MONETARY POLICY GUIDELINES

FOR 2001

December 2000

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The 2001 Monetary Policy Guidelines, as in previous years, provides the Hungarian Parliament and the general public with an overview of conditions for future policy actions and the range of objectives and available instruments of monetary management.

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Summary

The Hungarian economy has grown at a continuously high rate of more than 4.5% over the past four years. Productivity has improved, the country's external position has remained stable and improved even further, the financial position of general government has strengthened, inflation and unemployment have declined, and real demand and consumption have picked up. The economy has been progressing on a healthy, sustainable growth path since the end of 1996. Most economic indicators continue to be favourable in 2000, but inflation has suffered a reversal. Though end-of-year inflation will be lower than in 1999, since July monthly data show that inflation is increasing. This break in the downward trend of inflation, however, is believed to be only temporary and, with concerted efforts on the part of economic management, the decline in inflation may continue in 2001. The later economic policy reacts to the reversal of disinflation and tries to break increasing inflation expectations, the higher the incurred economic costs will be. This is a strong argument to resist any inflationary pressure.

A number of *external factors* exerted strong upward pressure on domestic prices. In particular, rising crude oil prices and the weakening euro were the most important factors impeding a further reduction in inflation recently. As regards the unfavourable effects from domestic factors falling outside the competence of the monetary authorities, the substantial rise in food prices should be mentioned. Wages in the corporate sector have been growing faster over the past six months. Nevertheless, the current rate of real wage growth does not constitute a problem. Rather, the major concern for monetary policy is that this real wage growth has been the result of higher inflation and nominal wages. The rapid response of nominal wages and the shift in the yield curve both point to worsening *inflation expectations*.

While households' net lending position declined in 2000, the lower-than-expected general government deficit and the falling corporate sector borrowing requirement offset this effect. The *current account deficit* is therefore expected to fall from 4.3% to below 4%, as a percentage of GDP. The *general government deficit,* calculated on an accrual basis, will likely be much lower than both official and market forecasts.

The roughly 7 per cent increase in administered prices, expected for 2000, will exceed the original plan by only a slight margin. However, it has distorted relative prices and led to the build-up of inflationary pressures in many areas (for example in gas supply and public transport). The *monthly devaluation rate of the currency* was cut once in April 2000, from 0.4% to 0.3%. The adverse external shocks to inflation have not allowed for further cuts in the rate of crawl. Within the framework of the current exchange rate regime a lower rate of crawl implies lower nominal interest rates, which, accompanied by persistent inflation expectations, would lead to insufficiently low real interest rates. This in turn would fuel aggregate demand and could lead to a deterioration in the current account and an increase in inflation.

Between January–September 2000 the Bank cut its policy rate, the rate on the two-week deposit, on five occasions. As a result of these cuts, the rate fell from 13.75% to 10.75%. Lower inflation in the first half of the year provided a favourable background for the rate cuts, which, at the same time, were triggered by heavy interventions on the foreign exchange market, induced by a fall in the risk premium, and the need to reduce the costs of sterilisation.. The temporary reversal in the downward trend of

inflation has led to a new situation where the contribution of exchange rate policy to disinflation is much more limited. The Bank and the government both recognise the need to abandon the current exchange rate regime and agree on how it should be done, but no agreement has been reached as yet about the timing of such a move. As a response to the higher inflation, raising the key rate from 10.75% to 11.75% on 11 October appeared to be the most adequate policy action. In order to check the influx of speculative foreign capital encouraged by higher interest rates, the Bank made a number of changes to its monetary policy instruments. After the rate increase real interest rates, using the Bank's forecast for 2001 inflation as deflator, returned to around 3 per cent, the level the Bank sees as the lower boundary of the acceptable range. At the moment, there is little scope for interest rate policy to alter interest rate conditions – the break in the downward trend of inflation in July–September suggests that real interest rates currently are lower than their equilibrium level. However, within the framework of the current exchange rate regime, the opportunities of the authorities to raise official interest rates more aggressively in order to combat inflation are limited.

The *prospects for economic growth* in 2000–2001 are good. In addition to strengthening domestic demand, the boom in external markets is also assisting growth. Economic growth in the Euro-area will reach 3.3% in 2000 and 3% in 2001. But, as the end of 2000 draws near, risks to world economic growth are mounting. Over recent years fiscal policy has played an important role in creating the conditions for economic growth – the Hungarian example clearly demonstrates that consolidation of government finances is a precondition for, and also a consequence of, rapid economic growth.

Hungary's inflation outlook has become much more complex to judge, given the increased number of uncertainties faced in 2001, as compared with earlier years. The factors making the 2001 inflation forecast difficult are the future developments in crude oil prices, movements in the dollar exchange rate of the euro and the behaviour of domestic food prices. The prospects for the world economy are also hard to assess, which constitutes another source of uncertainty – in the event of a possible significant drop in the growth rate the impact on the Hungarian economy may be quite severe. As regards fiscal policy, the change in the primary balance, based on the Bank's forecast for 2000 and figures from the government's proposed budget for 2001, will have an expansionary effect on aggregate demand of 1.2 per cent of GDP.

Due to the risk factors discussed above, there are significantly more uncertainties in forecasting inflation for end-2001 than under normal circumstances. Therefore, in preparing the Guidelines the Bank felt it compelling to shorten the horizon of economic forecasts to six-months, but to observe the law and the traditions, the Guidelines discusses a one-year period.

In accordance with its final goal as set forth by law, using its available instruments the National Bank of Hungary will make every step to achieve further reductions in inflation, which serves the interests of all economic agents. Monetary policy can contain inflation by maintaining adequately high real interest rates and by setting the pre-announced rate of devaluation lower than expected inflation, i.e. via real exchange rate appreciation. The exchange rate will continue to serve as a nominal anchor for economic agents in 2001. The current rate of monthly devaluation implies a total devaluation of less than 4% for 2001, suggesting a real exchange rate appreciation even alongside an optimistic inflation scenario. That, in turn, may contribute to the disinflation process through both moderate imported inflation and lower inflation expectations, without damaging competitiveness, as productivity growth is faster in Hungary than in the trading partner countries.

The Bank made a number of modifications to its monetary policy instruments in 2000. As a new instrument the Bank launched a three-month central bank bond (in effect central bank CDs). The introduction of the bond allowed the authorities to stabilise short-term rates and was useful in reducing the costs of sterilisation. As of 2 November, the two-week deposit is no longer a standing facility, rather the Bank operates the facility by conducting variable rate tenders. In the tender announcement, the Bank sets an upper limit for interest rates, equivalent to the policy rate, and a quantity limit consistent with the forecast liquidity position of banks excluding the potential effect of speculative capital inflows. Reform of the required reserve system will continue in 2001. In addition to the modifications which have already been announced, the reserve ratio will be lowered by an additional 4% in one step in early 2001, taking into consideration both efficiency criteria and the need to maintain a level playing field for participants. Thus, including the measures already announced, the required reserve ratio will have fallen from 17% in 1995 to around 6% by the middle of 2001. Other things being the same, the cut in the effective reserve ratio is to contribute to the narrowing of the spread between deposit and lending rates. In line with its other objectives, the Bank has worked out a solution that will offset the liquidity effect of the cut in the reserve ratio and ensure that the growth rate of the monetary base will be unaffected.

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The economy has been progressing on a sustainable growth track…

The Hungarian economy has been progressing on an exceptionally favourable course in the past four years even from historical perspective. The economy has grown at a continuously high rate of more than 4.5 per cent over the past four years. Productivity has improved, the country's external position has remained stable and even continued to improve, the financial position of general government has strengthened, inflation and unemployment both have declined, and real demand and consumption have picked up strongly. The economy has been on a sustainable growth track. Many of these favourable developments continued in 2000, with the exception of one factor, inflation.

Hungary's main macroeconomic indicators

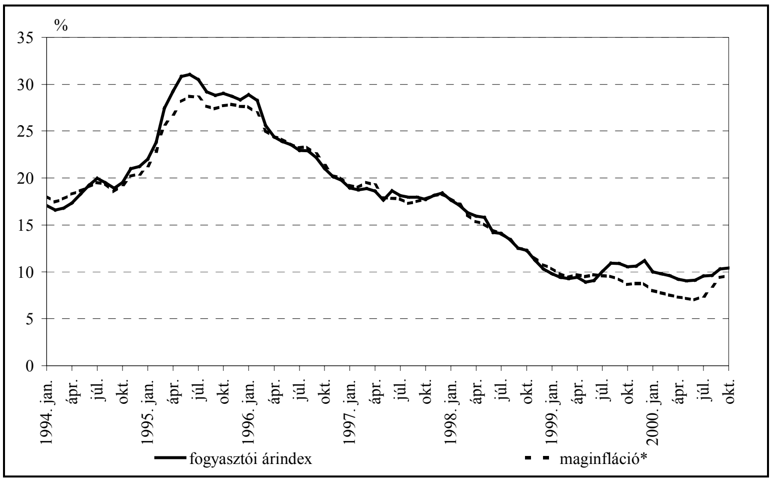
	1996	1997	1998	1999	2000*
GDP volumenindex	1,3	4,6	4,9	4,4	5-5,5**
Lakossági fogyasztás növekedése	-2,7	1,7	4,9	4,6	3,5-4**
Infláció (éves átlagos)	23,6	18,3	14,3	10,0	kb. 9,7
Infláció (december/december)	19,8	18,4	10,3	11,2	kb. 10
ÁHT teljes hiány/GDP	-3,1	-4,9	-4,8	-4,4	-2,9
Munkanélküliség (éves átlagos)	9,9	8,7	7,8	7,0	6,4
Reál nettó átlagkereset	-3,3	3,8	2,5	4,1	3,6
A feldolgozóipar termelékenységének növekedése	9,7	13,7	8,6	8,4	12,1
Folyó fizetési mérleg hiánya/GDP	3,7	2,1	4,8	4,3	3,5-4,0

**MNB-előrejelzés **PM-előrejelzés*

…, but results on the inflation front have been modest in 2000

A number of unfavourable, mainly external, shocks have caused a reversal of the disinflation process – the 10.4 per cent inflation rate in October 2000 shows only a modest improvement of 0.8 of a per cent relative to December 1999. Consumer price inflation is expected to be around 10 per cent in December 2000, with a yearly average inflation rate of 9.7 per cent.

Consumer price inflation and core inflation



**National Bank of Hungary calculation*

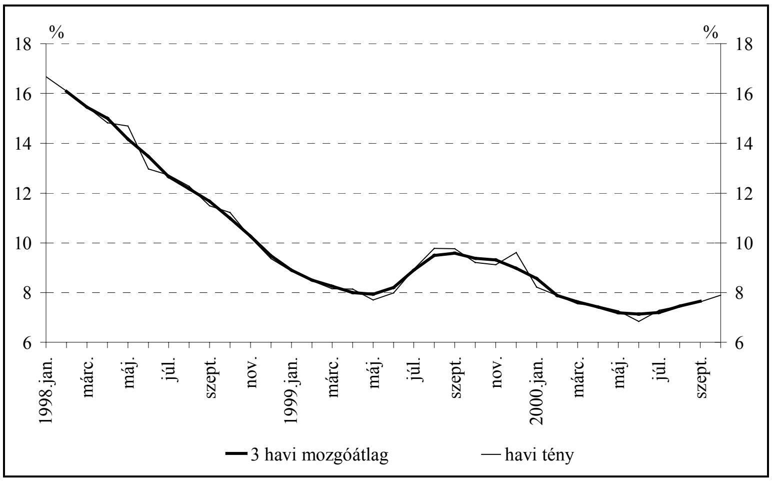
Negative shocks caused the downward trend of inflation to reverse

The process of disinflation stopped at mid-2000 and suffered a short-term reversal. Although year-on-year inflation is expected to fall by end-2000 relative to the previous year-end, the trend definitely has changed direction, with the monthly figures signalling rising inflation since July. This is cause for concern because the Bank's goal is not simply to reduce inflation – it is the *steady process of disinflation* that is of utmost importance. Twelve-month core inflation, as calculated by the Bank, fell continuously in the period between May 1995–June 2000, but rose nearly 3.5 percentage points over the subsequent three months. As a result, at the end of 2000 core inflation will likely exceed its end-1999 level.

Ensuring a steady reduction of inflation is absolutely vital for maintaining confidence in economic policy, and monetary management in particular. Inflation at the end of 2000 will be lower than a year before, though exogenous factors have been putting strong upward pressures on prices. This is clearly indicated by the recent increase in inflation in the countries of the EU (although from a much lower base), from 0.9 per cent in June 1999 and 1.7 per cent in December 1999 to 2.7 per cent in September 2000. As a result, the inflation differential between Hungary and the European Union continued to narrow through to June 2000. There has also been a pick-up in inflation in the CEECs recently.

There has been a recent strong pick-up in the countries of the region and the EU

Differential between Harmonised Indices of Consumer Prices in Hungary and the European Union



It should be taken into account that the closer inflation gets to the low levels associated with price stability the more difficult it will be to achieve further remarkable declines. Thus resisting inflationary pressures at this stage is very important because the later economic policy reacts to the reversal of disinflation and tries to break increasing inflation expectations, the higher the incurred economic costs will be.

Following the traditions of previous years, the *Monetary Policy Guidelines for 2000* listed the exogenous conditions, that is, those falling outside of the scope of monetary policy, which must be fulfilled in order for inflation to fall faster. These, at the same time, constituted the necessary preconditions for any further cut in the rate of devaluation, without risking a significant deterioration in the current account. These factors were the following:

- the general government deficit would not exceed 3.5 per cent of GDP, while revenues and expenditures would not be considerably higher than planned by government;
- government-controlled prices on average would not rise more than 6 per cent;
- the world market price of crude oil would remain around its long-term average of $18 per barrel;
- growth prospects in the European Union would improve in accordance with the expectations.

Rising crude oil prices and domestic food prices, and the significant drop of the euro against the dollar were the main obstacles to curbing inflation

As regards the external effects, the increases in crude oil prices and the weakening of the euro vis-ŕ-vis the dollar were the most important factors hindering a more significant decline in inflation. The direct effects of these two factors together boosted inflation by some 1.5 per cent. Higher oil prices had an indirect upward pressure on inflation via the general increase in prices abroad. Taken together, external factors grossly impeded the reduction in domestic inflation.

Among domestic shocks, the increase in food prices since the summer of 2000 deserves mention. Rising food prices alone pushed year-on-year inflation some 1.2 percentage points higher. The contribution of pork, egg and potato prices has been 0.7 per cent, and that of bread and milk prices has been 0.2 per cent. All these factors made it impossible for Hungary to register a further significant drop in inflation, which has been steadily declining for five years.[1]

The general government deficit and the rise in administered prices have not caused additional inflationary pressures

The general government deficit will likely outperform both the official projections and most expectations. The Bank estimates the general government deficit to be around 2.9 per cent against the projected 3.5 per cent, exerting a favourable effect on macroeconomic equilibrium. This has not been accompanied by lower redistribution – while expenditures will exceed official projections only slightly, revenues are expected to exceed targets by a large margin. As regards administered prices, the approximately 7 per

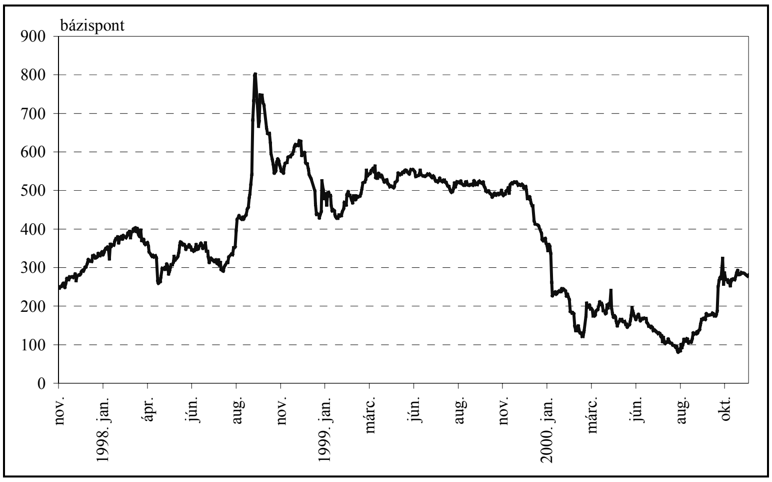
[1] The recent rise in food prices in Hungary is in part consistent with the long-run adjustment of the price structure from before the political changeover, and at the same time it is an accompanying feature of the integration process.

cent increase, expected for the year as a whole, will exceed the plan only marginally, but it has led to distortions in relative prices and to the build-up of inflationary pressures in many areas (for example in gas supply and public transport).

Due to risks to competitiveness the monthly crawl was cut only once during the course of 2000

The government and the National Bank of Hungary cut the rate of the monthly devaluation once in April 2000, from the previous 0.4 per cent to 0.3 per cent. Adverse external shocks to inflation did not allow further cuts in the crawl. Within the framework of the current exchange rate regime, a lower rate of crawl implies lower nominal interest rates, otherwise foreign capital inflow would incur excessive sterilisation costs. Lower nominal rates, accompanied by persistent inflation expectations, would lead to insufficiently low real interest rates. This in turn would fuel aggregate demand and could lead to a deterioration in the current account and an increase in inflation.

Interest premium on the one-year discount treasury bill



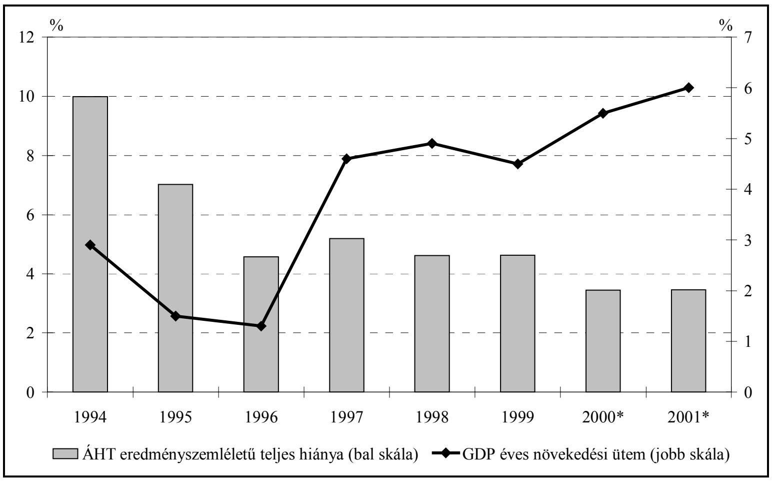
Volatile risk premium seriously limited the room for monetary policy actions

As regards interest rate policy, the Bank reduced its two-week deposit rate five times between January and September 2000, from 13.75 per cent to 10.75 per cent. Lower inflation in the first half of the year created good conditions for the official rate cuts. At the same time, these rate cuts were necessary because in the light of Hungary's positive economic performance in the recent past the country's external assessment has improved steadily, and investors' required risk premium has fallen significantly, dropping to levels not seen since the Russian crisis. While the fall in the risk premium is a welcome development, as it reduces the costs of external financing, it led to heavy central bank interventions on the foreign exchange market, and raised the costs of sterilisation. So, while inflation was falling, official interest rates were reduced in the first half primarily in order to avoid large-scale interventions and to prevent sterilisation costs from jumping higher.

Economic growth was fuelled by fiscal consolidation

Fiscal policy has played an important role in creating the conditions for economic growth over recent years – **the Hungarian example clearly demonstrates that the consolidation of government finances is a precondition for, and also a consequence of, rapid economic growth**. The shrinking budget deficit has contributed to the fall in inflation and nominal interest rates and, via the reduction of the crowding-out effect, to the drop in real interest rates and the interest premium as well. Through a positive feed-back, this has continuously improved the financial position of general government. All this has had a favourable impact on the private sector, particularly on enterprises, because it has allowed them to operate at lower real borrowing rates and lowered the costs of access to funding.

General government deficit (on an accrual basis, as a percentage of GDP) and economic growth

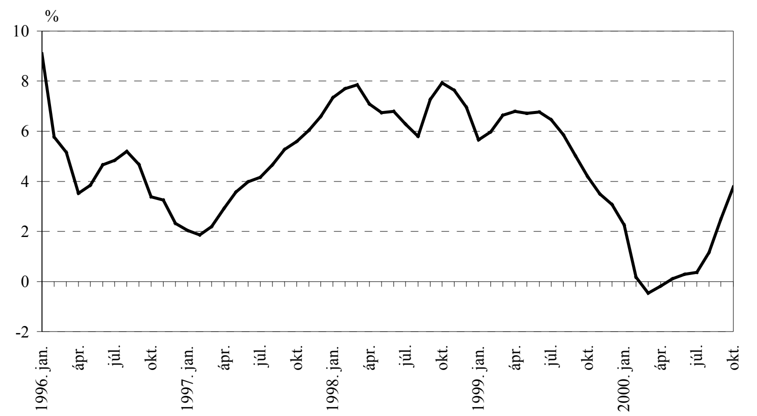


Relaxing the controls on the exchange rate regime could provide more room for interest rate policy and open the way for a sustainable appreciation without jeopardising competitiveness while giving a considerable boost to disinflation

As a result of recent external and domestic shocks to inflation, the exchange rate regime currently allows much narrower room for monetary policy to nourish the disinflation process. Relaxing the controls on the exchange rate regime could provide more leeway for interest rate policy, and it would also open the way for a moderate, sustainable appreciation, which would significantly facilitate the disinflation process without endangering competitiveness. A reasonable appreciation of the nominal exchange rate does not pose a threat because productivity is growing faster in Hungary than in its trading partners. There is consensus between the government and the Bank on strategic issues such as the exchange rate system, i.e. that the existing regime should be abandoned sooner or later, but opinions differ about timing. It is important to note that, parallel to a shift to a more flexible exchange rate system, steps should be made toward further liberalisation of capital transactions so that financial derivatives markets, used for hedging against exchange rate risk, would become more liquid and deeper.

Increasing inflation in the second half of the year justified the decision to raise the interest rate from 10.75% to 11.75% on the Bank's major policy tool, the two-week deposit, on 11 October. The Bank also made a number of changes to its monetary policy instruments in order to restrain the inflow of speculative capital encouraged by the higher interest rates.

One year forward-looking real interest rate



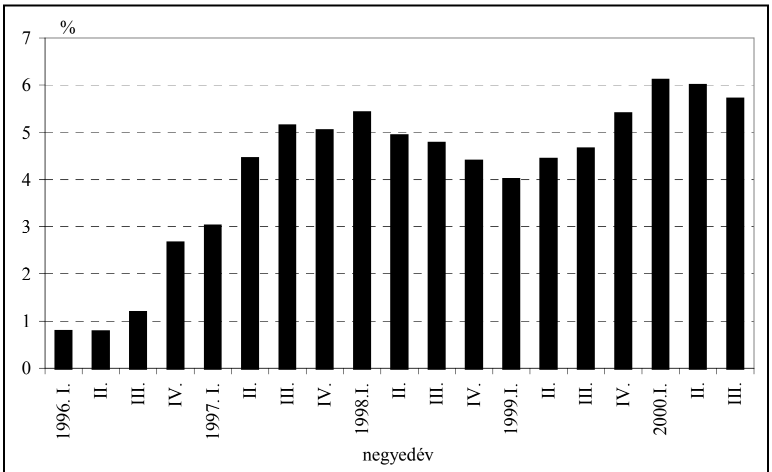
Megjegyzés: az 1 éves diszkontkincstárjegy-hozamok havi átlaga deflálva az MNB által számított maginfláció trendjének a következő 12 hónapra vonatkozó előrejelzésével

Following the decision to raise official rates, real rates, using the Bank’s forecast for 2001 inflation as deflator, returned to around 3 per cent, the level the Bank sees as the necessary minimum.

GDP growth is expected to remain high in 2001

Prospects for economic growth in 2000 and 2001 remain good. GDP growth has picked up gradually following the Russian crisis, and will likely stabilise at a high rate.

Quarterly real GDP growth (relative to the same period of previous year)



In addition to strengthening domestic demand, the upswing in external markets is also assisting growth. Economic growth in the Euro-area countries will reach 3.3 per cent in 2000 and some 3 per cent in 2001. But as the end of 2000 draws near the risks to world economic growth are mounting.

Domestic consumption is expected to rise, while net exports are seen to fall

The breakdown of GDP growth will probably change in 2001 – domestic absorption will grow at the same pace as, or even faster than, GDP, while, in accordance with this, the contribution of net exports to GDP growth will likely be negative. Households' income is expected to change only modestly, in spite of the expansionary fiscal stimulus on aggregate demand. The reason for this is that the proposed changes in the revenue and spending structure of the 2001 budget will mainly boost the income of the corporate sector. Increased government transfers, the lower costs of labour through the reduction of the social security contribution rate, and higher government spending on investment projects all will likely improve the corporate sector’s financial position. The terms of trade is not expected to have any significant impact on domestic absorption, as it will likely remain unchanged, after showing a significant deterioration in 2000.

Breakdown of GDP growth (per cent)

	1999	2000*	2001*
Bruttó hazai termék (GDP)	4,4	5-5,5	4,5-5,5
GDP belföldi felhasználása	4,2	4,5-5	5-6
Lakossági fogyasztás	4,6	3,5-4	3,5-4
Közösségi fogyasztás	0,8	1-2	0-1
Bruttó állóeszközfelhalmozás	5,9	kb. 6	8-10
Külkereskedelmi forgalom (áruk és szolgáltatások)			
Export volumen	13,1	15-17	10-12
Import volumen	12,3	14-16	10-12
A nettó export hozzájárulása a GDP növekedéshez	0,1	1,1**	-0,7**

**PM-prognózis* ***MNB-prognózis*

Available data point to a decline in the financial capacity of households in 2000. One reason for this decline is that the sudden jump in inflation reduced the real growth of earnings, which fiscal policy aggravated even further. The other reason may be the expected pick-up in the housing market, which contributes to the rapid growth of household credit. In addition to, and partly offsetting, the strong growth in consumer credit, there has also been a pick-up in mortgage lending, which is expected to exhibit robust growth in 2001 as well. The rapid increase in outstanding debt will likely contribute to a further drop in households' net financing capacity next year. This trend is expected to remain unbroken in the coming years, due to the joint effect of households’ delayed consumption in previous years and the current positive expectations about future earnings.

The lower-than-expected general government deficit and the decreasing corporate sector borrowing requirement counterbalanced the fall in the financing capacity of households in 2000. As a result, the current account deficit is expected to drop from 4.3 per cent to 3.6–3.9 per cent of GDP.

Financial position of sectors as a percentage of GDP

	1997	1998	1999	2000*	2001*
Államháztartás	-6,8	-6,1	-5,5	-3,8	-4,1
Vállalati szektor	-3,2	-6,2	-4,3	-3,8	-3,6
Háztartások	8,1	8,0	5,5	4,3	3,4
Nettó külföldi finanszírozási igény**	**-1,9**	**-4,4**	**-4,3**	**-3,3**	**-4,4**
Folyó fizetési mérleg	-2,1	-4,8	-4,3	-3,6	-4,5

** MNB-prognózis*
*** A folyó fizetési mérleg és a tőkemérleg összege*

The current account deficit may increase slightly, …

Rising corporate and household sector investment spending and slightly increasing consumer spending will likely lead to a slight deterioration in the current account deficit in 2001, but despite this the deficit will likely remain sustainable. Another risk factor worth mentioning is that foreign-owned firms may repatriate a larger share of their earnings. If the profitability of the corporate sector grows faster than GDP or if the stock of FDI increases, it will likely translate to higher profit repatriation, even with unchanged profit repatriation ratios. International experience suggests that the profit repatriation ratio is probably going to rise on the longer run. However, in order to evaluate the total impact of profit repatriation on the current account, it must be taken into consideration that, although higher profit repatriation means higher current account deficit, it also reduces the corporate sector's disposable income and thus leads to lower investment and import demand.

…but the deficit will continue to be sustainable

Inflation outlook for 2001 is surrounded by a number of uncertainties

Evaluating inflation prospects has become more difficult than in the past, because for 2001 there are significantly more risk factors to take into account.

- One of the most important external factors is how crude oil prices will evolve. The price of oil rose from around $10 in 1998 to over $30 by 2000, i.e. it tripled. This extremely large volatility was unprecedented in earlier years. Although the price of oil is expected to experience some adjustment in the longer run, opinions differ widely as to how large that correction will be and when it will occur.
- Persistently high oil prices have added to the uncertainties about the prospects of the economies of the European Union and the countries of east Asia. Coupled with signs of a slowing US economy, all this foreshadows a lower rate of global economic growth. It cannot be ruled out that economic difficulties in Argentina will lead to a serious, enduring financial crisis which, through capital market channels, may affect the Hungarian economy adversely.

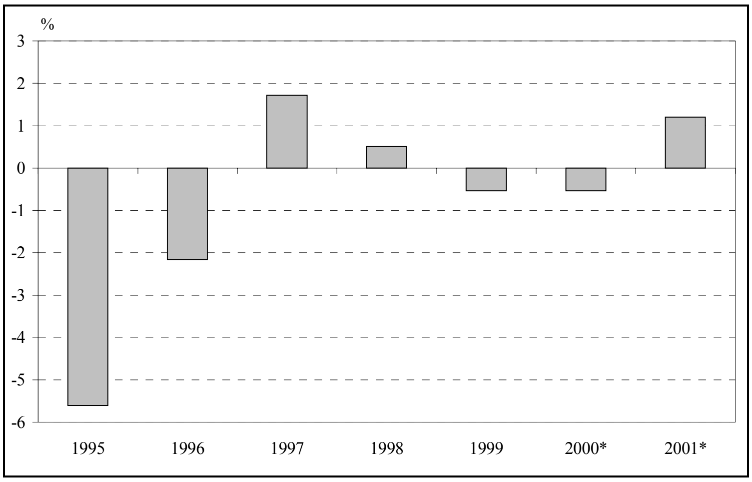
- The euro has lost about 20–30 per cent of its value against the dollar since its introduction in 1999. The strong dollar has had an unfavourable impact on the Hungarian economy through oil imports – it increased the current account deficit through the higher costs of oil imports and, at the same time, contributed to higher inflation.
- Prices of non-processed foods generally exhibit a high degree of volatility. The increase in food prices in 2000 can be seen as an almost full correction of the significant drop in their relative prices in 1998. Although it is very likely that non-processed food prices will increase at a much lower rate over the coming two years, it is uncertain whether this will take place in 2001.

Fiscal policy will likely have expansionary effects on aggregate demand

- The effect of fiscal policy on aggregate demand is best measured by the change in the general government primary balance (which excludes interest payments). In order to have a complete picture, in the case of Hungary this should be adjusted to reflect the revenues and expenditures of ÁPV Rt.[2] The change in the primary balance, based on the Bank's forecast for 2000 and figures from the government's proposed budget for 2001, will have an expansionary effect on aggregate demand of 1.2 per cent of GDP. Based on the government's own inflation forecast, the real growth of general government primary expenditure will exceed that of GDP. For five years, from 1995 to 2000, fiscal policy played a dominant role in the disinflation process. From this aspect, the stance of fiscal policy will likely change in 2001, but that will largely depend on whether potential excess revenues will be spent or used to lower the deficit as in the past.

[2] ÁPV Rt has a large number of tasks, which usually belong to fiscal policy that is, these are usually financed by the government. These tasks are delegated to the APV Rt. by the government and the necessary funds to implement them are also supplied by the government. As carrying out these tasks has an influence on domestic demand the evaluation of fiscal policy should be augmented by an analysis of APV's activity.

*Effect of fiscal policy on aggregate demand** as a percentage of GDP*



* *NBH forecast*
***Change in primary balance (negative values imply tightening fiscal policy)*

Growth rate of the general government primary expenditures

	1995	1996	1997	1998	1999	2000*	2001*
Nominális	7,2	20,0	16,6	16,6	12,7	8,6	14,0
Reál	-14,5	-1,0	-1,6	3,6	3,5	0,5	6,5-7,5
Megjegyzés:							
GDP-reálnövekedés	*1,5*	*1,3*	*4,6*	*4,9*	*4,5*	*5-5,5*	*5-6*

* *MNB-Prognózis*

The Bank's final goal is to further reduce inflation

Due to the external and domestic factors discussed earlier, the uncertainties surrounding the end-2001 inflation forecast are greater than under normal circumstances. It therefore seems reasonable to review developments in inflation in the first half of 2001 and reassess available monetary policy options. The National Bank of Hungary, in line with its core purpose set forth by law, will make every effort to achieve further reductions in inflation, a goal in the interests of all economic agents.

To prevent domestic demand from rising above the equilibrium level, and thus from fuelling inflation, monetary policy should keep real interest rates sufficiently high. Exchange rate policy is anti-inflationary if the rate of crawl corresponds to an expected devaluation lower than expected inflation: hence, the exchange rate will continue to serve as a nominal anchor for economic agents in 2001. On an annual basis, the current rate of monthly crawl implies a devaluation of less than 4%. This compares well even with a favourable inflation scenario, thus exchange rate policy may help further disinflation through moderate imported inflation and expectations..

Low inflation is of primary importance for both economic and social welfare policies.[3] The reduction in the monthly devaluation rate, with unchanged risk premium and foreign

[3] The variance of inflation is greater when inflation is higher, and therefore expected and actual inflation can diverge more in high than in a low-inflation environment. Hence, when inflation is high it is more likely to affect people with lower income disproportionately worse.

interest rates, implies a corresponding reduction in domestic interest rates, otherwise significant foreign capital inflow and heavy official interventions in the foreign exchange market may be expected. However, maintaining interest rates higher than investors require for long would lead to a jump in the costs of sterilisation.

Consequently, only an increase in the risk premium will open greater room for monetary policy, as, in this case, there would be no pressure to cut domestic interest rates, a step unjustified by developments in inflation.

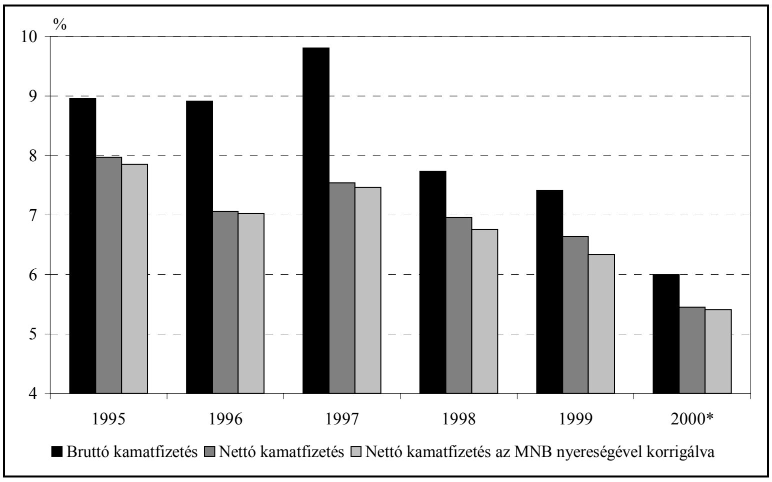
Hungary's sovereign credit ratings

	Japan Credit Rating Agency	**Moody's**	**Standard & Poor's**	**Fitch-IBCA**	**Duff & Phelps**	**Thomson Bank-Watch**
1993	BBB	Ba1	BB+	-	-	-
1994	BBB	Ba1	BB	-	-	-
1995	BBB	Ba1	BB+	-	-	BB+
1996	BBB+	Baa3	BBB-	BBB-	BBB-	BBB-
1997	BBB+	Baa3	BBB-	BBB	BBB	BBB-
1998	BBB+	Baa2	BBB	BBB	BBB	BBB
1999	A-	Baa1	BBB	BBB+	BBB	BBB
2000	A-	A3	BBB+	A-	BBB+	BBB+

However, in view of the current favourable macroeconomic data and outlook, the likelihood of this scenario is low. Following the 1994 low point, Hungary's credit rating has been upgraded each year by at least one credit rating agency, and it is hoped that all the prestigious agencies will upgrade Hungary into category 'A'[4] in the near future. This is partly due to the fact that, as declining government interest expenditures also show, Hungary has managed to escape the debt trap following the successful economic stabilisation in 1995.

[4] Moody's upgraded Hungary's sovereign debt into category 'A3" on 14 November 14, followed by Fitch-IBCA upgrading it into class 'A–'. Thus, including Japan Credit Rating Agency, three large rating agencies raised Hungary's debt into the 'A' category. Meanwhile, Standard & Poor's has decided on a prospective improvement in Hungary's rating.

Central government interest expenditure as a percentage of GDP



**Ministry of Finance forecast*

Government debt indicators as a percentage of GDP

	1995	1996	1997	1998	1999	2000*
A központi költségvetés bruttó adóssága	84,3	71,5	63,1	61,1	60	55,9
Nettó kamatfizetés az MNB nyereségével korrigálva	7,9	7,0	7,5	6,8	6,3	5,4

**PM-prognózis*

Changes in monetary policy instruments

Effects of the introduction of the NBH bond: more efficient monetary transmission mechanism, …

On 20 March 2000, the Bank broadened its range of monetary policy instruments by launching a new three-month bond. Commercial banks and primary dealers are allowed to submit bids for the bond, which is auctioned weekly. The range of counterparties had to be enlarged, because the wedge between the Bank's two-week deposit rate and three-month market returns, which the Bank intended to influence, had diverged considerably. Previously, capital inflows were sterilised via the domestic banking sector only. However, the size of sterilisation assets reached a magnitude which, because of the characteristics of banks' limit structures (counterparty limit, transaction limit etc.) and the insufficient supply of short-term securities, rendered the traditional transmission channel via commercial banks less effective. This became evident when three-month market returns sank to unreasonably low levels, relative to the Bank's dealing rate and the monthly rate of devaluation.

… lower costs of sterilisation, …

The introduction of the NBH bond has managed to stabilise market returns and reduced the costs of sterilisation. Since its launch, the yield on the NBH bond has been some 20 basis points lower on average than the two-week deposit rate, measured on comparable basis.

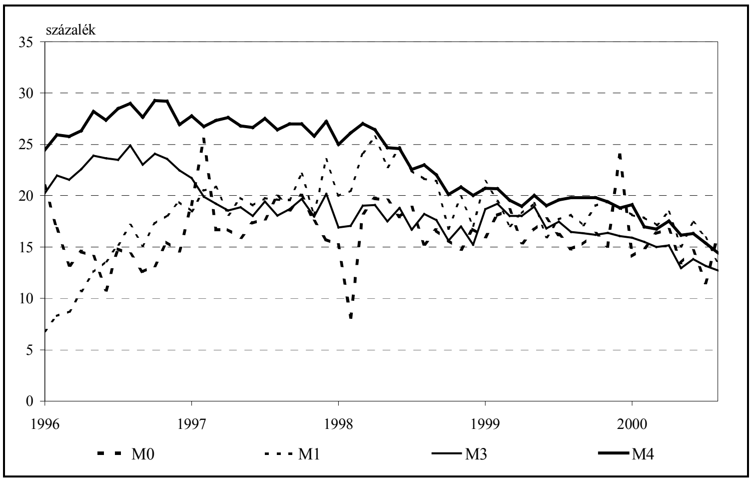
… and a falling stock of two-week deposits

The outstanding stock of two-week deposits has fallen since the launch of the bond, and liquidity has been channelled into NBH bonds mainly via non-bank financial intermediaries. The outstanding amount of two-week deposits has shrunk from around Ft 800–900 billion to Ft 300–400 billion, with the stock of NBH bills meanwhile surging to above Ft 450 billion. As a result, the average maturity of sterilisation instruments has increased, and both the size of the stock and the maturity structure have become more stable.

Two-week deposit tender

With effect from November 2000, the two-week deposit is issued through tenders instead of the Bank providing it as a standing facility. The Bank announces the maximum quantity, consistent with the actual liquidity position of banks, and the maximum interest rate it is ready to accept. Banks are competing with the interest rate bids they submit.

Annualised growth rates of monetary aggregates



Reform of the required reserves system will continue in 2001. The announced changes have affected the base of required reserves, the range of eligible assets and the reserve ratio as well. Part of these modifications came into force on 1 July 2000, making it possible to lower the required reserve rate to 11%, while leaving the effective reserve ratio unchanged. More changes are to be implemented on 1 July 2001. From that date on, in addition to liabilities already exempt from compulsory reserves, the new regulation will allow for more exemptions. These include savings deposits placed with home-savings associations, foreign liabilities with maturities of more than two years, and also long-term securities publicly issued by credit institutions and mortgage bonds of mortgage institutions, provided that the original maturity of the latter two is more than two years. The intention of the monetary authorities with these modifications is to encourage long-term savings and facilitate better terms for financing investment projects. At the same time, the whole range of foreign liabilities with maturity of less than two years will become part of the reserve base, and the 4 per cent preferential reserve ratio will be abolished. Also from 1 July 2001, vault cash will not be eligible as reserve asset.

The Bank plans to reduce the reserve ratio further, by at least 1 percentage point, but the actual size of the reduction will be determined in the course of the first half of 2001.

The Bank plans further significant reductions in the reserve ratio

In addition to the changes announced, partly to be introduced in 2001, further significant cuts in the required reserve ratio are necessary, for efficiency and competition policy reasons. Required reserves place a financial burden of some HUF 25 billion on the private sector's earnings. Although apparently the costs are borne by banks, they pass these costs on to their customers, for whom banking services, through higher borrowing or lower deposit rates, will be more costly. Other things being the same, the reduction in the effective reserve ratio may contribute to the narrowing of the spread between deposit and borrowing rates.

Reform of the required reserves system will continue in 2001

In early 2001, the National Bank of Hungary is going to lower the required reserve rate in one step by 4 per cent, in order to mitigate the negative effects of the high reserve ratio. This means that, including the steps already announced, the required reserve ratio will have fallen from 17 per cent in 1995 to 6 per cent by the middle of 2001. **In line with its other objectives, the Bank has worked out a solution that will offset the liquidity effect of the cut in the reserve ratio, that is which will ensure that the growth rate of the monetary base will be unaffected. The Bank will absorb excess liquidity by selling its holdings of variable-rate government bonds and central bank bonds to be issued by itself.** A number of EU member-states, and Poland lately, has adopted this approach during the accession process to the Union, to cut the reserve ratio. By now Hungary also had become ready for this step. Competition has reached a point where banks are forced to surrender the cost benefits of the reduced reserve ratio to their customers. The depth of domestic capital markets now makes it possible for the Bank to conduct large-scale outright sales of government securities efficiently. It is important to use long-term securities to absorb liquidity arising from the reduction in the required reserve ratio but, though the yield curve extends to 10 years since early 1999, the liquidity of the five-year maturity segment of the government securities market has only very recently reached required levels.

The negative effects of the cut in the required reserve ratio on the central bank's results and, indirectly, on the government budget should only be phased in gradually. The remuneration on required reserves will therefore be lowered by 2.2 per cent in January 2001. The implied tax effect of the required reserves system fell from over 200 basis points in 1996 to 71 basis points in autumn 2000, and will fall further to 60 basis points on 1 January 2001. According to the proposal, the burden imposed by the required reserves system on business sector earnings will be lowered further semi-annually, simultaneously with changes to the interest rate paid on required reserves. In other words, cost reductions in the banking sector and lower central bank profits will be only gradually realised. The benefits of the reduction in the effective reserve ratio will be spread through a wider range of economic agents, serving the interests of medium-term economic policy.

Market regulations will be upgraded

In order to achieve greater transparency of the government securities market and improve the monetary transmission mechanism, the Bank will continue to support initiatives to upgrade and develop capital market regulations. It will also encourage any steps that may result in a deeper and more concentrated domestic government securities market.