MAGYAR NEMZETI BANK

11 November 2002

Statement by the Monetary Council

At its meeting of 11 November 2002, the Monetary Council discussed the Economics Department's forecasts of economic developments and approved the November 2002 issue of the *Quarterly Report on Inflation* for publication.

Considerable upside risks to inflation...

Inflation has continued to moderate in recent months, prices rising by 4.6% in September year on year. In the Monetary Council's evaluation, however, there have been significant upside risks to inflation.

...due to the unsustainable increase in domestic demand over the long term

The rapid expansion of domestic demand is the most important among the factors exposing the economy to inflationary risks. Whereas the international business climate remains unfavourable, domestic demand has been rising above its long-term sustainable rate, mainly due to the increase in household expenditure. Although some sectors of the economy are faced with selling problems on account of weak external demand, there appear to be signs of excess demand in areas crucial for the disinflation process, primarily in sectors selling their output to the domestic market. This adds to inflationary pressures and leads to a rapid rise in Hungary's current account deficit, which may exceed 5% of GDP in 2002, despite continued weak corporate sector fixed investment demand.

Rapid real wage growth encourages expansion of demand

The most powerful driving force of the fast increase in domestic demand has been the massive expansion of household income. Despite the tightening of monetary conditions in the past 18 months the rate of private sector nominal wage growth has been slowing only modestly, jeopardising international competitiveness. Over the past year, real appreciation has been induced by faster increase in real wages than in productivity, simultaneously with a nearly flat nominal exchange rate. Public sector wages have been rising by 30% annually. The Government's measures aimed at reducing the tax burden have also contributed to the increase in net earnings.

The current rate of private sector wage growth is unsustainable

The rate of wage growth is likely to slow in 2003. The draft for next year's Budget does not contain a significant increase in public sector employees' wages. Nevertheless, annual average nominal wage growth is expected to be around 17% as a consequence of the full-year effects and earlier commitments, such as the adjustment of public servants' salaries. In the Monetary Council's view, a much lower wage growth than this is required, in order to be able to achieve the inflation targets without substantial real economic sacrifices.

Therefore, the Council supports the Government's and employers' joint recommendation of a 3%–4.5% gross nominal wage increase in 2003.

Rapidly rising household debt exerts upward pressure on domestic demand

Another key component in the expansion of domestic demand is the decline in households' net financial savings. A better outlook for income, decreasing nominal interest rates and the wide availability of government subsidised credit have led to a rapid rise in the stock of lending to households. The rise in household debt is a natural trend, which is taking the structure of Hungarian household wealth closer to that in Europe. However, the increased access to subsidised credit and the fast income growth have caused the process to accelerate, which is another source of inflationary pressure.

No rapid recovery in investment expected

Other components of domestic demand are expected to continue to grow at a subdued pace. In terms of the draft Budget, government will moderate its investment spending. Due to sluggish activity in Europe and the utilisation of manufacturing capacities, activity in the corporate sector is forecast to increase only slowly.

Fiscal policy is to contract domestic demand growth

The increase in the risks to inflation has been partly due to the expansionary fiscal policy in 2002. Most of the growth in demand could be attributed to higher wage and transfer payments and a drop in the debt burden, which continue to determine a great proportion of fiscal expenses and receipts in the course of 2003. In terms of the draft Budget, the government seeks to reduce the budget deficit in 2003 to the level defined by the Medium-term Economic Policy Programme. Available information suggests that the planned measures will likely curb aggregate demand by 1.2% of GDP.

Wage increases are the greatest risk to inflation

Thus, fiscal policy seeks to facilitate meeting the inflation target via dampening domestic demand growth. However, over the short term, the deficit will only be lowered in respect of expenditure items that have less significant bearing on inflation, while items with a direct impact on household income will continue to increase. The MNB's inflation forecast, based on the assumptions of moderate wage growth, fiscal tightening and that last month's average exchange rate and oil price remain unchanged, is around the still acceptable rate of 4.5% in December 2003 (at 4.6%), and falls within the upper section of the target range in 2004 (4.2%). In 2003, the overall risks to inflation are weighted to the upside, due primarily to uncertainty around the path for wage growth.

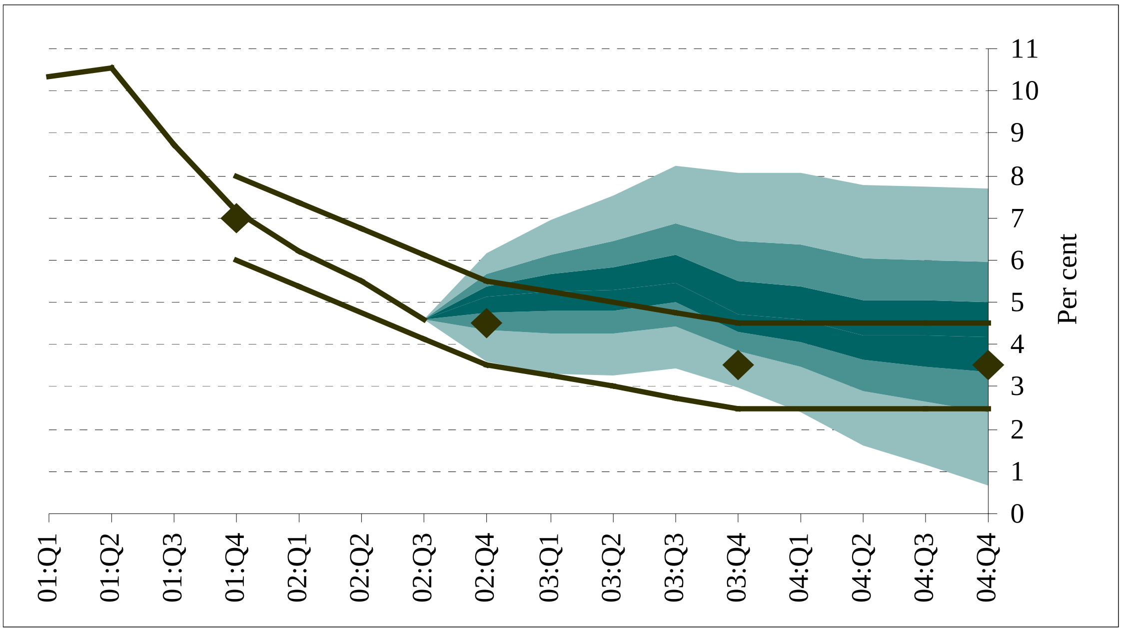
Investor sentiment depends on the prospective date of joining the euro

Recent uncertainty about the date of Hungary's joining the euro has significantly influenced changes in both the exchange rate and the yield curve. Progress made with the negotiations in preparation of Hungary's European Union entry, and the favourable outcome of the Irish referendum on the Treaty of Nice, have increased the probability of an early entry. Improvement in investor sentiment has also been reflected in the strengthening of the exchange rate.

Monetary conditions should remain tight

The risks to inflation are high. Although the recent tightening of monetary conditions will reduce the probability of inflation exceeding the target, the Monetary Council currently sees no room for easing monetary conditions.

Inflation projection fan chart
Percentage changes on a year earlier



The fan chart shows the probability distribution of the outcomes around the central projection. The central band with the darkest shading includes the central projection. The entire coloured area covers 90% of all probabilities. Outside the central projection (centred around the mode), the bands represent 15% probability each. The uncertainty intervals have been estimated relying on the Bank's historic forecast errors and the uncertainties perceived by the Monetary Council regarding the current forecast. The year-end points represent the fixed inflation targets (7%, 4.5% and 3.5%); while the straight lines mark the ±1% tolerance intervals on either side of the target rates.