MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 JANUARY 2005

Publication date: 2 p.m. 11 February 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. 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

In December 2004, consumer price inflation was 5.5%, with core inflation and the constant tax price index at 5.0% and 3.5% respectively. In 2004 H2, the base effect and certain benign factors both exerted influence towards lower annual price indices. In addition, the decline in trend inflation indicators also reflected that disinflation was well underway, particularly in the tradables sector. The annualised index of month-on-month core inflation fluctuated in a 3%–4% band during the period. This was broadly comparable in magnitude with inflation outturns in 2003 H1. Following the increase in indirect taxes, a combination of monetary policy effects (e.g. the strong exchange rate, falling inflation expectations, which were due – in part – to the former, and slowing wage growth) and other factors (e.g. intensifying market competition) must also have contributed to the disinflation process observed in the core measure of inflation over the period.

Oil prices, one of the factors previously identified as potential sources of risk to disinflation, have declined sharply since publication of the November issue of the *Quarterly Report on Inflation*. From nearly USD 50 a barrel in October, Brent crude oil prices fell to below USD 40 by December. This decline was even steeper measured in euro terms. However, prices began rising again in the first part of January.

As seen in earlier months of 2004, the December outturn for inflation proved to be lower than the expectations of analysts polled by Reuters. Market economists anticipate disinflation to be rapid in the period ahead. The mean of expectations for inflation in January 2005 is 4.7%, representing a decline of 0.8 percentage points relative to the actual data for December 2004. However, expected year-on-year inflation at end-2005 remains unchanged (4.3%), and the expected inflation rate of 3.6% at end-2006 is only marginally lower compared with the previous survey. According to the latest Reuters poll, all respondents expect inflation to remain within the MNB's target range at end-2005 and end-2006.

Private sector wage growth stood at 9.3% in the period January–November, with the November index at 9.9%. Different sectoral developments may have been behind the modest decline in private sector wage inflation in 2004 H2: wage growth in the market services sector continued to fall at a rate exceeding the private sector's average. The November figure suggests that although the decline in wage inflation observed in earlier periods continued, the rate of the prospective slowdown remained uncertain. Unemployment rose and employment stagnated, according to data received up to November. That was an indication of rising labour reserves.

External market demand rose robustly in 2004 H2, borne by the increase in imports by Hungary's trading partners. According to data available for October and November, domestic output growth picked up again, after stalling in Q3. Due to the retroactive adjustment of GDP data, however, in 2004 annual average growth in manufacturing value added is expected to be slower than at the time of the November *Report*. By contrast, market services value added may turn out to be slightly higher than projected in November. At above 30% in the first three quarters of the year, agricultural output growth continued to be very strong, contributing nearly 1 percentage point to GDP growth in 2004, despite the sector's relatively low weight.

The annual rate of household consumption growth was 5.4% in Q3; the slowdown in growth has remained below expectations. Revised financial accounts data reflect a lower household savings rate than earlier, placing the demand side in a somewhat different light. Consumer credit growth continues to be strong. According to financial market developments, other household income is assumed to have risen. Consequently, household consumption is now expected to be higher in 2004 than forecast in the November *Report*.

Third-quarter data on gross fixed capital formation also evidenced strong growth. Here, the pick-up in corporate investment was dominant, which – following the decline in Q2 – was strongly underestimated in the projection in the November *Report*. According to data on exports and imports of goods for October and November, however, corporate investment activity is expected to slow down somewhat in Q4. Public and household sector investment continued to be strong. Consequently, investment in the total economy may turn out to be significantly higher than forecast in the November *Report*.

According to trade data available up to November, export growth resumed rising at a higher rate, consistent with the pick-up in industrial exports in October–November. However, taking account of the adjustments related to purchases brought forward to the period preceding Hungary's EU accession and goods stored in customs warehouses, goods imports have slowed down in recent months. Consequently, the trade deficit and the current account deficit are expected to be slightly lower than the forecast in the November *Report*.

The exchange rate of the forint vis-à-vis the euro remained in a narrow fluctuation band, despite weakening in the early part of the year. Analysts do not expect Hungary's macroeconomic indicators, closely monitored by investors, to improve significantly in 2005. The downgrading by Fitch of Hungary's forint-denominated debt in January and the statement of disapproval from EU finance ministers once again directed investors' attention to the risks of the high government and current account deficits.

Investors' strong risk appetite around the world only partially offsets domestic fundamental risks; the market equilibrium was set with non-residents' forint position declining continuously. Purchases of forints by other, less interest sensitive, domestic market participants, presumably related to foreign currency-based house financing, had counterbalanced this decline in earlier months. But the inflow of foreign currency to the market has markedly slowed down recently. Foreign investors' stock of forint-denominated government paper have stagnated. The divergent paths of U.S. dollar and forint interest rates foreshadow a continued fall in the premium of the forint.

The decline in long-term yields underway since mid-September stalled in early January, with the flattening of the yield curve. This flattening of the curve may further depress foreign investors' demand for government securities, and it may even cause existing holdings to fall. Following the drop in December, the long-term forward premium rose again in January.

The interest rate path priced in the yield curve has remained practically unchanged since the latest Monetary Council meeting. The slight increase in expectations of an interest rate reduction in December was corrected in January. The market priced in a base rate of 8.5% for the end of March and 8.0% for end-2005. Six of the 16 analysts polled by Reuters in January expected a total of 50 basis points in reduction up to end-February, one expected a total reduction of 75 basis points, and nine expected a total reduction of 100 basis points. The average of expectations was consistent with the end-February 8.7% level of the key interest rate priced in the yield curve. Consistent with the yield curve, market economists on average expected official interest rates to be slightly above 8% at end-2005.

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

After reviewing information which had become available since the previous rate-setting meeting, Council members were unanimous that there was an opportunity to reduce the central bank base rate.

Two proposals were set forth for reducing interest rates. Accordingly, the Council considered the alternatives of a 50 basis point or a 25 basis point reduction in the base rate.

Considering exclusively the outlook for inflation, one member mentioned the possibility of a 75 basis point reduction in interest rates; however, he was of the view that other risks and uncertainties were against such a reduction. Other members also clearly ruled out a reduction of more than 50 basis points under the current circumstances.

Several members regarded lowering interest rates by 25 basis points as acceptable.

According to arguments for a smaller interest rate reduction, although inflation had turned out to be more favourable than expected, individual and technical factors had played a role in this. The slight fall in oil prices and the continued weakness of the U.S. dollar, resulting in a decline in the price index of motor fuel due to the high base, were cited as exogenous factors. The decline in unprocessed foods, the price-depressing effect of competition in the tobacco market and the delay in the statistical measurement of the increase in district heating prices had contributed to the lower-than-expected price index. Consequently, inflation prospects had not improved to the extent suggested by headline inflation data.

Taking a longer-term perspective, while the massive macroeconomic imbalance may have eased, it appeared to be reluctant to ease further. According to forecasts, although fundamental equilibrium indicators are not expected to deteriorate over the coming period, they do not show signs of improvement.

Concerns over economic balance were reinforced by the launch of an excessive deficit procedure by the EU against Hungary and by the downgrading of the country's long-term forint-denominated debt. Most members of the Council regretted the Government's inadequate approach to the criticism of economic policy from international institutions. One member was of the opinion that, despite the EU's apparently weak actions, the consequences of disapproval would be onerous.

Some members were of the view that the tendency to relax economic policy, stemming from the political cycle, had introduced uncertainties into the longer-term outlook and might cancel out the results of the modest adjustment carried out so far. Several members noted that, by adding to the uncertainty, the Government's communications in respect of the exchange rate had caused risk premia to rise, rendering further reduction of interest rates difficult. The consequences of amending the Central Bank Act may also increase uncertainties surrounding monetary policy. Several members stressed the primary role of professional considerations and the importance of maintaining central bank credibility.

Market participants were well aware of the unfavourable outlook for economic balance. Any related news probably would not take investors by surprise and, consequently, no abrupt change in the assessment of forint-denominated investments was expected.

The assessment of the domestic economic environment did not change significantly since the latest interest rate decision. In addition to favourable individual factors, recent data provided clear evidence that disinflation was continuing and did not contradict the picture of slower-than-expected wage growth. No information became available which refuted the finding that the faster rise in prices in 2004 had not fed through to inflation expectations. Core inflation data also appeared to support the clear improvement in the outlook for inflation. The consumer price index was expected to fall rapidly in early 2005. In sum, upside risks to inflation eased; and the probability of inflation being above the target range at end-2005 and end-2006 appeared to have fallen.

However, it was generally held that the assessment of wage developments was surrounded by uncertainties, due to the volatility in time series data. In respect of the future outlook, some members judged that, after assessment of the trend taking into account fresh data, it could not be ruled out that the trend of declining wage growth had stopped; consequently, the future outlook for wage growth was uncertain. Some other members, judging the latest data as more encouraging, were of the opinion that wage dynamics did not threaten current and improving inflation prospects: although the rate of wage growth in manufacturing had stopped slowing down, it continued to decline in the market services sector, crucial for inflation developments.

The international investment climate continued to be relatively benign. Although willingness to take risks in emerging markets had stopped growing, and risk premia even rose a little, they remained at low levels. Future prospects, however, were surrounded by uncertainties; and a weakening in investors' risk appetite could not be ruled out. The strengthening of the U.S. dollar and faster-than-expected interest rate increases by the Fed might lead to a rise in general risk premia.

Some members stressed that exchange rate stability, facilitating the pass-through of disinflationary effects, was one of the important factors in the favourable outturn for inflation. In 2004 H2, the direct effect of the stable and strong exchange rate had offset price pressures associated with imported inflation, and may have indirectly helped to reduce the threat of rising inflation expectations, while keeping wage growth under control.

Some members concluded from movements in long-term yield spreads that the market would probably accept a 50 basis point reduction in interest rates and regard it as credible; however, further actions would require special caution. Members attached importance to monetary policy credibility, in addition to the inflation prospects and developments in risk assessment. Other members of the Council stressed the importance of the interrelationship between actions and communication of the central bank and market expectations.

While accepting the 50 basis point reduction as being in line with the gradual approach to lowering interest rates, several members of the Council emphasised that with this step interest rate policy will have reached a crossroads, as the interest rate spread was now approaching a level which requires an even greater degree of caution than before in setting interest rates.

All members of the Council voted in favour of a 50 basis point reduction. Based on this unanimous vote, the Monetary Council decided to reduce the central bank base rate by 50 basis points with effect from 25 January 2005.

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

Zsigmond Járai, Chairman of the Monetary Council
Henrik Auth, Vice Chairman
Péter Adamecz
Dr. György Szapáry
Vilmos Bihari
Dr. Ilona Hardy
Dr. Béla Kádár
Dr. György Kopits
Dr. Gábor Oblath

Péter Tabák, Head of Department of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 21 February 2005. The minutes of that meeting will be released at 2 p.m. on 19 March 2005