6 May 2002

Statement of the Monetary Council

At its meeting of 6 May 2002, the Monetary Council discussed the latest issue of the *Quarterly Report on Inflation* and approved it for publication.

Developments hampering disinflation have gained momentum

Disinflation continued in the first quarter of 2002. The annual rate of price inflation dropped from 6.8% in December 2001 to 5.9% in March. In the three months to March, core inflation fell by 1.9 percentage points to 6.2%. Simultaneously with these favourable trends, a number of factors that might hamper the process of disinflation have gained momentum. Of these factors, inflation imported from Hungary's trading partners and the sharp rise in oil prices can be viewed as exogenous to monetary policy. Stronger domestic demand growth also exerts downward pressure on the pace of disinflation. In addition, faster private-sector wage growth tends to increase the real economic costs of disinflation.

Higher imported inflation

Inflation imported from the euro area does not take long to feed through into domestic tradables prices. The National Bank's management of the resulting inflationary risk is consistent with the policy of the European Central Bank (ECB). While during the previous few months, the ECB had emphasised the role of temporary factors in the strong increase of the level of European tradables prices, its latest statements have stressed the upsurge in persistent inflationary risks.

Rising oil prices

Oil price increases tend to affect consumer prices directly via household energy and fuel prices. However, in previous episodes of rising oil prices, the rise in inflation did not stop at the direct cost-push effect but, generating a cost-price inflationary spiral, led to a permanent upturn in inflation. As far as the direct inflationary pressure is concerned, monetary policy makers have to consider the extent they will let these developments gain ground or, else, decide to tighten monetary conditions. As will be remembered, the direct impact tends to raise inflation only over the short term, whereas monetary policy actions affect economic developments with a lag. Nevertheless, potential spillover effects may necessitate a tightening in monetary conditions.

Private sector is slow in adjusting wage costs

Data for the first two months of 2002 indicate that nominal wages have continued to rise at the fast pace seen last year. The persistence of this trend may undermine corporate profitability, threatening a slowdown in economic growth. Companies will not be able to maintain profitability over the longer term unless, when planning nominal costs, they take account of the expected disinflation in selling prices.

Stronger domestic demand

Compared with the previous report, GDP is expected to grow faster both in 2002 and 2003. The prospect for more buoyant global activity may give impetus to corporate investment demand. The expected rapid rise in household income, due to higher transfers and robust wage growth, projects further expansion in consumer demand. Demand growth continues to be unhampered by general capacity shortages over the short term, but will enable higher costs to be incorporated into consumer prices, which can slow down the economy's adjustment to the path for disinflation.

Next year's inflation is expected to be higher than previously projected, but the central projection remains below the upper limit of the designated path for disinflation

The current inflation projection, which takes account of real economic forecasts and changes in exogenous assumptions, is higher than that published in the previous Report. The factors at work behind the shift include changes in the projections for oil prices and labour costs. As oil prices started to increase sooner than assumed in the February Report, the Monetary Council judged that the oil price assumption should be maintained around the current price of USD 25.5 per barrel over the forecast horizon, which seems to be a cautious assumption from the point of view of inflationary risks. Based on the above assumptions, the central inflation projection for December 2002 is 5.3%, near the upper boundary of the inflation target range, while the projected rate of inflation for December 2003 remains in the medium range of the target band at approximately 3.4%. The annual rates corresponding to these projections amount to 5.5% in 2002 and 4.3% in 2003.

Further upside risks to inflation in 2003

In the Council's current assessment, further upward risks to inflation should be expected in 2003. Recent movements in wages suggest that inflation inertia may prove to be stronger than expected. There was no available information in respect of the future courses of the central budget and regulated prices at the time of preparing the forecast. Therefore, the forecasts of neither the path of macroeconomic performance nor inflation justified a modification of the Bank's earlier, 'technical' assumptions for the fiscal path. The current forecast of the expansionary effect of the central budget on demand only takes into account the decisions that have already been passed by government. These have raised by 0.5 percentage points to 1.3% of GDP the expected expansionary impact of fiscal policy in 2002 relative to the earlier forecast. According to recent indications, fiscal policy will likely be more expansive in 2002. Therefore, the Monetary Council judges the likelihood of a shift towards higher inflation to be greater in the case of forecasts of the

expansionary impact of fiscal policy and regulated prices. As an effect of these factors, the December 2003 inflation may increase to 4%.

Monetary conditions have been little changed in the past three months

Monetary conditions have been little changed in the period since publication of the previous *Report*. Although international investors' demand for assets categorised into similar classes of risk as those of Hungarian financial assets has increased, the risk premium on forint investments has not fallen. Country-specific factors provide the primary explanation for this. The current account deficit turned out to be higher than expected earlier, and inflation expectations intensified. Uncertainties related to the parliamentary elections were another factor leading to the temporary rise in the risk premium. While the Bank has maintained the major policy rate at 8.5% since the official rate reduction on 19 February, the exchange rate has stabilised around HUF/EUR 240–250, aside from narrow and brief fluctuations.

Rising upside risks to inflation may require the maintenance of tight monetary conditions

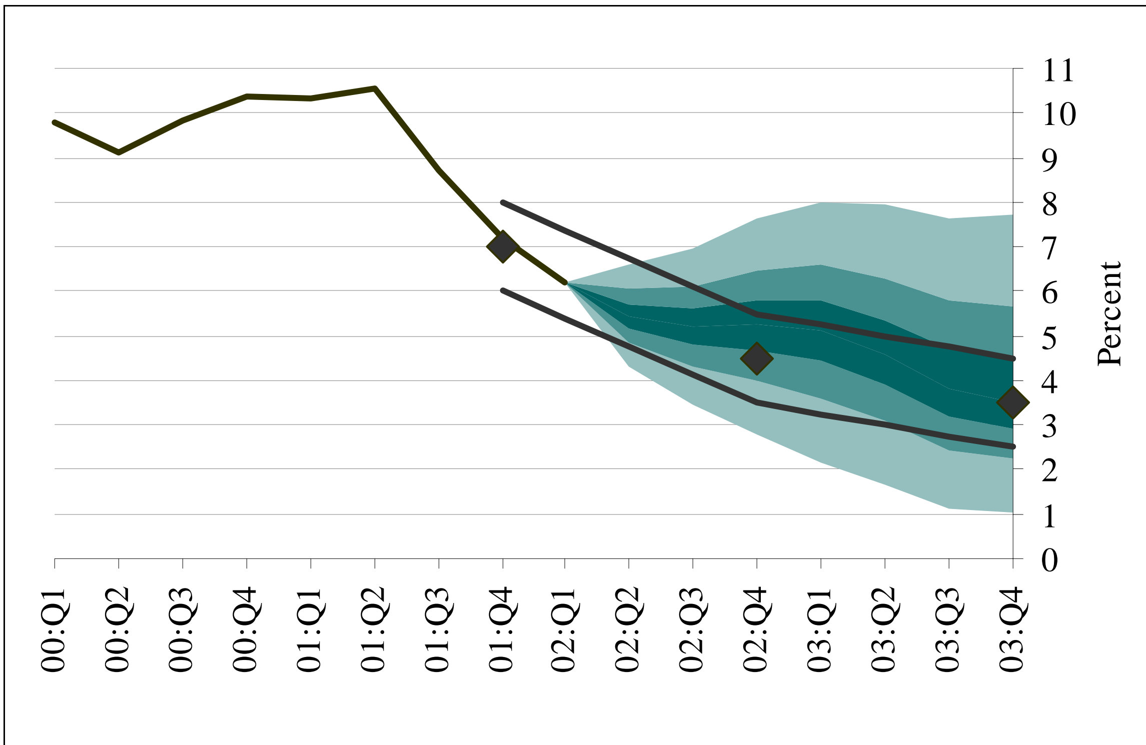
Increased risks to disinflation do not allow to relax current monetary conditions. If the exchange rate remained at the weaker levels seen in the preceding few months for a prolonged period, this would jeopardise the achievement of the inflation target. In the coming months, the Monetary Council will closely monitor changes in nominal incomes and the pass-through from higher oil prices to the domestic inflation process. A potential amplification of unfavourable developments for inflation may require a further tightening of monetary conditions.

Monetary Council

of the National Bank of Hungary

Inflation projection fan chart

Year-on-year rates



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.