Statement of the Monetary Council

At its meeting of 18 February 2002, the Monetary Council discussed the latest issue of the *Quarterly Report on Inflation* and approved its publication.

Success in meeting the December 2001 target

Members of the Monetary Council view 2001 as a successful year in terms of the path of inflation. In the two years since mid-1999, prior to changing the monetary policy regime, prices had increased at an annual rate of around 10%. In the wake of widening the forint's exchange rate band and adopting an inflation-targeting system, the rate of inflation started on a downward trend, and at 6.8% in December 2001 it was lower than the target rate of 7%. The 4 percentage-point drop in inflation achieved during a period of six months was partly due to factors outside the control of monetary policy, in particular the fall in the price of unprocessed foodstuffs and the world price for crude oil. At the same time, measures constructed by eliminating one-off effects also clearly reflected the reduction in inflation. The new core inflation index published by the Central Statistical Office fell from 10.5% in June 2001 to 8.1% in December 2001.

Slow adjustments on the cost side

In the judgement of the Council, recent experience suggests that economic agents have been relatively slow in adapting to the designated disinflation path. Changes in nominal wages have not been completely consistent with the decline in inflation. This poses the risk that firms will not be able to maintain their competitiveness over the long run unless they take account of the prospective downward trend in sales prices when projecting nominal costs.

Changes in the exchange rate and interest rates in the period since the previous report

The period since the publication of the previous inflation report has seen a tightening in monetary conditions. There has been an upsurge in global investors' demand for forint investments, resulting in a significant drop in the risk premium. This enabled the Council to reduce the central bank's key rates in several steps, consistent with the fall in inflation expectations. Long-term yields kept pace with the reduction in the key rates, reflecting the rising credibility of the announced disinflation programme in the eyes of market participants. Despite the lower yields, the exchange rate of the forint against the euro has strengthened by roughly 4% over the past quarter, simultaneously with a drop in exchange rate volatility compared with the summer and autumn of 2001, a period plagued by capital market crises.

Disinflation receives support from the macroeconomic environment

Corporate managers and analysts are expecting the world economy to recover from its current downturn in the second half of 2002. This means that the Hungarian economy is likely to grow at below its potential growth rate, at least for a couple of months of the year. In the first half, the less favourable world economic environment may dampen firms' investment demand. Household consumption may continue to expand at a robust pace, which, in turn, may slow the further reduction in inflation primarily in the services sector. In the Bank's projection, the expansionary effect of fiscal policy on demand will be more moderate in 2002 than in the previous year.

Changes in the inflation forecast

There has been a tightening of monetary conditions in the past quarter, assisting the faster reduction in inflation. However, this effect may be offset by the Hungarian economy adjusting to the inflation target at a slower pace than the Bank expected earlier. Based on recent experience, the Monetary Council has decided to take as a starting point a slower exchange rate pass-through in the future, more consistent with economic agents' behaviour so far.

Rising oil prices may be another factor exerting upward pressure on inflation. In the Council's judgement, higher oil prices than the current USD20 per barrel cannot be ruled out in the coming 18 months, as the world economy gathers momentum. Consequently, the Council's inflation projection assumes the likelihood of oil prices returning to around USD24, taking into account international forecasts.

The central inflation projection continues to be in line with the disinflation target

Assuming unchanged oil prices, inflation is expected to proceed along the path outlined in the previous Report. The central projection falls within the lower range of the target band at every horizon. The more conservative estimate, based on rising oil prices, depicts a somewhat less favourable picture. A 4-dollar increase in oil prices will cause inflation to be higher by an additional 0.6 percentage points. The impact on the inflation path depends on the timing of such an increase in prices. The forecast horizon does not include a period when the assumed price increase could push the central projection outside the target range. In the Council's view, the uncertainties arising from the potential rise in oil prices currently do not call for a pre-emptive tightening of monetary conditions, although the resulting inflation risks require constant monitoring.

Developments in regulated prices and excise duties are one of the most important risk factors influencing inflation in 2003. The underlying assumption of the projection is that in 2003 regulated prices will rise at the yearly average inflation rate defined by the disinflation target.

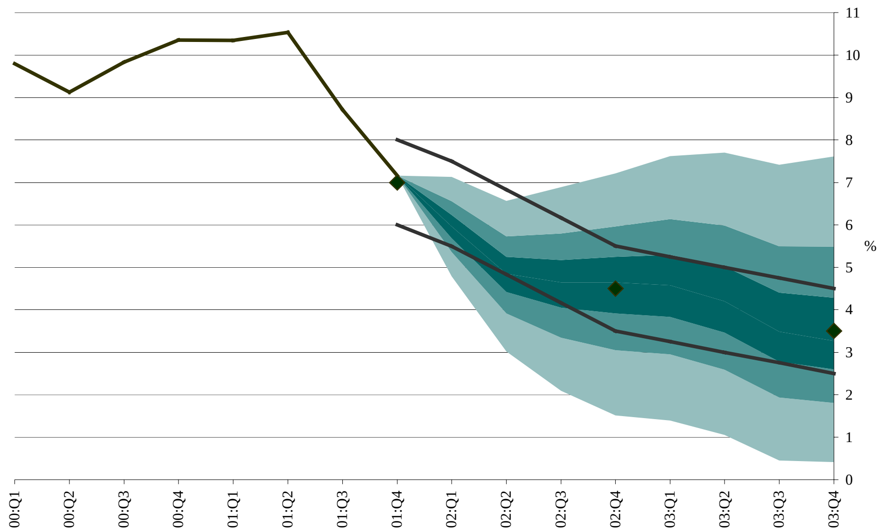
In view of the above considerations, the inflation projection based on the conditions viewed as having the greatest likelihood by the Monetary Council is as follows:

Following a rapid decline in the first half of 2002, inflation will be virtually stagnant in the second half due to the base effect and the presumed rise in oil prices. The average rate of inflation is expected to be 5.0% in 2002, with the Council expecting the December 2002/December 2001 consumer price index to be 4.8%.

Disinflation is expected to proceed slowly in 2003, at a yearly average rate of 3.9%, with the Council forecasting the December 2003/December 2002 consumer price index to be around 3.3%.

National Bank of Hungary
Monetary Council

Inflation projection based on increasing oil prices
Year-on-year growth rate



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 two white dots represent the inflation targets (7%, 4.5% and 3,5%); while the straight lines mark the ±1% tolerance intervals on either side of the target rates. The forecast is based on the assumption of increasing Brent oil prices in 2002 (to USD 24 / barrel by the end of the year) followed by constant oil price at that level in 2003.