MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 27 AUGUST 2007

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 economy

Consumer prices rose at an annual rate of 8.4% in July, up 0.2 percentage points on the June figure. Core inflation, as calculated by the CSO, was 5.6% in the twelve months to July, 0.3 percentage points higher than in the previous month. The slight drop in core inflation was also reflected in the month-on-month price indices: after eliminating the effects of changes in excise taxes and VAT as well as in medical visit fees, the annualised month-on-month rate of core inflation has recently been around 3%. This decline may be closely linked to the drop in processed food price inflation over recent months. By contrast, there continued to be hardly any sign of inflation slowing in the tradables sector. With regard to durable goods, this may be explained by the sharp increase in new car prices. But within non-durables, no product group has been found which could be associated with this phenomenon. Services inflation continued to fluctuate at around 6%, after removing the effect of the July increase in visit fees. The prices of items excluded from the core measure put upward pressure on inflation in the month.

According to the CSO's preliminary estimate, 2007 Q2 GDP grew by 1.4% relative to the same period of the previous year, down from 2.0% in Q1. This rate was considerably slower than earlier expected. By mid-year, Hungary's average 2 percentage point lead against the euro area in terms of GDP growth had turned into a negative gap of 1 percentage point. In the absence of detailed data, it is assumed that, on the output side, unfavourable weather conditions may have reduced the contribution of agriculture to growth. In addition, public sector output also fell, due to the corrective actions in government finances. On the expenditure side, the slow rate of consumption and investment growth in the government sector may have contributed to the weaker outturn for GDP growth.

The drop in retail sales volumes since the end of 2006 continued in July. This slowdown affected every major product group; and the month-on-month trends fell to historically low levels. In the first five months of 2007, retail sales fell less than real incomes, which was consistent with the assumption of consumption smoothing behaviour by individuals.

The July figure for industrial production suggests a reversal of the downward trend which began in mid-2006. Looking at the sectoral breakdown of industry, this turnaround seems to be broadly based, and is apparent in the latest figures on both domestic and export sales. All this is consistent with developments in the euro area and the CEE region, and may point to the temporary nature of the slowdown in industrial production this year.

The picture for trade in goods and industrial output was broadly similar: trade volumes grew faster than in the previous months. Based on the month-on-month indices, staff had expected a recovery from the lows in the previous two months, which, after incorporating the June figure, was reflected in the annual indices as well.

Wage data for Q2 were in line with staff's expectations. The overall rate of wage growth stagnated at a high level in June, and regular pay growth remained robust, particularly in manufacturing and services. It should be noted, however, that service sector wage growth has been slowing recently, according to the month-on-month indices. The higher indices for manufacturing may be explained by rising productivity.

Financial markets

In financial markets, investors' appetite for risk fell significantly. The problems facing the US sub-prime mortgage market and the related derivative and securities markets triggered heavy losses for participants; and increased volatility spilled over to other markets. In early August, a number of European investment funds and banks reported losses. This led to a general lack of confidence among European and US banks, as the scale of participants' exposures and losses could not be measured. The decline in liquidity in the euro and dollar interbank markets was also reflected in the substantial rise in overnight interest rates. In order to restore confidence and steer short-term interest rates to previous levels, the Fed and the ECB temporarily injected liquidity into the banking sector and adjusted the terms of access to central bank credit.

In the face of increased uncertainty and volatility, investors scaled down their risk exposures globally. They mainly focused on liquidating their leveraged positions. As a consequence, the prices of risky assets fell further, with investors reallocating their funds to government securities and other highly liquid assets. The decline in equity prices affected both developed and emerging markets. In foreign exchange markets, high-yielding currencies with poor fundamentals weakened, while funding currencies appreciated. As, according to market sources, the likelihood of a financial crisis affecting the real economy increased, participants revised their expectations of the future path of interest rates. The market expects US official interest rates to be reduced within one month, and has priced in a 100 basis point easing over the next twelve months. Previously market participants were confident that the ECB would increase rates in September. They are now divided over whether the bank will do so, and have priced out any further tightening.

The unexpected repricing of risks led to rises in risk premia. However, their level is still not exceptionally high by historical standards. The higher cost of funds, the tightening of lending criteria and realisation of losses caused by price movements over the past may keep volatility at high levels in the coming weeks, and consequently, there remains a risk of further rises in the required risk premium.

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 proposals put to the Council were to maintain interest rates, or to reduce them by 25 basis points.

The majority of members present at the meeting agreed that the outlook for inflation was basically favourable, similarly to earlier months. Also, there was general agreement in the Council that inflation had passed its peak, as evidenced by the latest data: the trend inflation indicator, after eliminating the effects of changes in regulations, was close to levels around 3%. Members were unanimous in their views about the disinflationary effects of the slowdown in demand caused by the stronger-than-expected decline in economic growth. They argued that, whilst assessing labour market developments continued to be difficult, upside risks to inflation stemming from wage growth seemed to have abated.

Nonetheless, there was a range of views on the Council about the projection in the August update of the *Quarterly Report on Inflation* and the conclusions that could be drawn from the projection. The path of inflation in the conditional projection was changed to take account of the recent rises in agricultural prices: the forecast for 2008 was revised up, while the rate of CPI inflation was now projected to drop below the 3% medium-term target. Some members noted the negative effects on expectations of a temporary rise in inflation. Others judged this risk to be relatively small, and stressed the importance of central bank communications in keeping inflation expectations in check.

Those members who preferred no change in interest rates this month noted that uncertainty had increased in international financial markets; risk premia had risen significantly in the past month, and therefore, the interest rate cuts warranted by domestic developments should be implemented with increased care. They also said that, for the time being, the market's assessment did not fully reflect the recent significant fall in deficits of the government and the external sector. On another view, monetary policy should strive to prevent an increase in inflation expectations in response to the rise in inflation in 2008. One member warned that food prices could rise more strongly at home than internationally. Several other members noted that not only supply factors, but also demand factors could explain the recent slowdown in economic growth, which, in turn, could dampen the disinflationary effects of lower growth.

Those members who supported a reduction in interest rates put forward two arguments. First, they stressed the importance of real economic developments. Second, they noted that August's was the second consecutive *Report* which contained a lower inflation projection than the target on the horizon relevant for monetary policy. It was argued that participants continued to expect policy easing to continue in the future, despite current uncertainty in money markets. Several members were of the view that the output gap could increase beyond expectations, due to the slowdown in 2007 Q2 growth. One member thought that the Bank did not need to respond to the temporary surge in the price level caused by supply shocks; in view of the Government's contractionary economic policy, inflation could return to the Bank's 3% target after rising due to increases in food and materials prices.

After the discussion, the Chairman invited members to vote on the two propositions. Five members voted to maintain the base rate, and five members voted for a 25 basis point reduction. Under the MNB Act, the Chairman has a casting vote in the event of a tie. Accordingly, the Council left the base rate unchanged at 7.75%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.75%	**5**	Béla Kádár, Júlia Király, György Kopits, Gábor Oblath, András Simor
In favour of reducing the base rate to 7.50%	**5**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáki, Judit Neményi

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

András Simor, Chairman
Tamás Bánfi
Péter Bihari
Vilmos Bihari
Csaba Csáki
Béla Kádár
Júlia Király
György Kopits
Judit Neményi
Gábor Oblath

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 24 September 2007. The minutes of

that meeting will be published at 2 p.m. on 12 October 2007.