MINUTES

OF THE MONETARY COUNCIL MEETING

OF 20 DECEMBER 2004

Publication date: 2 p.m. 14 January 2005

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 rate-setting 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. Based on the findings of the first part, the second part presents the decision-makers' assessment of current economic conditions and factors they consider when deciding on the base rate.

1 Macroeconomic and financial market developments

In November 2004, consumer price inflation was 5.8%, core inflation stood at 5.3% and the constant tax price index was 3.8%. The decline of 0.5 percentage points in the CPI relative to October was stronger than the decline in core inflation, suggesting that factors exogenous to monetary policy may have also played a role in disinflation. Of these effects, the decline in unprocessed food prices and motor fuel prices were the most notable. The persistent strength of the forint, increasingly keen market competition and high, although slowing, wage growth were all factors conducive to the fall in core inflation. Nevertheless, the month-on-month annualised index of inflation, calculated from trend data, did not decline further from around 4%, viewed as historically low for inflation in Hungary.

Following the lower-than-expected outcome for inflation in November, macroeconomic analysts expected disinflation to be slightly faster than they had previously, according to the Reuters survey. Expectations for annual inflation at the end of 2004 were revised down from 5.96% to 5.68%. Inflation expectations for end-2005 (4.33%) remained practically unchanged relative to the previous survey, actually edging down by 0.09 percentage point. All of the analysts polled by Reuters expected inflation to remain within the MNB's target range at end-2005.

Information on the Government's specific intentions with regard to increases in administered prices in early 2005 became available in December. On balance, the plans did not exhibit a departure from the path assumed in the November issue of the *Quarterly Report on Inflation*; increases in certain prices (e.g. household gas) were expected to be below average while others (e.g. electricity) above average.

The slowdown in private sector wage growth suggests that the disinflationary environment is developing favourably. According to wage data released by the CSO for October, private sector gross wage growth fell to 6.4% following readings of around 8%–9% in earlier months of the year. It appears that wage growth slowed mainly in the market services sector. Although the rate of wage growth was fairly rapid, at 9.3% in January–October, due to the high wage inflation characterising the first half of the year, the likelihood of private sector wage growth remaining below 9.4% in 2004 as a whole, as forecast in the November *Report*, increased in the light of fresh data. However, based on the experience of previous years it should be noted that monthly wage data show considerable fluctuations. Accordingly, at the current juncture it was not possible to decide whether and to what extent the October figure foreshadows a stronger-than-expected slowdown in the rate of wage growth in the coming period.

Gross domestic product grew by 3.7% in 2004 Q3 relative to the same period a year earlier, taking growth in the first three quarters to 4.1%. The quarterly indicators, prepared on the basis of seasonally adjusted data, reinforced the view that the pick-up in GDP growth stopped at end-2003 and that its rate gradually slowed from 2004 Q2.

On the production side, the slowdown in GDP growth was mainly accounted for by developments in manufacturing value added. Nevertheless, the data released on industrial sales in October once again reflected a robust increase in manufacturing sales after end-2003. This necessitated a reassessment of third-quarter data evidencing a slowdown.

On the absorption side, the slowdown in household consumption expenditure growth continued, in contrast with gross fixed investment, which picked up in Q3. Although the rate of household consumption expenditure growth is slowing, it still remains relatively high.

Exports and imports of goods and services, as shown in the national accounts, slowed in Q3. However, monthly trade figures recording only trade in goods reflected a pick-up in the growth rates of both exports and imports in October. Taking account of the retroactive adjustment by the CSO, which resulted in a lower trade deficit, there was a higher probability that the annual current account deficit would be slightly below the MNB's forecast of EUR 7.3 billion.

Based on autonomous fiscal processes, the ESA95-based government deficit seemed likely to exceed even the MNB's forecast of a 5.6% deficit as a percentage of GDP in 2004, unless transitory measures were taken. However, the actual deficit figure for 2004 released in early January may have been affected by two different transitory measures of potentially major significance: (i) the postponement of VAT refunds caused by tax inspections; and (ii) the rescheduling of expenditures by budgetary units for 2005. As the impact of these year-end transitory measures was difficult to assess, formulating a forecast of the deficit figure to be released in early January was only possible within a very wide range of uncertainty. For this reason, a more accurate picture of the 2004 deficit on the ESA95 basis is only likely to emerge after the CSO release in March, as the accounting period for the ESA95-based deficit only closes in February.

The exchange rate has stopped appreciating since the previous rate-setting meeting, and is currently fluctuating near the preceding month's level. Yields have continued to decline by around 40–50 basis points. Based on the yield curve, market participants expect a total 125 basis point decline in yields over a three-month horizon. According to the latest Reuters poll, the majority of market analysts expect a 50 basis point reduction in interest rates at the Monetary Council meeting on 20 December.

A number of factors facilitated exchange rate stability and the further decline in yields. The global investment climate developed very favourably throughout the major part of last month. Investors' willingness to take risks continued to be high, as reflected by the historically low level of the EMBI Global index and long-term euro yields. Presumably, domestic non-bank participants generated steady demand for forints, linked to foreign currency-based lending for house purchases, which is likely to be sustained in the coming months, according to market participants' expectations. In terms of domestic news and macroeconomic data, the lower-than-expected outturn for the consumer price index resulted in exchange rate strengthening and a decline in yields.

Despite the extremely favourable international business climate and substantial purchases by US dollar-based investors regionally and in emerging markets, non-residents were net sellers of forints for over three months, and their government securities holdings have virtually stagnated since end-October. As a combined effect of the decline in the interest rate differential and the rise in implied volatilities derived from option prices, expected profits on positions against the forint increased relative to earlier periods.

As a consequence of foreign investor passivity, movements in government securities yields were influenced by domestic market participants, particularly institutional investors. The decline in yields since mid-September continued; however, long-term forint-euro forward differentials, an indicator of attitudes towards the long-term convergence process, rose slightly over a period of one month, as the decline in forint forward rates was short of that in European forward rates falling towards historical lows.

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

After reviewing current macroeconomic news and financial market conditions, Council members were unanimous that there was an opportunity to reduce the central bank base rate. Disinflation had continued, wage growth had proved lower than expected and, according to indications, this year's faster increases in prices had not fed through to inflation expectations. All members viewed these as encouraging developments. They set forth two proposals for reducing the base rate. Accordingly, the Council considered the alternatives of a 50 basis point or a 75 basis point reduction in the base rate.

For prudential reasons, supporters of a 50 basis point reduction did not propose a reduction of more than 50 basis points, a measure fairly widely expected by the market. They stressed that the Council should take a cautious approach when making a decision on interest rates, as financial

market developments were out of line with fundamentals. Some members argued that there had not been a perceptible shift in equilibrium conditions relative to the previous year: external imbalance had not improved considerably, and improvement was identified only in the financing structure of the current account deficit, facilitated by an increase in non-debt financing. However, the proportion of debt-generating financing still remained excessively high. Although the revised deficit target for 2004 might be met, fiscal policy credibility might nonetheless be undermined in the light of the ever increasing target throughout the year. According to slightly differing views, although fundamentals were developing in the right direction, the scale of this shift was far from sufficient.

Movements in government securities yields were dominated by domestic investors at present – while foreign investors took a wait-and-see approach. And convergence investors, capable of ensuring the sustainability of favourable financial market processes, refrained from buying forint-denominated assets. However, domestic investors had limited potential for keeping the market in balance. Any change in the market's mood posed risks to market equilibrium, so caution was called for to preserve stability. Although market participants viewed forint demand arising from households' foreign currency indebtedness as a persistent element in maintaining the balance of the foreign exchange market, the fall in demand threatened to upset equilibrium.

Nevertheless, inflation had fallen more strongly than expected, in response to the decline in core inflation and one-off, technical effects, for example, the short-term reduction in petrol and food prices. This made it possible to reduce the base rate to the extent accepted by the market. Based on monthly inflation data in 2004, concerns that increases in indirect taxes early in the year might feed through to expectations had not materialised. Consequently, the price index was expected to fall significantly in January 2005. Some members of the Council noted that monetary policy had also contributed to this favourable development. Looking ahead, in the current interest rate cycle it was important to find the extent and timing of interest rate reductions which were consistent with the inflation targets and did not threaten to lead to turbulence in the foreign exchange market.

The benign international investment climate, which also had a positive impact on the assessment of Central and Eastern European countries, supported the interest rate reduction as an external factor.

Some members maintained that expected inflation developments would be sufficient to warrant an even larger interest rate reduction; however, the possibility of a more substantial cut was limited by risks to stability. Given the uncertain circumstances, they considered the message transmitted by a more modest reduction in interest rates as more important, accordingly, under the current circumstances and in the light of the available information, they viewed a 50 basis point reduction as being more consistent with the Council's earlier communications.

Other members were of the view that it was developments in market expectations rather than the profile of inflation which made a case for an interest rate reduction. Deriving from their yield requirements based on the forward-looking real interest rate, domestic investors were ready to accept lower nominal yields, hence, with the current level of yields, they would be willing to take a larger share in financing the increase in government debt. Due to their excess risk arising from exchange rate exposure, foreign investors required higher interest rate premia, but so far they were flexible in the face of the gradual decline in the interest rate spread. In the case of a significantly greater-than-expected shift in the external environment, domestic fundamentals or monetary policy, which could potentially cause a deterioration in market sentiment, the interest rate spread might prove insufficient to sustain financing. For this reason, it might be uncertain and risky to anticipate the market's future expectations.

Arguments for a 75 basis point reduction in interest rates were centred around the decline in wage growth, in addition to the benign inflation news. Members judged it as a particularly favourable development that the slowdown in private sector wage growth affected mainly the services sector, as wage raises in services were generally offset by productivity growth to a lower extent than in the tradable sector. This development might place the outlook for inflation in a more favourable light. The decline in wage inflation and modest real wage growth might reduce inflationary pressure on both the supply and demand sides. Consequently, accompanied by favourable expectations, the inflation targets could be met with greater certainty.

In addition, sentiment in the global capital market was very optimistic; and certain factors appeared to support the maintenance of the current positive investor mood in the domestic market.

As regards external balance, the risk of a higher current account deficit than the forecast in the *Report* appears to have diminished; and, technically, the government deficit target for 2004 did not seem to be untenable. Due to the base effects, the decline in inflation might be spectacular in the early months of 2005, particularly in January. The forint exchange rate continued to be strong, making it possible to meet the inflation targets. Yields were falling. Markets might interpret these developments favourably; and this positive assessment may prove sustainable, despite the uncertainties. Portfolio adjustments, usual around the start of the year, could influence foreign investments positively. Domestic institutional investors' demand for government securities might prove to be lasting: as an effect of attractive returns, investors reallocated capital from money market funds to bond funds offering longer-term investment opportunities. Consequently, the risks to sustainability were subsiding: equilibrium in the government securities market might develop at lower yields. For foreign investors, Hungary's EU membership might represent a strong safety net, which might ensure foreign financing at lower interest rate premia. Some Council members regretted that government statements, urging the necessity of a weaker forint, had caused an increase in required premia and had thus proved counterproductive, making it more difficult to reduce interest rates.

Supporters of a larger base rate reduction shared the view that it was necessary to continue pursuing a cautious interest rate policy. They did, however, maintain that a 75 basis point reduction would not go beyond the limits of such a policy stance: it would be acceptable for the market and would not endanger stability.

After the collective consideration of arguments, the Chairman invited members to vote on the propositions of a 50 basis point and a 75 basis point reduction in the base rate. Seven members of the Council voted in favour of a 50 basis point reduction, one member voting in favour of a 75 basis point reduction. Based on this majority vote, the Monetary Council decided to reduce the central bank base rate by 50 basis points with effect from 21 December 2004.

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

Dr Zsigmond Járai, Governor of the MNB and Chairman of the Monetary Council
Henrik Auth, Deputy Governor of the MNB
Péter Adamecz, Deputy Governor of the MNB
Dr György Szapáry, Deputy Governor of the MNB
Vilmos Bihari
Dr Ilona Hardy
Dr Béla Kádár
Dr Gábor Oblath

Dr György Kopits was not present at the meeting.

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

The Council will hold its next rate-setting meeting on 24 January 2004. The abridged minutes of the meeting will be released at 2 p.m. on 11 February 2005.