MAGYAR NEMZETI BANK

12 May 2003

# Statement by the Monetary Council

At its meeting on 12 May 2003, the Monetary Council discussed and approved for publication the May 2003 issue of the *Quarterly Report on Inflation.* The Council made the following assessment of developments in inflation.

**Better inflation outlook for 2004; the projections are closer to the inflation target**

Previous measures to tighten monetary policy have stimulated goods markets to adjust their pricing behaviour to the lower inflation environment, as reflected in a sharp decline in core inflation seen in the past few months. The Monetary Council judges that, over the next eighteen months, the economy will continue to adjust.

The MNB's central inflation projection for end-2004 has been revised down to 3.9%, which is closer to the inflation target of 3.5%, relevant for monetary policy decisions. There is greater likelihood of a lower oil price than that underlying the inflation projection, which, in turn, adds to the downside risk to the central inflation projection.

**Wage growth and fiscal policy continue to present upside risks to the inflation outlook**

Nevertheless, the slow adjustment by wages to lower inflation and the moderate pace at which fiscal policy is contracting demand continue to present significant upside risks to inflation.

**Factors enhancing and weakening the disinflation process in 2003**

Disinflation has continued in 2003, especially in respect of the prices of goods and services influenced by monetary policy. Buoyant consumption growth continues to be a source of inflationary pressure, due partly to a number of fiscal measures passed in 2002 and partly to rapid growth in real wages. However, during the rest of the year, factors exogenous to monetary policy are expected to put downward pressure on inflation. As concerns developments in the foreign and domestic markets, the fall in oil prices and the strengthening of the euro against the dollar as well as the change in regulated prices, respectively, are likely to give further momentum to disinflation. The Bank’s annual inflation projection for December 2003 is around 4.6%.

**Slow wage adjustment**

Private sector wage growth has continued to moderate at a slower-than-expected pace. Hindering labour market adjustment, government sector wages have been rising robustly, due to last year's measures. In addition, employment in the public sector has risen by more than 4%. Firms adjust to the brisk increase in labour costs by reducing their demand for labour, which, in turn, results in higher unemployment. Faster wage adjustment would help the corporate sector to improve profitability and maintain competitiveness as well as the economy to register higher growth.

**Continued robust growth in domestic demand slows disinflation**

Hungary's GDP is expected to grow by 3.5% both in 2003 and 2004. This can be attributed to the fact that there continue to be no signs of a fast recovery of global business conditions. Consequently, growth in exports and investment demand will likely remain modest. In addition to cost-push inflation caused by fast wage growth, the continued rapid rise in domestic demand is also acting to slow down disinflation. As a positive effect of households' favourable income position, consumption is expected to increase by 7% in 2003 and by around 5% in 2004, followed by last year's expansion of more than 10%.

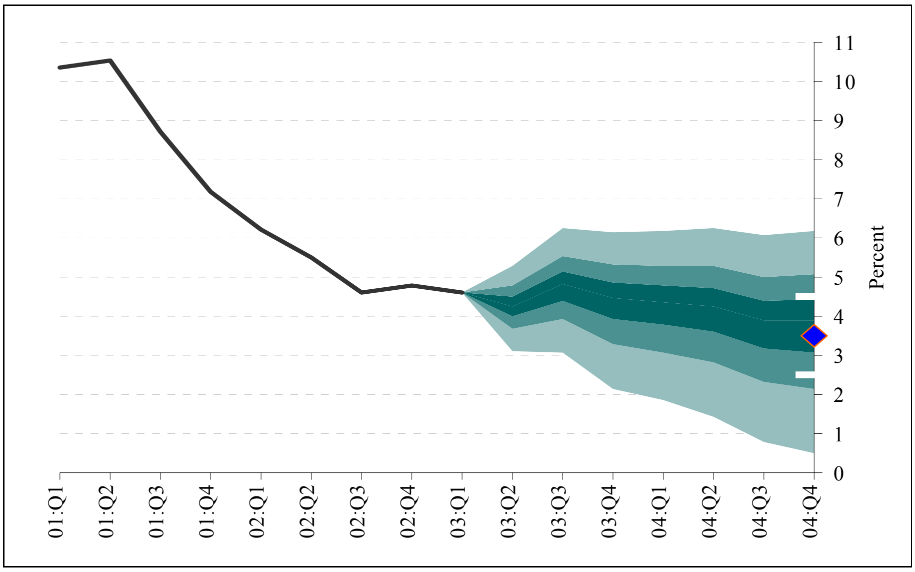
**Only further fiscal adjustment can help return to the path envisaged in the Medium-Term Economic Policy Programme**

Despite the measures to improve the balance, the contractionary impact of fiscal policy on demand will likely be significantly lower than planned in 2003, and is expected to amount to 0.5% of GDP. Given the current situation, fiscal policy will likely be able to offset this year's delay in the process of implementing the Government's Medium-Term Economic Policy Programme only partially in 2004. Unless further substantial actions to improve the balance are taken, general government will be able to reduce growth in aggregate demand by 1.3% of GDP in 2004, on the basis of the foreseeable macroeconomic developments. A departure from the original fiscal path would hamper any correction of last year's unfavourable economic policy mix, i.e. tight monetary and lax fiscal policies.

**Successful stabilisation after speculation on the appreciation of the forint**

During the one-and-a-half months following the revaluation speculation of 15–16 January, the main motive of the official interest rate decisions was to return to the normal course of business and stabilise monetary conditions. The efforts proved successful – through a more proactive presence on the foreign exchange market, the Bank had managed to ensure that the bulk of the speculative capital left the Hungarian banking system without jeopardising the stability of the exchange rate and the financial system. The forint has stayed around HUF/EUR 245 since early February. The yield curve, too, has been stable since the restoration of the standard width of the Bank’s overnight interest rate corridor on 24 February.

**Fan chart of the inflation projection***




** The fan chart presents the probability distribution of the outcomes around the central projection. The entire coloured area covers 90% of all probabilities. The central, darkest band contains the central projection (as the mode) with a 30% probability. Outside the central projection, the bands represent 15% probability each. The year-end 2004 point, and the upper and lower limits of the target band, respectively, represent the fixed inflation target (3.5%) and the ±1% tolerance interval.*