in 2004 following 50.4 % in 2003. Within expenditures, investment expenditures will not decrease, and the ratio of investment expenditures to GDP is 4 % in both years.

In 2004, the gap between accrual and cash-based indicators will temporarily widen. After EU accession in May, VAT accounting related to EU imports will assimilate to that of domestic turnover, and therefore, the payments due on one-month import will only appear on a cash basis later. The legislative change concerning the salary paid for the 13th month salary also has different impacts on the two types of accounting. (In

accordance with the regulation effective from February 2004, wages for the 13th month are not payable for the previous 12 months, but in January. The remuneration paid to some public servants this January still belongs to 2003 in the accrual-based accounting, but the payments made in January 2005 will not increase the expenditure of the previous year (2004) on accrual basis, but they will relate to 2005 according to legislation.) As a result of this, the 4.6 % ESA95 deficit corresponds to a cash deficit of 5.8 %. The time profile of this deficit figure will be uneven. Payments due at the beginning of the year and in the second quarter (expenses of the motorway network, interest payments, etc.) are important from this perspective. After accession, the value-added tax revenues on imports appear with some lag on cash basis, but the VAT refunds related to import for April still have to be paid. Thus, the cash-based deficit will temporarily increase. Taking these into account, preliminary data for the first four months indicate that the annual projection can be fulfilled, despite the fact that nearly 46 % of the annual deficit has already been reached.

Concerning the targeted deficit, the use of unspent appropriations of previous years and management of uncapped appropriations falling under the decision-making competence of the ministries may represent a risk. If monthly data during the year indicate that it is necessary, the Government will take further actions to control expenditures. Risks on the revenue side can be mitigated by stricter collection of revenues. The changes in VAT collection after EU accession imply that VAT revenues can be projected with a significant degree of uncertainty.

4.3 Expected fiscal outcome in 2004

4.3.1 Revenues

It was an assumption in PEP 2003 that as a result of the planned changes in the tax system, the revenues of the general government will increase by more than 1 percentage point of the GDP in 2004. According to the revised projection, both total revenues and tax and tax type revenues, will slightly decrease in 2004 (by 0.2-0.3 percentage points). Although the changes of the tax system mostly offset the revenue-reducing effects of adjustment in the structure of economic growth, the revenue/GDP ratio will not increase.

The most important objectives of the modifications of the tax and contribution system in 2004 include improvement of competitiveness, more equitable sharing in taxation and adaptation of the conditions required for the accession to the European Union.

In addition to the entry into force of new tax rates, the most important objective of the amendments of **personal income tax** rules included changes in tax breaks, harmonisation of tax burden related to various types of income and limitation of opportunities for tax avoidance. The tax rates dropped from 20-30-40 % in 2003 to 18-26-38 %. The lowest bracket increased from HUF 650,000 to HUF 800,000, and the highest one increased from HUF 1,350,000 to 1,500,000. Minimum wages remained tax-exempt. From 2004 no tax credit can be accounted for individual pension contribution and private pension contribution (being at 25 % earlier). The maximum tax credit on the repayments of housing loans was reduced from HUF 240,000 to HUF 120,000, and the proportional amount of the repayment was reduced from 40 % to 30 % (with the exception of loans taken for new homes) and eligibility for the tax credit was made dependent on income levels.

The changes in **corporate profit tax** and **dividend tax** were aimed at the improvement of competitiveness and harmonisation obligations related to EU accession. Consequently, the tax rate was reduced from 18 % to 16 %, while it increased from 3 % to 4 % in the case of offshore companies. The profit before tax can be reduced by 25 % of the local business tax, and the conditions of eligibility for development tax credit have been eased significantly.

The revenue limit applicable for the **simplified business tax**, available for small enterprises from 2003, was raised from HUF 15 million to HUF 25 million (including VAT).

Changes in the **value added tax** involved significant restructuring in the system of the VAT rates, reclassification of certain products and services, and modification of the value added tax system in accordance with EU regulations. The zero per cent tax rate was raised to 5 %, the 12% tax rate went up to 15 %, and the 25 % normal rate did not change. The annual revenue limit for tax-exempt subjects was increased from HUF 2 million to HUF 4 million.

The modifications of **excise regulations** involved changes in tax rates as of 1 January 2004. The changes of excise tax rates were mostly driven by the law harmonisation requirements, but they typically contributed to the revenues of the 2004 budget. The excise duty on tobacco products and on all drinks subject to excise duty has increased.

The modifications of the **social security regulations** were related to a contribution system which is in line with EU standards, harmonisation of employer' and employee' liabilities, and reflection of other changes taking place in other areas of law, affecting social security contributions. The harmonisation of employers' and employees' liabilities called for a one percentage point increase in health insurance contribution, raising employees' health insurance contribution to 4 % from 2004.

Regarding **customs and import payments**, the customs regulations, remaining within the national scope of competence, and effective from the accession, are being implemented. With the accession, the possibility of autonomously changing the customs system reflecting national interests disappears. Thus, as Hungary became a full member of the EU single customs area, the Community customs law and customs procedures regulations are applied directly in Hungary too, together with the customs tariffs and customs preferences related to the trade policy of the Community.

The modification of the act on **local taxes** has introduced the concept of tax suspension and reduced the local business tax base. Further minor corrections intend to harmonise regulations internally and use the experience gained in law application.

The majority of amendments of the act on **fees** related to fees on capital gain, achieved free of charges. The fee of recourse acquisitions has changed in some areas too, and the procedural duty fees at the courts of registration have been simplified.

The act on **vehicle tax** had to be amended in order to reduce tax administration with regard to domestic vehicles and retain the real value of tax revenues, while in the case of foreign vehicles, changes were required in relation to the customs procedures which changed with the accession.

In order to harmonise with EU regulations, the **energy tax** was introduced as a new tax type (payable by utility suppliers, energy traders and large consumers eligible to enter the free market), and **environmental fee** (payable by enterprises issuing materials that have a potential environmental hazard on air, water, sewage or soil). The **registration tax** replaces the consumption tax of vehicles. Its amount varies according to cylinder volume, age and environmental classification.

In order to achieve the targeted revenues, there will be no major tax changes during the year, apart from some minor modifications in personal income tax and excise duty. In the case of personal income tax, the conditions of eligibility for tax credit related to computers and computer technology devices will become stricter. In the excise duty, the deadline for the payment of tax on cigarettes will become shorter, which is a one-off cash-type measure.

In 2004, the internal composition of taxes and contributions will change. As a result of the reduction of the corporate tax rate, and the carry over effect of 2003 processes, the share of corporate tax revenues will decrease as a percentage of GDP. In relation to the increase of the revenue limit applicable for simplified business tax, the revenue of this tax type will slightly increase. On the other hand, VAT revenues will increase significantly, by 0.5 percentage points, primarily as a result of reclassifications arising from law harmonisation obligations and economic processes. Due to the moderate increase of wages and salaries, and overall effect of tax measures, the personal income tax/GDP ratio will fall. There will be a sharp, approximately 0.5 percentage point decline in the share of customs revenues in GDP, which is the consequence of the accession to the European Union. The share of social security contributions is relatively stable.

Major tax and contribution revenues

in % of GDP

	2002	2003	2004
Corporate profit tax	2.37	2.23	2.06
Simplified business tax	0.00	0.24	0.28
Customs duties	0.77	0.71	0.22
VAT	8.20	9.17	9.68
Excise duties	3.54	3.60	3.62
Personal income tax	7.73	7.11	6.93
Contributions into social security and labour market funds	13.05	12.63	12.56

4.3.2 Expenditures

The changes in the structure of the expenditure side reflect the following priorities:

- in line with the objective of a smaller but more efficient public sector, expenditures on general public services will decrease by 3.7 % compared to 2003;
- defence expenditures will increase by nearly 15 % in relation to the performance of tasks originating from NATO membership, and the implementation of the military reform;
- one of the most important tasks of the Government is the maintenance of the value of pensions and social supports. The 13th-month pension will gradually be introduced. In 2004, pension expenditures will increase by approximately 9.8 %, which is the result of the increase of old-age and relative pensions according to the legislation, the payment of the second week's amount of the 13th-month pension, and the carry over impacts of the widow pension increase introduced last year. Outstanding attention will be paid to the strengthening of the role of families in the society, and putting in place the right conditions for raising children within families. The Government will spend 8.3 % more on sick-pays, maternity and temporary disability benefits than last year;
- the expenditures of economic functions, including transport and telecommunications activities, reflect the Government's efforts to spend additional resources on the development of the motorway network in order to satisfy the requirements of EU accession. In addition, the investment project of Budapest Metro No. 4 will begin in 2004 as well. The expenditures related to road transport will increase by approximately 5 %, and represent more than 1.5 % of GDP. Of this total amount, the sum spent on the development of the motorway network is close to 1 % of GDP.

In financing, the funds from the European Union play a very important role in addition to the national resources. Capital transfers will amount to HUF 78 billion this year, and, adding Hungarian co-financing, the amounts rise to HUF 112 billion. EU funds will finance investments in transport and environment protection (preservation of nature, water management, etc.).

Compared to 69.5 % last year, investments implemented and financed by government agencies represent 72 % in the capital expenditures of the government sector. The majority of these projects are infrastructure and economic development projects,

regional and rural development, innovation activities, and investments into environment protection and institutional development. The share of local government investments (primarily local infrastructure, environmental protection and economic development projects) amounts to approximately 25 % of capital expenditures.

4.4 Fiscal objectives for the period of 2005-2008

The medium-term economic policy programme of the Government aims at a turn in the operation of the public sector. The focus of the fiscal policy is on a smaller, but more effective public sector, which reduces the expenditures of the general government by providing higher quality services as a result of the implementation of modernisation programmes that have been postponed before.

With the cautious but definite and consistent transformation of the public sector, government expenditures, containing also the impact of increasing EU transfers, may be reduced by 2 percentage points, to below 47 % of GDP by 2008. The extent of the withdrawal of the state is even higher (4.3 percentage points) on the basis of the expenditure/GDP ratio, without taking into account the impact of EU transfers. This will allow for a further, approximately 0.5 percentage point reduction of the government deficit each year, and 2 percentage points decrease in tax burdens between 2004 and 2008 too.

Fiscal development

in % of GDP

	2004	2005	2006	2007	2008
Deficit of the general government	4.6	4.1	3.6	3.1	2.7
Tax and tax-type revenues	39.0	37.9	37.5	37.3	37.0
Consolidated revenues (centralisation)	44.2	43.4	42.9	43.2	44.0
Centralisation without EU transfers	43.6	42.3	41.7	41.4	41.2
Consolidated expenditures (redistribution)	48.8	47.5	46.5	46.3	46.7
Redistribution without EU transfers	48.2	46.4	45.3	44.5	43.9
General government gross debt	59.4	57.9	56.8	55.6	53.7

As a Member State, Hungary is eligible for transfers from the EU budget and contributes to the EU budget. Although from the point of the general government position, the contribution to the EU budget is an additional liability, it is significantly exceeded by the direct and indirect impact of funds originating from the European Union. EU transfers will promote the development of the Hungarian economy and, in line with their objectives, they will have a very important role in accelerating the catching up process of Hungary. The amount of funds from the EU budget will gradually increase between 2004 and 2008, reaching 3.6 % of GDP in 2008. Of these amounts, the items showing up in the Hungarian budget amount to approximately 2.8 % of GDP. (In 2007 and 2008, apart from payments being carried over from the period before 2006, the significant increase in EU transfers involves the payments included in the new financial perspective of the European Union.) The use of the increased transfers represents further growth potential for the Hungarian economy.

In the calculation of funds available from the EU budget and items due to the EU budget, two periods have to be separated. Transfers between 2004 and 2006 have been calculated on the basis of the payment schedule prepared from the commitment figures included in the Accession Agreement in accordance with the measures taken for receiving transfers to date. In 2007 and 2008, apart from the payments being carried over from the period before 2006, a significant increase in EU transfers relates to payments made on the basis of the EU financial perspective after 2007. The commitments and payments of

the period starting in 2007 were defined on the basis of a document issued by the European Commission in February 2004¹.

The annual amount of items related to the EU budget (own resources) in 2004 is the amount shown in the 2004 budget of the EU, while the amounts calculated for 2005 and 2006 reflect the assumptions made during the accession negotiations, corrected with the difference between the estimated figures and those actually contained in the 2004 budget. The amounts for 2007 and 2008 were defined on the basis of the 2006 adjusted estimated base, taking into account the growth rate of the payment totals included in the document of the European Commission issued in February 2004.

4.4.1 Revenues – tax policy

The longer-term tax modernisation programme includes the following objectives:

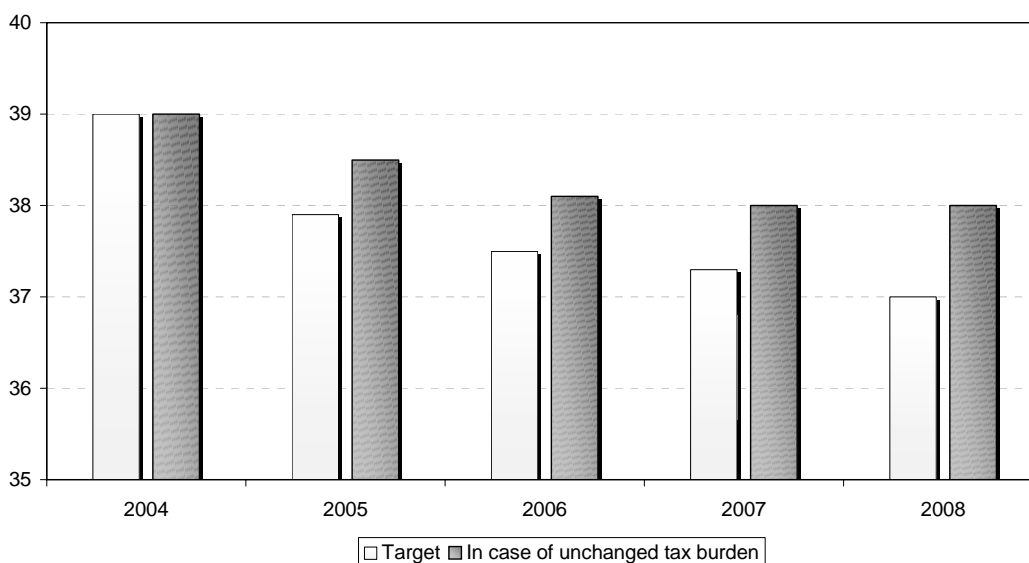
- a marked reduction of the tax burden on enterprises and households;
- the tax system should provide incentives for the performance of the economy, encourage savings and investments, and strengthen the capabilities of the country to attract and retain investments.

Although GDP growth leads to a somewhat lower tax/GDP ratio, significant tax reduction and modernisation can only be achieved with reduction of budgetary expenditures.

The share of tax and tax-type revenues of the general government in GDP will drop from 39 % to 37 % by 2008.

Estimates of tax and tax-type revenues

(in percent of GDP; ESA95 method)



In the framework of the tax modernisation programme, the following principles will be implemented in the form of specific measures, during a four-year term, starting in 2005.

- **Strengthening the neutrality of the tax system**, more consistent application of the principle of proportionality and **finding a basis for reducing tax rates and the average tax burden**, taking into account the impact of the widening of the tax base.

¹ Communication from the Commission to the Council and the European Parliament – Policy challenges and budgetary means of the Enlarged Union 2007-2013 COM (2004)101

In the **personal income tax** system, these objectives will be achieved with the following short-term measures:

- the average tax burden will be reduced as a result of extending the tax base to currently non-taxable income;
- reduction of tax breaks on the basis of practicality and target orientation;
- modification of brackets in the tax table as a result of which the average income will no longer be taxed at the highest rate;
- simultaneously with changing the taxation of capital income, reinvestment needs to be encouraged.

- **Reduction of the total tax burden on enterprises on a long-term basis**, in which the first step is to increase the deductible amount of local business tax from the corporate profit tax base of enterprises. The low corporate profit tax rate is not envisaged to be reduced.
- In the **value added tax system from the end of the period, a gradual reduction in the normative tax rate** is considered, subject to changes in EU requirements, and the budget position.
- The most effective method of employment promotion measures is the **reduction of social security burden**, thus, a decrease is projected in the amount of contribution to be paid by employers on wages in the next few years.
- The taxation system must be simplified. In this context, the reduction of unnecessarily wide variety of tax types is planned. During the following year, the merger of certain tax types may reduce the **administrative burden of taxpayers and tax administration** (for example, the contribution into labour market fund can be integrated into the social security contribution). Certain, practically insignificant tax types can also be terminated (for example, certain local taxes) which will also reduce the complexity of the tax system.
- The **tax authority will mostly assume the obligations of private individual taxpayers concerning tax declarations** in 2005. Later on, this concept should be extended to an even wider category, reducing the administrative obligations of employers too.
- On a long-term basis, consideration needs to be given to the reduction of the local business tax rate.

4.4.2 Expenditures

As a result of the envisaged deficit reduction and the projected reduction in the tax burden (centralisation), general government expenditures, calculated without EU transfers, will drop by 4.3 percentage points from 48.2 % to 43,9 % of GDP.

In addition to the reduction of expenditures, there will be major changes in their internal composition. The share of current expenditures will fall, while the share of investment expenditures will increase (from 4 % to 5.5 % of GDP between 2004 and 2008). In line with the objective to operate the public sector more efficiently, there will be a sharp decline in the share of collective consumption and social benefits in kind within current expenditures. As government debt will return to a declining trend and spreads (and yields) decline, interest expenditures will drop by cca. 1 percentage point of GDP between 2004 and 2008.

Components of expenditures	(in % of total expenditures)					
	2003 preliminary fact	2004 projection	2005	2006	2007	2008
			indicative estimate			
Collective consumption	15.8	14.8	14.5	14.3	14.0	13.6
Social benefits in kind	23.4	23.1	22.7	22.5	22.0	21.2
Social transfers other than in kind	26.5	27.4	27.5	27.6	26.9	25.9
Interest	8.1	9.0	8.7	8.3	7.6	7.0
Subsidies	6.5	6.4	6.4	6.5	6.1	5.6
Gross fixed capital formation	7.9	8.2	9.4	10.3	10.7	11.8
Other expenditures	11.7	11.0	10.7	10.4	12.5	14.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Initial steps to achieve these objectives were already taken by the Government earlier this year, instructing the budgetary chapters to revise the scope of their tasks, to implement efficiency-increasing measures and rationalise their expenditures.

The first measure to control expenditures in 2004 was the freezing of the appropriations of the budget chapters in an amount representing nearly 1 % of GDP. The amended appropriations, defined by the Government for each budgetary chapter in 2004, will be used as the basis of budget planning for the next years. The Government will make a proposal for the budgetary appropriations of individual chapters on the basis of the base, and within these appropriations, the individual budget chapters will establish the amounts required for their tasks. This requires a revision of the system of appropriations currently administered at chapter level, and the review of the objectives of government investments.

Chapter 7 of the Convergence Report provides a summary of structural reforms in the public sector to be implemented in order to ensure the rationalisation of government expenditures.

4.5 Public debt

In line with Hungary's debt management strategy, the maturing FX debt is financed by FX issuance, while the maturing HUF debt and the net financing demand of the central budget in a given year are financed mainly by HUF issuance. The objective is to increase the duration of marketable HUF debt and the share of government securities with fixed interest rate. The FX composition of the FX debt is 100% defined in euro, and all differences are managed through hedging transactions. In line with the current economic policy and government securities market situation, temporary deviations may be made from the basic principles of the strategy taking into account domestic demand and the amount of FX reserves in the central bank.

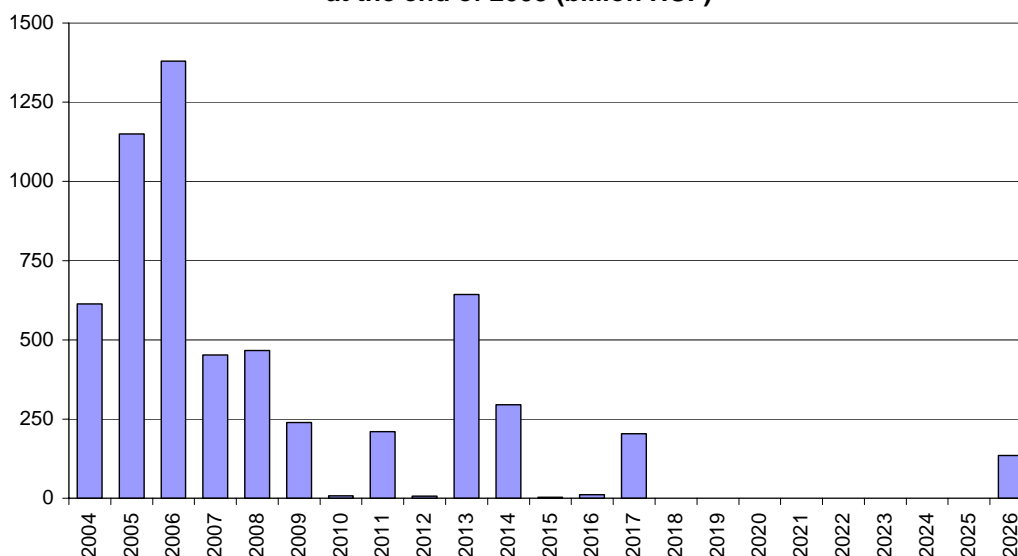
With the exception of the last two years, the public debt to GDP ratio has been declining since 1993 and has been below 60 % since 1999.

The falling trend in the debt ratio was reversed in 2002-2003. This can be explained by the increasing budget deficit, higher real interest rates exceeding economic growth, and valuation loss on FX debt.

At the end of 2003, gross public debt was 59.1 % of GDP on accrual basis. By the end of 2004, the gross debt will increase to 59.5 % of GDP. 24 % of the total debt was denominated in FX, 76 % was denominated in HUF at the end of 2003. In 2004 due to HUF financing under unfavourable conditions, there will be a positive net FX issuance and the share of FX debt will rise to 27 %.

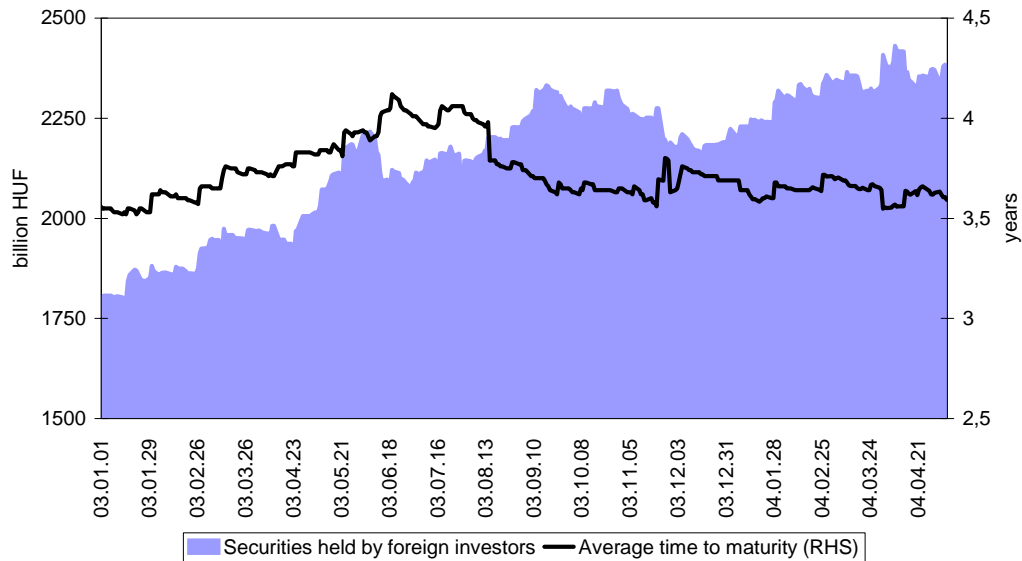
In order to improve the structure of HUF denominated debt, the duration is being extended and the share of marketable government bonds with a fixed interest rate is being increased. The maturity profile of HUF bonds is uneven, it is concentrated in the next few years. Thus, the volume of government debt redemptions is high; 70 % of total maturities are due in the 2004-2008 period (11 % of the government bonds issued in HUF until the end of 2003 are due in 2004, 20 % in 2005 and 40 % in 2006-2008.) Although the share of short-term debt decreased already in 2003, to create a more balanced maturity profile still remains a key objective. Longer-term securities (10 and 15 years) have an increasingly important role. The extension of the duration is indicated by the fact that by the end of 2003 the average term-to-maturity of marketable government bonds rose to 3.97 years compared to 3.38 years at the end of 2002, and it will increase to 4.07 years in 2004.

**Maturity structure of HUF denominated government bonds
at the end of 2003 (billion HUF)**



HUF denominated bonds with a fixed interest rate amount to 63 % of the government securities portfolio at the end of 2003, while in 2004 this share will increase to 67.8 %. The duration of the total marketable debt issued in HUF (discount treasury bills, government bonds, loans) will increase as a result of the increasing share of long term government securities with a fixed interest rate: from 2003 to 2004, it will increase from 2.31 years to 2.42 years, which reduces the interest and refinancing risk of the total HUF denominated debt. Fixed interest rate was preferred to variable ones from the perspective of both interest expenditures, due to the movement of the yield curve, and the better projection of interest payments. Therefore all government bonds are issued with a fixed interest rate.

Hungarian government securities held by foreign investors

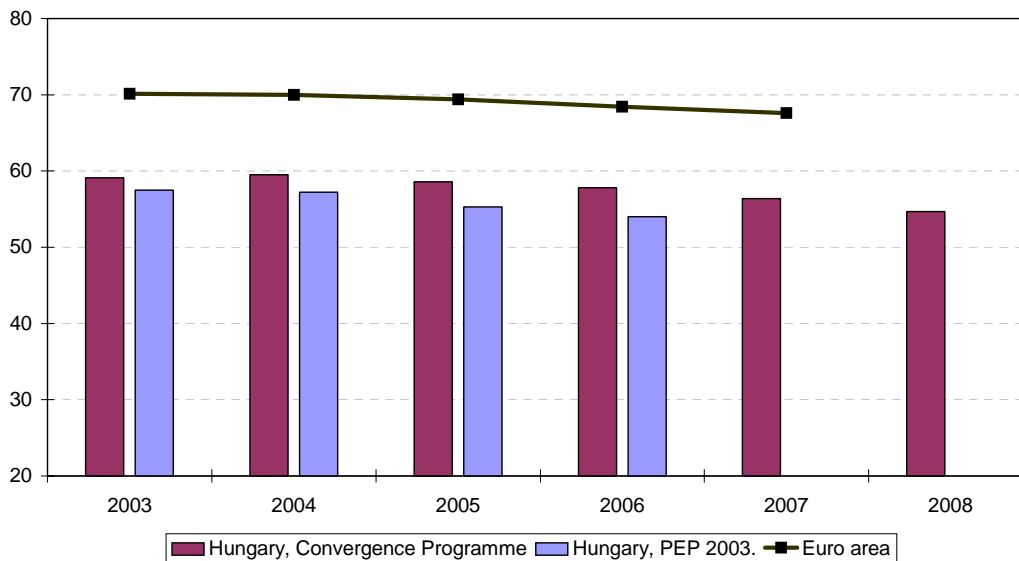


Within the total debt, the stock held by non-residents has increased.

- On 31 December 2003, government securities denominated in HUF, held by non-residents, amounted to HUF 2,223 billion (12 % relative to GDP), which increased by HUF 429 billion throughout the year. This stock represents 34 % of marketable government securities, with an average-term-to maturity of 3.66 years.
- In 2003, the FX debt increased by HUF 312 billion and reached HUF 2,579 billion (13,9 % relative to GDP), mainly because of the valuation loss. This represents 24 % of the total debt stock, with an average term-to-maturity of 4.8 years.
- In total, the share of debt held by non-residents increased to 45.1 % in 2003 from 44.1 % in 2002.

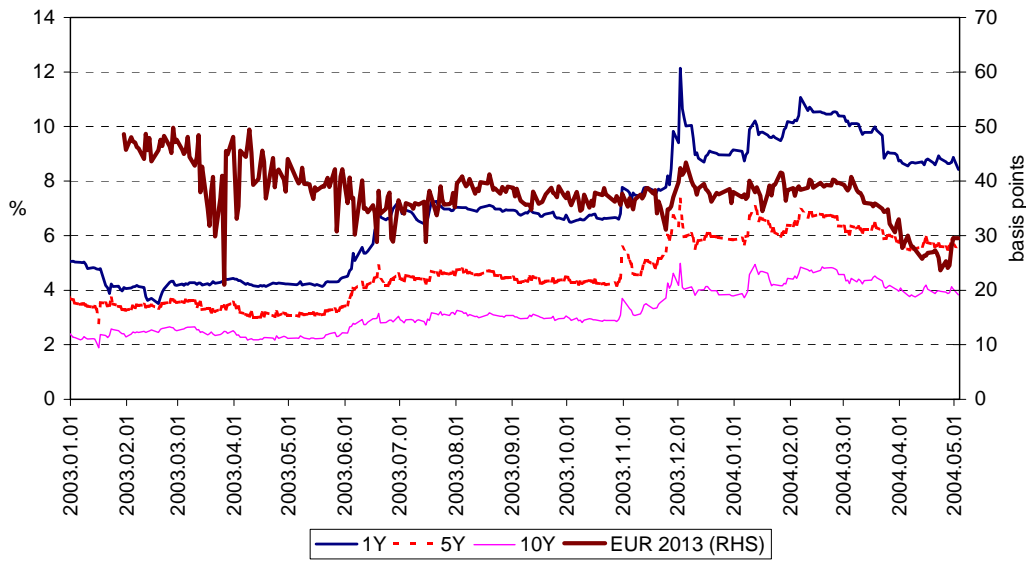
The development of public debt

(relative to GDP, ESA95)

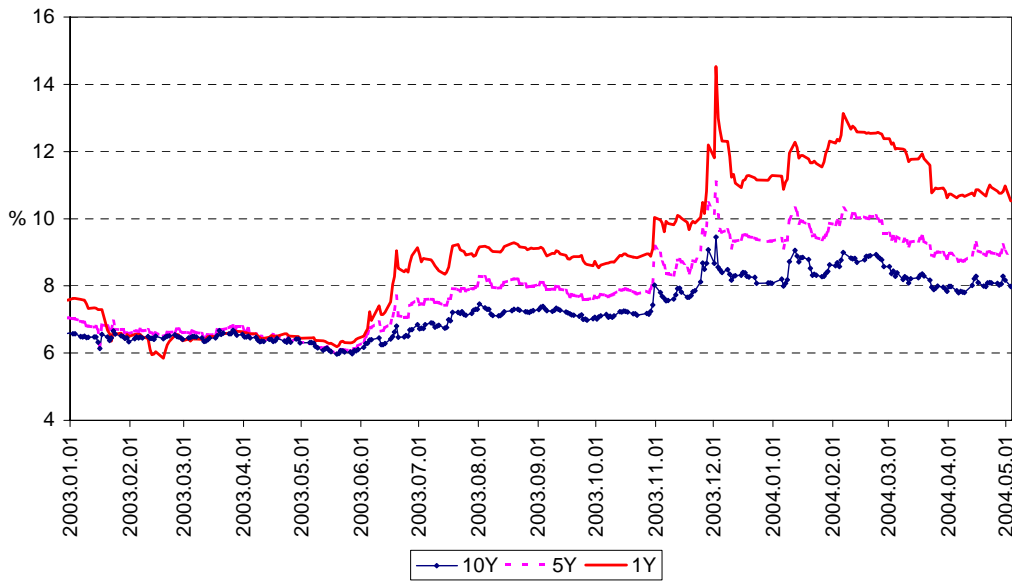


Deviation from the projection in PEP 2003 is explained by the higher primary deficit (0.8 % of GDP), increased interest expenditures (0.3 % of GDP) and the valuation loss on FX debt (1.4 % of GDP).

HUF-EUR interest rate differentials



Hungarian yields



The yield curve used for the projection of interest payments is based on EUR forward yields plus an assumed Hungarian interest premium. The projected yield curve moved upwards compared to the curve used in PEP 2003. Yields rose significantly from June 2003, especially in the short maturities, because the 600 basis points increase in the base rate by NBH in the second half of 2003, having the strongest impact on this segment of the yield curve. Because of the unfavourable money market developments prevailing at the end of 2003, the HUF/euro interest rate differential has widened significantly. By the end of the year, interest premium was 1.5-2 times as high as the stable premium between July-November 2003 (1.5-4 percentage point increase depending on maturity), and Hungarian yields also rose accordingly. This trend resulted in increased interest payments for 2003 and 2004, and to a gradually decreasing extent for the next few years. Since then, the premium has declined slightly, but it was still extremely high at the beginning of May. At the same time, the spread on EUR-denominated government securities has remained stable. Compared to Bund, it varied around 30-40 basis points.

In 2004, the public debt to GDP ratio will rise by 0.3 percentage point and reach 59.4 per cent by the end of the year. Interest payments are now projected to be higher (by 0.7 % of GDP) than in PEP 2003, resulting from the unfavourable conditions on government securities market prevailing at the end of last year and beginning of this year. Further, as explained above, the cash based deficit in 2004 will be higher – by 1.2 % of GDP - than the ESA95 deficit, implying stock-flow adjustment in debt accounting. The primary deficit projection for 2004 is now 0,1 percentage point higher than the figure in PEP 2003. Other factors influencing the debt ratio (privatisation revenues, changes in government financial assets, pre-financing of EU transfers, impacts of the exchange rate changes, etc.) show a balance, which is 0.3 percentage point worse in this projection than in PEP 2003. Nevertheless, this projection was made with the assumption of weaker exchange rate (260 HUF/EUR) than the current exchange rate, implying that at the end of the year, as the result of revaluation, the HUF value of FX debt might be lower than it is currently projected.

The public debt to GDP ratio will start declining from 2005, due partly to the improving primary balance, and partly to declining interest payments. The pace of improvement is slightly slower than the one indicated in PEP 2003. The reason for this is that the primary balance will improve gradually, but more moderately than it was projected in PEP 2003; the current projection is a primary surplus of 0.4 % of GDP in 2008. With regard to interest payments, the pace of the decline is the same as in PEP 2003, but the starting position (the levels in 2003 and 2004) is higher, as the impact of declining yields on interest expenditures will show up gradually. In total, between 2004 and 2008 the interest balance will improve by 1 percentage point. The favourable change mostly reflects the impact of the falling debt ratio. As the majority of the debt stock has a fixed interest rate, the impact of changes in market yields will be gradual. On a long-term basis, however, interest rate convergence to EU interest rates constitutes a significant reserve concerning the reduction in interest payments. No exchange rate changes were assumed in this projection.

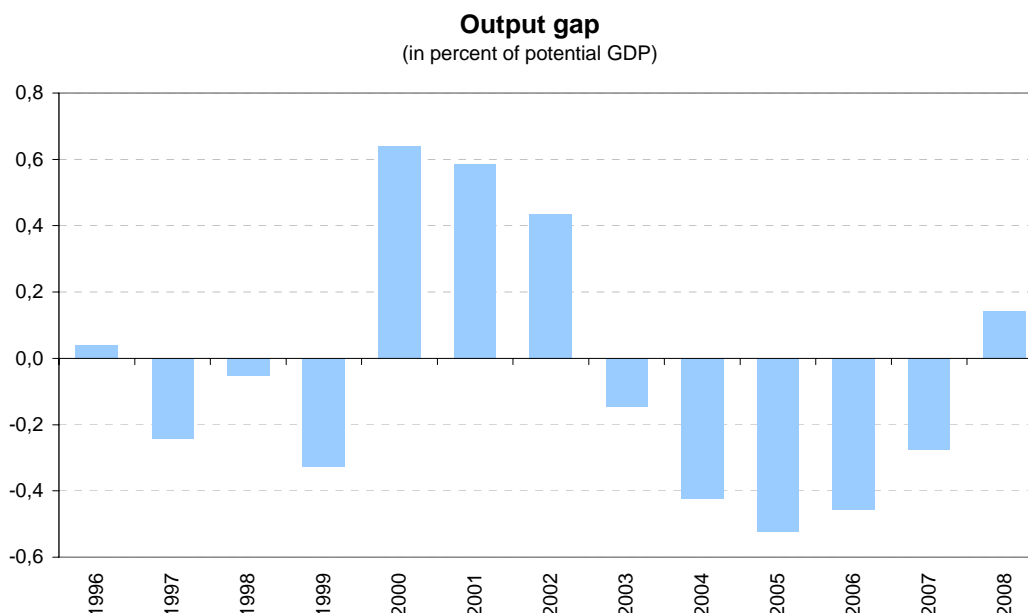
Apart from the primary balance, public debt developments are sensitive to the following factors on the medium term:

- Exchange rate effect: Changes in the exchange rate of HUF may increase or decrease the debt stock due to valuation losses or gains on the FX debt, which represents nearly 25 % of the total debt stock. In the medium term, an exchange rate change of HUF 1 results in HUF 10-15 billion variation in the debt stock per year.
- Yield effect: If yields are higher than currently projected, interest payments will increase (approximately one third of the public debt has to be refinanced annually, due to which the shift of the yield curve is relatively soon integrated into the debt stock through changes in interest payments). Here we consider a favourable change more probable, as the current yield assumption is a prudent one. According to our calculations, if the entire yield curve moves by 1 percentage point, interest payments will change by approximately HUF 18-30 billion in a given year, but subsequently the effect of the movement in the yield curve will be felt increasingly in interest payments.

5. SENSITIVITY ANALYSES

5.1 Cyclically-adjusted balance²

The positive output gap accumulated during the fast growth period of the late 1990s disappeared by 2003. With the resumption of growth starting in 2004, actual GDP is projected to exceed potential output in 2008.



Due to the negative output gap until 2007, the cyclical budgetary component will worsen the general government deficit and the primary balance by 0.1-0.2 percentage point. The cyclically adjusted primary balance ceases to be negative already from 2005. The cyclically adjusted deficit will not be higher than 3 % of GDP in 2007.

Cyclical developments

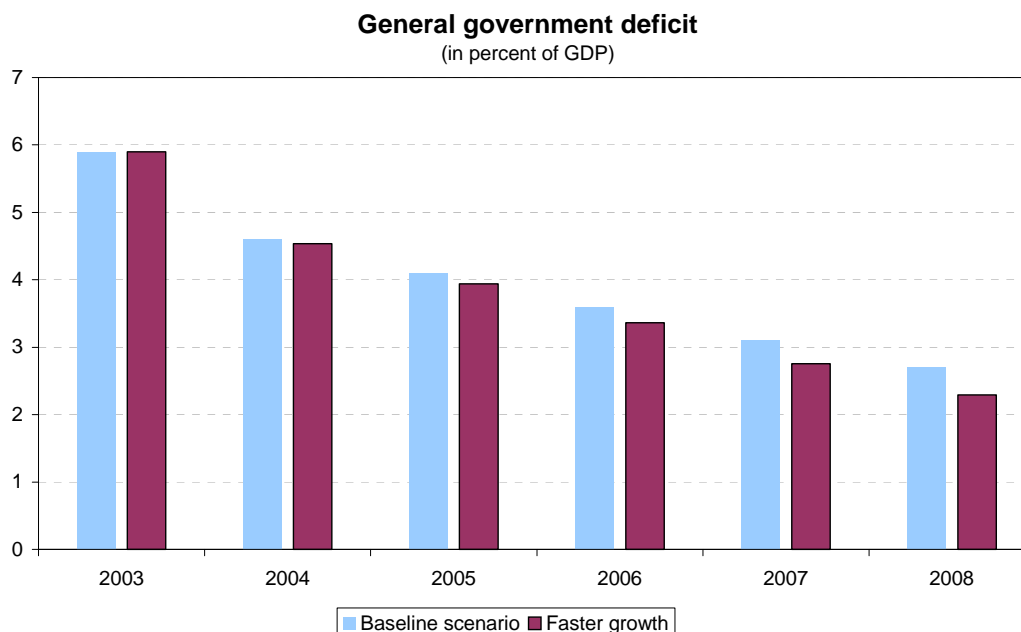
in % of GDP

	2003	2004	2005	2006	2007	2008
GDP growth at constant prices, %	2.9	3.3	3.6	4.0	4.3	4.7
Potential GDP growth, %	3.5	3.6	3.7	3.9	4.1	4.2
Output gap	-0.1	-0.4	-0.5	-0.5	-0.3	0.1
General government balance	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
Primary balance	-2.0	-0.5	-0.2	0.1	0.3	0.4
Cyclical budgetary component	0.0	-0.1	-0.2	-0.1	-0.1	0.0
Cyclically-adjusted balance	-5.9	-4.5	-3.9	-3.5	-3.0	-2.7
Cyclically-adjusted primary balance	-2.0	-0.4	0.0	0.2	0.4	0.4

5.2 Other sensitivity analyses

According to our calculations, the sensitivity coefficient of the government balance related to 1 percentage point change in GDP is 0.324 (see Annex). The cumulative growth impact of the faster export - faster growth scenario will be close to 0.5 percentage point until 2008, and the general government deficit may drop below 3 % of GDP already in 2007.

² The calculation method is summarised in the Annex.



According to the calculations, the deficit is less sensitive to inflation. One additional per cent of inflation causes 0.11 percentage point lower deficit. For the calculation of inflation sensitivity, we assumed an identical consumer price inflation rate for all products contained in the basket.

Regarding interest sensitivity, we assumed identical changes in the base rate of the central bank, BUBOR and government securities yield. An upward shift of 1 % in the yield curve raises the deficit by 0.10 percentage point.

Assuming identical changes in the annual average and end-of-year exchange rates, as well as constant cross rates, a HUF 1 stronger exchange rate improves the balance insignificantly. (However, most of the effect is due to customs revenues, therefore, their decrease can even reverse the positive impact.)

6. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

6.1 Pension system

According to demographic projections, the proportion of the population over the retirement age compared to the population of working age will increase significantly from 32.6 % in 2004 to 53.4 % in 2050. Nevertheless, as a result of the raise in retirement age until 2009, there will be a temporary decline. Improvement in the employment rate implies that the share of retired people compared to those employed will increase from 60.2 % to 76.7 %.

Apart from the demographic and macroeconomic situation, three measures of the pension reform will have an important effect on pension expenditures: introduction of mixed financing, application of the Swiss indexation (50 % wage increase, 50 % inflation), and the raise of the retirement age.

In 2003, the expenditure related to social security pension amounted to 9.2 % of GDP. It needs to be noted that these are mainly financed from the Pension Insurance Fund (8 % of GDP) but certain services (primarily disability pension below retirement age) are financed from the Health Insurance Fund (1.2 % of GDP), which is not covered by the long-term projections.

The impact of the introduction of the funded system on expenditures will be significant starting in the 2020s. By that time, newly retired people will retire as members of the two-pillar system in an increasing number, and as such, they will only be eligible for a reduced amount of pension from the pay-as-you-go pillar. In 2050, the private pension funds will relieve the budget from pension expenditures representing 1.6 % of GDP (compared to the situation without reform). The increase in social security expenditures is held back by the raise in the retirement age, and the indexation of pensions below the GDP growth rate. As a result of these factors, gross pension expenditures of the Pension Insurance Fund are not expected to be higher in 2050 than in 2000 (7.5 % of GDP).

Regarding revenues, it has to be emphasised that members of the mixed system pay a reduced amount of contribution into the pay-as-you-go pillar. Due to this, there will be an additional deficit in the pay-as-you-go system, which will increase until the 2020s, parallel with a change that an increasing share of the active population joins pension funds. The other most important effect reducing revenues is the decrease of the absolute number of employees due to demographic factors. Later on, the effects of the reform can be felt on the expenditure side too. The mixed system will fully mature around 2060. It is also important that in the same period the private pension fund pillar will achieve savings (accumulation) in the same amount as the temporary deficit of the social security system.

As a result of the effects on both expenditures and revenues, the deficit of the pension insurance fund (including also the temporary deficit arising from the lost contribution revenues) will fall until 2009 – due to the raise in retirement age –, and increase after that. In 2050, the deficit calculated with gross pension expenditures amounts to 2.6 % of GDP.

In sum, it may be concluded that demographic developments have an unfavourable impact on the Hungarian pension system. However, this unfavourable effect will be mitigated by the measures adopted in the context of the pension reform of 1997 on a long term. Nevertheless, the deficit of the pay-as-you-go system is expected to widen, the financing of which will require an increasing role of the budget.

Pension expenditures in Hungary

(Without pensions financed from the Health Insurance Fund)

	2000	2004	2010	2020	2050
Gross pension expenditures (as a % of GDP)	7.6	8.0	6.9	7.6	11.0
of which: First pillar	7.6	8.0	6.7	7.1	7.5
Second pillar	0.0	0.0	0.1	0.4	3.5
Deficit of the pay-as-you-go pillar (as a % of GDP)	0.5	1.4	0.7	1.7	2.6
of which: temporary excess deficit due to reform	0.5	0.7	1.3	1.5	0.1
Number of retired people (million)	2.4	2.3	2.3	2.5	2.7
of which: in the pay-as-you-go system	2.4	2.3	2.3	2.4	0.8
in the mixed system	0.0	0.0	0.0	0.1	1.9

6.2 Health care, social policy

In general, the economic growth outlined in long-term projections is not threatened by a health cost explosion driven by demographic changes until 2050 if the system is sufficiently restructured.

In the last three years, the in-kind benefits of the health insurance system increased faster than GDP. This was the result of fast dissemination of innovative drugs, wage adjustments for employees in health care and fast increase of service provisions.

Because of the strict budgetary requirements in 2004, numerous short-term measures were adopted (freezing of medicine prices, degressive financing techniques, introduction of cost-volume agreements) which may assist in controlling the appropriations.

In order to achieve a lasting reduction of the increasing tension in financing, the Government has started preparations for a financing reform of health care. The reform will curb expenditure growth, and introduce cost effective services by changing the financing and incentive mechanisms.

The envisaged changes in the social care system will increase efficiency, eliminate redundancies and ensure the application of the principle of targeted services in a wider range.

7. STRUCTURAL REFORMS

In order to have a smaller and more effective government sector, structural reform measures will be implemented in the public sector in the next few years. The reforms will make the operation and management activities of central budgetary institutions and local governments more effective, and their implementation is of key importance for keeping the government expenditures within the planned limits.

The revision of budgetary procedures and sectoral policies, and the relationship between legal regulations and the budget is important for controlling the approved expenditure totals. It may be achieved by setting up a multi-annual fiscal framework, and defining decision-making points, so that the availability of budgetary means and competing needs for funding could be confronted already at the beginning of the budgetary process. Legal regulations could only define tasks and obligations to be performed by the government sector, if revenues are generated or expenditures are saved for them. In order to promote more efficient public services, organisational and performance requirements must be defined, responsibilities need to be decentralised, and accountability must be extended to results and performance.

- The **performance requirements** need to be increased by changing the central and local administration. Measures representing the basis of this change need to be started this year and the one-off additional expenditures related to it shall be financed from the budget. Consequently, real wages in the public sector should increase by approximately 2 %. Differentiated wage increase is required in wage systems in order to reduce any disproportionality in wages.
- Currently, a lot of parallel tasks are performed in the government sector. **All these parallel tasks should be gradually eliminated, focusing mainly on the objectives approved in the National Development Plan.** An increasing amount of EU funds will be available for these purposes from the Structural and Cohesion Funds.
- The public-private-partnership framework should be extended. The **motorway construction programme** should be continued in this manner, achieving a higher involvement of private investments and reduction of construction prices as a result of more intensive competition.
- The **comprehensive academic, financing and organisational reform of higher education** will start from 2005. In this framework
 - an **education system** has to be established that takes into account labour market requirements and projections in quantitative and qualitative aspects (number of students in line with demographic and labour market conditions, shorter training, later specialisation, reduction of the mandatory lessons for

- students, etc.), in the spirit of joining the European High Education Area as well as Bologna Process,
- development and operation of a new **financing system** model, encouraging cost efficiency, adjusted to the structure of training, applying supplementary target subsidies, based on output requirements defined on the basis of organisation and performance parameters,
 - reform of the **organisational structure** and management, including the continuation and extension of institutional integration (primarily in the internal organisational structure) and introduction of the management approach in institutional management.
- The efficiency of the **health care system** needs to be improved, as a result of which funds need to be raised from outside the budget too. The financing system has to be restructured, a new type of health service organisation has to be introduced, and a new system is needed for subsidising medical drugs. Draft legislation on these measures will soon be submitted to Parliament.
 - **Social services** also need to be restructured, with a higher efficiency, reducing parallel features, and ensuring that the target-oriented principle is applied as widely as possible, and the situation of families with children and families with children and low income is improved. The efficiency of distribution needs to be improved primarily within the available framework. Schemes aiming at increased flexibility need to be extended and encouraged (part-time jobs, partial social care, part-time use of social institutions).
 - The military **reform programme** aims at a smaller army which is technically more effective, and is capable to meet the requirements of military capabilities of NATO and EU.
 - The sectoral services and public administration tasks to be performed in development regions, and requiring more extensive regional organisation must be identified on the basis of the **modernisation programme of public administration services**. In relation to this, the scope of competence of regional administration agencies, and the tasks and responsibilities of regional administration offices must be re-defined. The modernisation programme aims at decentralisation, i.e., strengthening the role of regions compared to sectoral functions and at the development and simplification of regional and small regional institutional systems. In this context, opportunities offered by e-administration will be of crucial importance, based on the requirements of transparency, efficiency, accessibility and security.
 - Simplification steps will be introduced in the **organisation of local government public services**. These steps aimed at the performance of tasks by small regional associations, which are more effective, and the development of an incentive system primarily in the area of public education.
 - The **institutional system responsible for public tasks** needs two-way modernisation:
 - **Regionalisation of public administration:** establishment of regional governments, voluntary associations and, during the restructuring of public administration agencies, delegation of a considerable part of tasks to regional level, with the principle that public services are not separated from citizens, to disseminate e-government and the supply of public services and to create conditions for effective and cheap operation in general, supported by EU funds.
 - **Restructuring of the central budget system:** this involves budgetary institutions, public foundations, and non-profit and economic organisations and is based on a comprehensive set of requirements defined at government level. These changes include, for example, the following:
 - reduction of the scope of the general government,

- operational management control introduced at budgetary institutions,
- the re-definition of funding ratio and size of institutions based on economies of scale), and the restructuring of the internal organisational structure,
- development and extended application of benchmarking, and modernisation of information systems,
- performance of tasks by market participants with regard to non-technical functions,
- accountability of non-budgetary agencies with regard to durable and significant external fund-raising capabilities,
- in certain tasks (for example, tendering) the exclusivity of the budgetary institution form shall remain,
- termination of non-budgetary agencies with a high level of government financing.

Annex: Estimation method for the output gap and the cyclically adjusted budget balance

The output gap can be estimated as the difference between the actual and potential output. The European Commission proposes to apply the production function approach for estimating the latter one. Unfortunately, for lack of capital stock data for the decade beginning with the transition period this method cannot be applied yet. Ex post estimation of the necessary data is just about to be completed. At present, we applied the Hodrick-Prescott filter, which was formerly used for most EU countries. The filter was used on seasonally adjusted quarterly GDP data between 1996 and 2009. Within those, the projections between 2004 and 2008 originated from the quarterly breakdown of the annual basic scenario and then this time series was extended by four quarters with ARIMA forecast in order to reduce the end-point bias.

The budget sensitivity factor, required for the calculation of the cyclically adjusted budget balance was estimated in the following way:

On the *revenue* side, the personal income tax, corporate profit tax, four various types of contributions, three consumption tax types and the local business tax were taken into account. Among *expenditures*, three items were examined: interest payments, pension and unemployment related expenses (in Hungary, wages significantly influence pensions because of the Swiss indexation). The calculation was performed for the period from 1991 to 2002, and the same method was used for revenue and expense items.

The elasticities were defined in five steps:

In the first step, elasticities of taxes, contribution revenues and expense items according to their corresponding bases were estimated. The table summarising the results contains elasticities estimated either with econometric methods or by experts (Columns (1) and (2) of the Table below).

In the second step, the GDP elasticities of tax bases as short-term coefficients of econometric equations (Columns (3) and (4)) were defined.

In the third step, we identified some coefficients correcting the slight difference between the explanatory variables applied in the first step and the dependent variables of the second step (Column (5)). *In the fourth step*, we calculated the shares of budget items related to GDP on the basis of the 2004 annual projections (Column (6)).

The revenues involved in the calculation represent almost 35.1% of GDP, and approximately four fifths of the consolidated gross revenues estimated for 2004.

Finally, *in the fifth step*, the sum-product of Columns (2), (4), (5) and (6) resulted in the sensitivity factor equal to **0,324** (see the Table).

Calculation of the general budget sensitivity							
Revenues	sensitivity of budgetary item to the respective base		sensitivity of the respective base to the GDP		elasticity of (3) to (1)	the share of budgetary item in GDP	sensitivity
	base	sensitivity	base	sensitivity			
	(1)	(2)	(3)	(4)	(5)	(6)	(7) = (2)*(4)*(5)*(6)
Personal income tax	Difference between net and gross wages and salaries of employees net of employees' social security contributions	1.36	Income of employed persons	0.93	1.01	7.3%	0.093
Social security contributions							
Health insurance	Gross wages and salaries of employees * rate of the respective social contribution of employees	0.75	Income of employed persons	0.93	0.99	4.1%	0.029
Pension insurance	Gross wages and salaries of employees * rate of the respective social contribution of employees	0.93	Income of employed persons	0.93	0.99	6.3%	0.055
Employer's contributions + employee's contributions	Gross wages and salaries of employees	0.90	Income of employed persons	0.93	1.00	1.1%	0.009
Vocational training contributions	Gross wages and salaries of employees	0.95	Income of employed persons	0.93	1.00	0.1%	0.001
Corporate tax	Operating surplus	1.22	Operating surplus	0.90	1.00	2.3%	0.025
VAT	Retail sales	1.23	Purchased consumption	0.93	0.95	9.3%	0.101
Excises							
Excise on fuels	Purchased consumption	0.43	Purchased consumption	0.93	1.00	1.9%	0.008
Excise on tobacco	Consumption of tobacco	0.46	Purchased consumption	0.93	1.00	1.0%	0.004
Registration tax	Retail sales	1.40	Purchased consumption	0.93	0.95	0.3%	0.004
Local business tax	GDP	1.00	GDP	1.00	1.00	1.4%	0.014
Total						35.1%	0.342
<i>Expenditures</i>							
Net interest payment	Effect of 62,9 billion forints improvement in primary balance	1	GDP	-0.51	1.00	3.6%	- 0.018
Pensions	Net average wages and salaries of labour force	0.47	Income of employed persons	0.93	0.95	9.2%	0.038
Unemployment benefit	number of registered unemployed	1	number of registered unemployed	-0.55	1.00	0.4%	- 0.002
Total						9.6%	0.018
Balance						25.5%	0.324
<i>EU-average*</i>							0.50
<i>EU-minimum (Austria)*</i>							0.30
<i>EU-maximum (Denmark)*</i>							0.80

* Fiscal policy in Europe: how effective are automatic stabilisers?, by Anne Brunila (Ministry of Finance, Finland), Marco Buti and Jan in 't Veld, Directorate General for Economic and Financial Affairs, http://europa.eu.int/comm/economy_finance, N° 177 -