MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 28 APRIL 2008

Article 3 (1) of the Central Bank Act (Act LVIII of 2001 on the Magyar Nemzeti Bank, as amended) defines achieving and maintaining price stability as the primary objective of the Magyar Nemzeti Bank. The MNB's supreme decision-making body is the Monetary Council. The Council convenes as required by circumstances, but at least twice a month, according to a pre-announced schedule. At the second scheduled meeting each month, members consider issues relevant to immediate policy decisions. Abridged minutes of the Council's rate-setting meetings are released regularly, before the next policy meeting takes place. The minutes are divided into two main parts. The first part contains a discussion of economic and financial developments, derived from analyses presented by Bank staff to the Council, as well as information which has become available since the previous meeting. Taking into account the findings of the first part, the second part goes on to present the decision-makers' assessment of current economic conditions and the factors they consider when deciding on the base rate.

The minutes are available on the MNB's website at:
http://english.mnb.hu/engine.aspx?page=mnben_mt_jegyzokonyv

1 Macroeconomic and financial market developments

The domestic economy

In March 2008, annual inflation increased by 6.7% on the CPI measure and by 5.3% on the core measure. The consumer price index fell by 0.2 percentage points compared with February, while core inflation remained unchanged. Lower processed food price inflation was the main factor behind the slight drop in consumer price inflation, with the fall in core inflation being offset by the rise in industrial goods and services inflation. The most important information drawn from the latest data is that the higher rates of industrial goods and services inflation may have reflected the recent rise in energy prices. The scale and direction of these developments appear to be in line with earlier expectations, and therefore, their assessment has not changed materially since March.

According to data released by the CSO, the volume of retail sales in February 2008 declined by only 1.9% (after adjusting for seasonal and calendar effects) compared with the same period of a year earlier. The data provide evidence that the modest pick-up in the rate of sales growth since January continued in February. Labour market trends in the first two months of the year may be a key factor behind this improvement, suggesting that household consumption expenditure may have reached a turning point.

Private sector gross average earnings grew by 14.4% in February 2008 compared with the same period of 2007. Although higher-than-expected wage growth may be explained in part by one-off factors, the data exceeded the Bank's forecast, even after adjusting for these factors. One possible explanation for this is that the effect on total wages of the increase in the minimum wage for skilled workers was greater and felt more quickly than expected. In manufacturing, sustained strong export growth may be the driving force behind the acceleration in wage growth. In contrast, rising wage growth in market services cannot be explained by market developments, and consequently, second-round effects from previous inflation shocks cannot be ruled out in this regard.

Financial markets

The external financial market environment has been supportive for forint assets in the past month. Since the bailout of Bear Stearns, the US Federal Reserve has been easing conditions on lending to the financial sector. This has helped to reduce the probability that credit institutions and investment banks would go bankrupt. The latest US macroeconomic data have so far been in line with, or slightly better than, market expectations. However, spreads rising to new peaks in European and US interbank money markets provide a good indication of the fragility of sentiment on the capital markets.

Expectations of further interest rate cuts by the Fed eased somewhat, probably partially reflecting the recent rise in the price of crude oil to new historical highs, in addition to slightly improved macroeconomic prospects. Markets have priced in another 25 basis point reduction in rates by the Fed at its next rate-setting meeting. The path of official interest rates expected for the end of the year has also turned upwards slightly. This may reflect the market's expectation that the fiscal and monetary stimulus, which was provided to the economy earlier, will have made itself felt by that time.

In the euro area, indicators of economic activity largely matched market expectations, although the outlook for future inflation deteriorated. Euro-area overall inflation rose to 3.6% in March. Consequently, the probability that interest rates would be reduced over the period to the end of the year is no longer priced into the market. A statement by the ECB indicated that the bank's next action would be an interest rate increase.

Fuelled by increasing risk appetite, the currencies of the Central European region strengthened to multi-year highs. The forint exchange rate weakened in the immediate aftermath of the coalition crisis, but then began to appreciate together with the Polish zloty on the back of the interest rate increase and improving investor sentiment. Market analysts expect the exchange rate to be close to its current level in May. Implied volatilities fell.

There was a sharp rise in yields in the government securities market in the days following the break-up of the coalition government. But this time market turbulence lasted only a couple of days. Yields have been falling in recent weeks, particularly around the middle of the yield curve, with the optimistic mood amongst investors being a contributing factor, in addition to improving liquidity conditions. On balance, domestic political events had little lasting impact on Hungarian asset prices. Nevertheless, despite these positive developments, yields and liquidity did not return to their February level.

The Debt Management Agency issued Swiss franc-denominated bonds. In the secondary market, the eight-year bonds are trading 10–20 basis points above the nine-year Polish bonds, also issued in Swiss francs recently. This difference is materially smaller than the 100–110 basis point difference observed for ten-year CDSs.

Simultaneously with the appreciation of the forint, non-residents' outstanding FX swaps fell sharply and their long forint positions increased. According to a widely accepted hypothesis in the market, investors who had been selling the forint short – unsuccessfully – over a protracted period are now closing their positions, which may be a factor behind the recent exchange rate appreciation. Non-residents' holdings of Hungarian government securities did not increase in April. Consequently, primary dealers presumably hold more government paper than desired, which is the reason why market liquidity continues to be inadequate.

Expectations of interest rate increases have increased since the Monetary Council's last policy decision. The money market yield curve clearly implies a rising path for the base rate to 8.75%, in contrast with 8.50%–8.75% last month. FRA quotes indicate that the market expects rates to be raised by 25 basis points at the Council meetings in April and May and then to remain on hold from June, i.e. it expects a cumulative 50 basis point increase. According to the Reuters poll of economists, the majority of respondents think that the Council will raise interest rates by 25 basis points at its April meeting. However, forecasts of interest rates for the end of the year vary in a wide range between 7.25% and 9.00%.

2 The Council's assessment of current economic conditions and the interest rate decision

Following discussion of the latest macroeconomic news and financial market developments, the Council considered arguments both for raising and for maintaining the base rate. Members agreed that the February projection, according to which inflation could be above target in 2009 assuming unchanged monetary conditions, should remain the starting point.

However, members' views were divided over the question of whether upside risks to inflation had increased since the publication of the February *Report*. Several members stressed that energy prices had reached new historical highs recently and the moderation in food price inflation had been weaker than expected. As a consequence, external, cost-push inflationary pressures in the economy had increased further. On another argument, the strong wage data in the beginning of the year as well as the rise in services price inflation did not seem to confirm the positive developments observed at the end of last year. In this context, several members emphasised that although the second-round effects of the inflation shocks could not yet be clearly identified, the risk of spillover had increased. However, several other members argued that data received so far were too noisy to interpret, and that the forthcoming May *Report* would provide an opportunity to assess inflation risks in greater depth. It was also argued that in the future increased attention should be paid to the current employment situation when assessing labour market conditions, as a change in the rate of wage growth might not in itself be a true reflection of developments in demand pressures in the economy, if the number of jobs were to fall significantly.

In members' judgement, prospects for growth had neither improved materially over recent month, nor had there been much evidence of a marked improvement in the main components of domestic demand. Some members stressed that the Monetary Council should pay more attention to real economic fundamentals in formulating its interest rate policy. Conversely, it was argued that the problems facing the Hungarian economy were fundamentally structural in nature, and consequently, the instruments of monetary policy were insufficient to influence them over the long term. Moreover, a more accommodating interest rate policy would only give a temporary respite from finding an effective solution to the problem, while it would prove to be unhelpful to the Bank in achieving its ultimate objective. Others noted that, according to the latest data, the disinflationary effects of the decline in demand appeared to weaken, and so weaker economic performance did not necessarily increase the Bank's room for manoeuvre to meet the inflation target.

Members agreed that the risk premium on forint assets had fallen since March, due to the improvement in international and regional investor sentiment; however, it continued to be significantly higher than its level in the second half of last year. Some members, however, warned that the government securities yield curve was currently a less reliable tool for measuring the expected return on forint assets and the currency risk premium, as the liquidity premium on government paper was expected to fall only moderately after the gradual reduction in market turbulence.

Members agreed that the inflation outlook continued to be surrounded by a high degree of uncertainty. Under these circumstances, decisive action could reinforce the role of the inflation target in guiding expectations, and consequently, they could reduce the real economic costs of achieving price stability. Due to the unfavourable outlook for inflation, it was especially important for monetary policy to maintain credibility, and therefore, the Monetary Council stood ready to take the necessary actions in order to meet the target.

Members' views were divided over the timing of an interest rate decision. Some members thought that processing new information and also taking a pause before the next interest rate increase were needed, particularly in the periods between publications of the *Quarterly Reports on Inflation*. However, several other members stressed that available information and the logic of inflation targeting implied a continuation of the tightening cycle and further increases in interest rates in a series of small steps.

After the discussion, the Chairman invited members to vote on the propositions. Seven members voted to raise the base rate by 25 basis points and four members voted to maintain the rate at 8.00%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.00%	**4**	Tamás Bánfi, Vilmos Bihari, Csaba Csáki, Judit Neményi
In favour of raising the base rate to 8.25%	**7**	Péter Bihari, Ilona Hardy, Ferenc Karvalits, Júlia Király, György Kopits, Gábor Oblath, András Simor

The following members of the Council were present at the meeting:

András Simor, Chairman	Ferenc Karvalits
Tamás Bánfi	Júlia Király
Péter Bihari	György Kopits
Vilmos Bihari	Judit Neményi
Csaba Csáki	Gábor Oblath
Ilona Hardy	

Álmos Kovács, State Secretary of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next policy meeting on 26 May 2008. The minutes of that meeting will be published at 2 p.m. on 13 June 2008.