MAGYAR NEMZETI BANK

Statement by the Monetary Council

18 August 2003

At its meeting on 18 August 2003, the Monetary Council discussed and approved for publication the *Quarterly Report on Inflation.* The Council made the following assessment of developments in inflation.

1. The Central Bank supports the Government's objective of adopting the euro in 2008

The Government has set 1 January 2008 as the target date of adopting the euro and announced that, shortly after joining the EU, it will request Hungary's admission into the European Exchange Rate Mechanism (ERM 2). A condition for joining the euro is consistent implementation of a stringent convergence programme based on the realistic assessment of the state of the economy. Any divergence from the programme may trigger undesirable reactions from the market and an increase in the costs of adjustment. The Bank supports the Government's objective and, in its conduct of monetary policy, will endeavour to foster economic and financial integration, as well as to meet the criteria set as a condition for adopting the euro.

2. Joining ERM 2 will influence monetary policy's room for manoeuvre in the pre- and post-entry period

The preparations to be made prior to adopting the euro influence the conduct of monetary policy in several respects. Entry into the ERM 2 exchange rate regime will entail introduction of a new exchange rate band with a width of ±15%, identical with the current system. The central parity will be defined by means of negotiations with the finance ministers and central bank governors of the EU member countries. With respect to successful convergence, it is crucial that the central parity equally fosters price stability and competitiveness, in addition to being sustainable. Therefore, it seems desirable to avoid an excessively under- or overvalued exchange rate during the period prior to entering ERM 2. Provided that the economy can successfully follow the course set out in the Government's Medium-term Economic Policy Programme, the Monetary Council puts the equilibrium exchange rate which fosters rapid economic growth without endangering price stability in the range of 250 to 260 forints per euro.

3. **Rapid disinflation is a pre-condition of adopting the euro**

The target date of 2008 is based on the condition that in the reference period between March 2006 and March 2007, the rate of inflation may not exceed the average rates of inflation of the three EU member states with the lowest inflation by more than 1.5%. Reaching this end will probably require a rate of inflation in the range of 2.5% to 3%. The inflation target set for the reference period cannot be met unless the fiscal, price and income policies are consistent.

4. **Monetary policy continues to follow the rules of inflation targeting**

Within the boundaries of the prevailing exchange rate band, the Bank continues to rely on inflation targeting while supporting the Government's disinflation policy. The stability of the exchange rate, monitored continuously by our foreign partners, will be an important measure of the success of economic policy during the pre-and-post-ERM 2 period. Provided that economic policy is co-ordinated efficiently, the dual requirements of price and exchange rate stability will not run contrary to each other. However, exchange rate stability should not be the immediate goal but rather the result of monetary policy committed to the achievement of price stability.

5. **Low inflation in the first six months of 2003**

During the first half of 2003, annual CPI growth reached a twenty-year low. However, in the past few months, core inflation has started to edge up and the rate of wage growth has also declined slower than previously anticipated. In the Monetary Council's view these developments are primarily related to excessive growth in consumption, wages increasing out of line with productivity, and continuing labour market tightness in certain areas, in addition to undesired weakening in the exchange rate.

6. **Greater-than-usual uncertainty about the inflation outlook**

Prospective developments in inflation are surrounded by larger uncertainty than usual. This is because the measures announced by the Government on 16 July have not received a final approval yet. Another source of uncertainty is that it is difficult to predict how economic agents will respond to the proposed measures. The Bank has based its projections published in the 18 August *Report on Inflation* on the assumption that the budgetary measures announced by the Government will be approved in an unchanged form.

7. **The proposed budgetary measures will cause a temporary rise in inflation**

Fiscal consolidation is indispensable in order to maintain macroeconomic equilibrium. The recently announced measures imply divergence from the fiscal path earlier anticipated by the MNB, proposing to curb the budget deficit primarily by increasing revenues. The measures relating to next year's budget will affect the rate of price increases via a number of channels. The measures to have the greatest impact in 2004 are changes in the VAT system and related excise duty measures. Assuming an unchanged tax base, the VAT change will directly raise the price level by 1 percentage point. In addition, based on international experience, a further increase of approximately 0.4 percentage points can also be expected.

In the past two years, disinflation has been considerably impeded by unsustainable growth in domestic demand. Fiscal instruments planned to be used in order to curb excessive demand may mitigate the ripple effect of inflationary pressures triggered by the one-off tax measures. The slowdown in domestic demand growth in the wake of the fiscal adjustment may exert disinflationary pressure in the latter half of the year.

8. **Main risks include rising inflation expectations, wages**

In the Monetary Council's view, the most important of the risks inherent in the measures in the pipeline is that one-off measures representing upside pressure on prices may lead to increased inflation expectations, and the economy may have a higher wage path ahead.

9. **and a weak exchange rate.**

Of the factors posing upside risk to inflation, in addition to the budget, the exchange rate of the forint has been permanently weaker than the one that the Monetary Council deems as ideal for creating monetary conditions in favour of disinflation. The MNB has broadened the appeal of forint investments by increasing its key policy interest rates, sending the message to investors that it would insist on supporting developments in the exchange rate that were predictable and consistent with inflation targets. As a result of such measures, consolidation in the FX market has been slowly picking up and a gradual appreciation of the forint's exchange rate has also commenced.

10. **Projection for higher inflation**

The Bank's provisional projection based on the average July rate of exchange of HUF/EUR 264 and prepared in accordance with the relevant technical rules is for increasing inflation until mid-2004 and for declining consumer prices in the second half of 2004. Accordingly, inflation would probably stand at approximately 5.2% and 5.8% at year-end 2003 and 2004 respectively. The inflation indicator excluding one-off effects may be around 4.4 to 4.8% at year-end 2004. In 2005, inflation will have to be substantially reduced. The price index is unlikely to include the one-off effects of tax measures, but in order for the process of disinflation to continue, it is also important that these transitory measures should not increase inflation expectations and that domestic demand growth should remain subdued.

11. **In order for the inflation criteria to be met, an exchange rate of HUF/ EUR 250 to 260 must be achieved.**

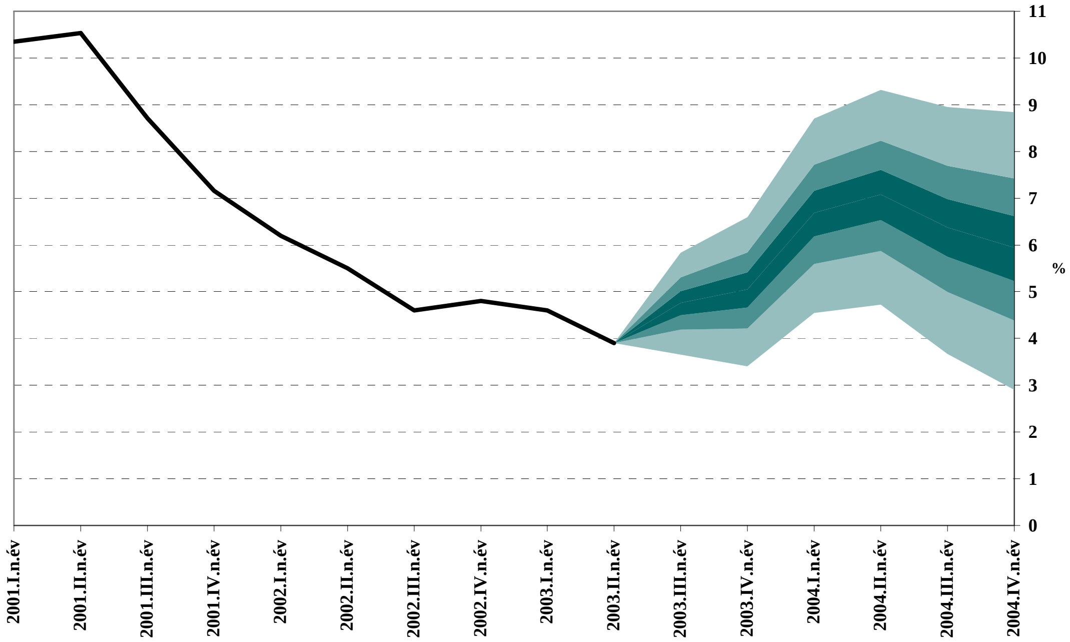
In the current uncertain situation, which can be characterised by the simultaneous presence of both upside and downside risks to inflation, the basic principle of monetary policy is that the following of the long-term path of disinflation, instrumental in fulfilling the Maastricht criteria, should be ensured. The full off-set by monetary means of the short-term inflationary pressure from tax and regulated price-related measures would entail excessive real economic costs. At the same time, indicators excluding one-off effects and reflecting longer term inflation trends should not be allowed to rise.

In the Monetary Council's opinion, the HUF/EUR 260 *exchange rate* that prevailed last week still allows upside risks to inflation too much latitude in making themselves felt. In order that short-term risks can be reduced and that the Maastricht criteria will bet met in 2006 and 2007, the Monetary Council recognizes the need for an exchange rate stabilising near the stronger limit of a HUF/EUR 250 to 260.

Due to upside risks, the MNB cannot envisage any interest rate cuts before the exchange rate permanently stabilises near the upper limit of a HUF/EUR 250 to 260 band. An exchange rate permanently below this level may necessitate further rises in the Bank's key policy rate so that the rate of inflation at end-2004 remains below 5.5%.

Fan chart of the inflation projection

Percentage changes on a year earlier



The fan chart shows the probability distribution of the outcomes around the central projection. The entire coloured area covers 90% of all probabilities. The central band contains the central projection (as the mode) with a 30% probability. Outside the central projection (centred around the mode), the bands represent 15% probability each. The point *for end-2004 represents the value of the inflation target (3.5%), while the two straight lines the ±1% tolerance intervals.*