MAGYAR NEMZETI BANK

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Statement by the Monetary Council

Inflation was above target in 2003. However, in 2004 consumer prices are unlikely to return to the original path jointly set by the Government and the MNB in 2002. In the Monetary Council's assessment, the 4% inflation target for end-2005 may only be met with a tight monetary policy conduct, continuing fiscal consolidation and lower inflation expectations.

2003 and 2004 exhibit significant differences in terms of the factors responsible for above-target inflation. In 2003, inflation was fuelled by a rapid pick-up in consumer demand as well as certain fiscal policy measures. On the cost side, inflationary pressure was strengthened by the persistence of soaring wage costs and the effect of the low exchange rate of the forint on import costs. In addition, the rise in unprocessed food prices at end-2003, which is expected to remain transient, may also have contributed to higher inflation. Expectations did not point to disinflation, either. Surveys of economic agents suggested a gradual rise in inflation expectations in the course of 2003.

By contrast, 2004 is characterised by different inflation developments. The rapid consumption growth seen in earlier periods is expected to come to a halt, and the plans for fiscal contraction of demand are likely to result in easing price pressures. At the same time, a higher increase in regulated prices relative to inflation, coupled with higher indirect taxes (VAT, excise duties), pushes up CPI by as much as 2 percentage points. Taken together, these effects will result in inflation running at 6.9% in December 2004, assuming that monetary conditions remain unchanged. However, after eliminating the effects of the increase in indirect taxes, the rise in CPI is likely to be somewhat lower, around 5%. In other words, the net inflation indicator, which eliminates the increase in VAT and excise duties, is likely to fall by end-2004 relative to the CPI at end-2003.

Earlier, the Monetary Council had decided that, instead of offsetting the effects of the increase in indirect taxes by restricting monetary conditions, it would only take measures to remedy the lasting inflationary effects of the surging price index on inflation expectations. If that is achieved, the price effect of the increase in indirect taxes is likely to wind off in the price index in the course of 2005, and given a modest growth in domestic demand, the inflation target of 4% can be met by December 2005.

However, there are a number of preconditions for disinflation to continue. First, the price increasing effect of indirect taxes should be interpreted by market participants as a one-off increase in prices. Second, accelerating inflation should not to be built permanently in price and wage inflation expectations. Third, the moderation of wage inflation should continue in 2005. Moreover, wage developments carry considerable (upside) risks to inflation, since the rate of wage growth must be curbed in the context of a tight labour market. A shortage of labour reserves is reflected in the fact that in 2003 H2 even the previously slow decrease in private sector wage inflation stalled, while wage inflation picked up in the services sector. The Council, therefore, is of the view that there are significant risks to the inflation target of 4% set by end-2005.

Risk premia on forint-denominated investments have risen recently, as reflected in the depreciation of the exchange rate and the increase in yields. These have added to the factors of risk facing monetary policy. Concerns over the medium-term sustainability of economic processes are mainly in the background of the recent loss of investor confidence, although the deterioration in risk assessment may also be closely related to a potential postponement of the date of Hungary's accession to the euro area.

By contrast, the current account deficit, being the most important indicator of macroeconomic imbalance, is expected to be downwards in 2004 and 2005. The Government's measures, restricting household consumption, and the expected reduction in the government deficit may play an important role in this. The measures already taken by the Government are likely to influence consumption with a certain time lag. It cannot be ruled out that the household sector will react to the expected decline in the real rate of income growth in 2004 by smoothing consumption and, therefore, the current account balance will only improve from the second half of 2004. The recent pick-up in corporate sector fixed investment activity has increased Hungary's external financing requirement. However, Hungarian firms mainly finance their fixed investment programmes by attracting direct investment capital and by borrowing, which in turn is more favourably judged by investors. Consequently, the financing structure of the balance of payments has been changing positively.

In the current circumstances, it is one of monetary policy's objectives to prevent deteriorating inflation expectations from becoming self-fulfilling and the economy from shifting to a path characterised by higher inflation and a permanently weaker exchange rate. Potentially higher inflation expectations, therefore, could make it necessary to tighten monetary conditions.

In the period ahead, greater emphasis is expected to be placed on the Bank's interest rate policy. In addition to its direct effect on the exchange rate and expectations, the interest rate level also influences domestic demand growth.

Currently, there is limited information on the 2004 balance of general government. The Monetary Council appreciates the Government's efforts to reduce the general government deficit to 4.6% of GDP. The official measures announced so far appear to be consistent with this goal. However, the fiscal and economic risks not rule out that the deficit will turn out to be higher than the official projection and further measures will be required in order to meet the target.

A fundamental precondition for meeting the inflation target is that fiscal consolidation should continue in 2005. In addition to the Government supporting disinflation on the demand side, the reduction in the government and current account deficits is indispensable for regaining capital market confidence. This will require implementing major structural changes in the public sector and introducing measures to improve productivity and efficiency.

Based on last year's data and this year's expected economic developments, the Hungarian economy today is farther from meeting the Maastricht convergence criteria than was assumed in the Government's Pre-Accession Economic Programme, aimed at laying the foundation for adopting the euro in 2008. This lag significantly increases the need to adjust in the coming years. The Monetary Council continues to support the introduction of the euro at the earliest possible date, as stability and long-term predictability, accompanying membership in the euro area, are expected to bring lasting and significant improvement in Hungary's prospects for growth.