MINUTES

OF THE MONETARY COUNCIL MEETING

OF 29 MARCH 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

Data received over the past one month confirmed earlier expectations of a rapid fall in inflation. In fact, they foreshadowed an even speedier decline in the consumer price index. The central inflation projection in the February issue of the *Quarterly Report on Inflation* was for the CPI to be 3.6% at end-2005 and 3.4% at end-2006, taking into account domestic monetary conditions and the EUR/HUF exchange in January, an expected fall in crude oil prices based on futures quotes and other assumptions. In the light of February data, inflation is more likely to be lower at end-2005 than forecast. Risks to the projection for December 2006 continue to be symmetrical. The underlying reason for this is that the persistence of factors triggering a slowdown in inflation is much harder to assess than usual.

It is still unclear whether the strong decline in core inflation can be attributed to changes in the market structure induced by Hungary's EU accession, monetary conditions or dwindling consumption demand. Accordingly, longer-term developments in inflation may vary markedly according to which of these possible reasons is offered as an explanation. If the accession impact dominates, then data mostly reflect a one-off shift in prices, which may influence longer-term inflation developments only indirectly, primarily through its impact on expectations. If, however, the underlying reason for rapid disinflation is dwindling demand, trends in inflation will change course, and disinflation will persist.

Recent data on macroeconomic determinants of inflation are conflicting. They suggest an expected slowdown in economic activity and the rising role of the demand side in disinflation. However, an increase in disinflationary pressure is not discernible on the cost side (e.g. oil prices and labour costs). Although there are signs of accelerating labour market adjustment, wage inflation is still consistent with higher inflation than its current level. The slowdown in productivity growth may be greater than that in wage inflation expected for Q1, thus unit labour costs may even increase. The recent sharp rises in oil prices may add to cost-push inflation.

Analysts' inflation expectations diminished significantly in March. The most recent Reuters consensus forecast is practically consistent with the projection in the February *Report*. Average year-on-year inflation expected for end-2005 fell considerably (by 50 basis points to 3.6%), while expected inflation at end-2006 only declined slightly (by 20 basis points to 3.3%) relative to the previous survey. All analysts polled by Reuters expect inflation to remain within the Bank's target range at both end-2005 and end-2006. While the Bank's projection was in the lower range of analysts' forecast in February, broadly half of those included in the survey forecast year-end inflation to be lower than the Bank's projections.

Meeting expectations, Q4 GDP data reflected a pick-up in economic growth. However, its structure suggests a more marked slowdown in domestic demand than expected earlier. Fixed investment activity and household demand grew more slowly compared with the February projection. The contribution of external trade to growth was slightly more favourable. Overall, Q4 data reveal more sluggish growth in domestic demand.

The most recent data for early 2005 point to a slowdown in economic activity. Both domestic and international confidence indices show subdued corporate business activity, which is underpinned by industrial output data for January. The picture becomes somewhat more differentiated if data on external trade turnover are taken into account. The reason for this is that the previously robust trends in exports and imports have continued.

Growth in retail trade, an indicator of the household business cycle, was lacklustre in January. This justifies the growth path outlined in the *Report*, lower in comparison with most analysts' expectations, according to which consumption growth was expected to slow further in 2005.

An overall assessment of the domestic business cycle indicates that the rate of slowdown may be somewhat higher than the forecast in the February *Report*. The amount of this difference is still rather uncertain, but currently available data suggest that it might not be higher than 0.1% or 0.2% of GDP.

The international investment climate has deteriorated slightly over the past month. Brighter prospects for the US business cycle, a weak US dollar and crude oil futures prices stabilising over USD 50 a barrel heightened concerns over inflation. As a result, long-term US yields, which have been on the rise since the first half of February, continued to increase. This led to a decline in willingness to take risks in the second half of March, interrupting a trend during the preceding weeks dominated by expectations of a further dollar depreciation and vigorous demand for higher-risk currencies pegged to the euro. In the light of an expected increase in borrowing costs, dollar-based investors reduced their risk exposure, mainly in higher-yield currencies. As the increase in yields stopped in mid-March, most markets experienced a partial correction. Although risk premia approximated their levels in January, they are still at a historically low level.

The selling wave accompanying the rise in US yields also affected the Central European region, bringing about a reversal of sizeable capital inflows observable since mid-January. The Hungarian and Czech markets saw both rising yields and depreciating exchange rates, whereas the Polish and Slovak markets experienced significant exchange rate depreciation. The exchange rate of the forint weakened to EUR/HUF 248, a level prevailing in early 2005. Non-residents' government securities holdings shrank by HUF 50 billion due to maturing portfolios and secondary market sales. There was an upward 30–40 basis point shift across the entire length of the yield curve. The correction which has occurred since then has proved only temporary; and investor uncertainty is now higher than earlier. Risks going forward are asymmetrical, with a further likely reduction in willingness to take risks around the world.

The February interest rate reduction, which slightly exceeded market expectations, led the market to anticipate further cuts. This, however, proved short-lived due to the depreciation of the forint. The two-week interest rate path, derived from the yield curve, reveals that market expectations are consistent with a 100 basis point cut in the base rate in three months' time, the base rate remaining broadly level afterwards. The most recent Reuters poll of analysts and currency traders clearly indicated a 50 basis point reduction at the Monetary Council's rate setting meeting of 29 March. Despite the better-than-expected inflation data for January and February, the longer-term risk assessment of the Hungarian economy has not improved, with the five-year forward premium five years ahead rising above 180 basis points again.

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

After considering the latest benign developments in terms of the future outlook for inflation, Council members unanimously saw that there was an opportunity to reduce the central bank base rate. Several key points were raised during the evaluation; and members attached various weights to each individual factor.

The Council discussed in detail the alternatives of a 50 basis point or a 75 basis point reduction in the base rate.

Assessing the latest economic news, members were of the view that some of the risks identified earlier had materialised in the international environment, which, in consequence, had turned less favourable in the period leading to the meeting. The interest rate hike in the United States, reducing the relative attractiveness of emerging markets for investment, had also affected capital flows: investors' reduced willingness to take risks had also been reflected in rising indicators of risk. The Fed's indicated bias towards tighter interest rate policy relative to earlier expectations foreshadows a further increase in yields, which might have a lasting impact on the market of higher-risk assets. Hungary might also be negatively affected by such changes in circumstances in a global and regional comparison. Accordingly, the majority of Council members were of the opinion that the uncertainties surrounding the global investment climate had increased and that external risks were supportive of a smaller reduction in interest rates.

In the evaluation of the supporters of a 50 basis point reduction, the low February inflation outturn was clearly positive news. Stronger-than-expected disinflation increased the probability of meeting the inflation objectives. The consumer price index had turned out to be lower than previously anticipated. This might encourage an increase in household savings through higher real incomes, which, in turn, might have a favourable effect on economic balance. However, as a risk in the opposite direction, higher income might induce a pick-up in consumption growth, which might affect disinflation negatively from the demand side. Consequently, the near-term prospects for the apparently moderating rate of consumption growth were uncertain. The January wage data showed a slowdown in wage inflation and thus a moderation in cost-push inflationary pressure.

Fundamental economic risks remained: the general government borrowing requirement continued to be high, which, coupled with the corporate sector's borrowing requirement stemming from its stepped-up investment activity, held the country's external financing requirement at a high level, even considering an expected slight improvement in households' financing capacity. Adverse changes in the international environment might add to the risks related to the market's assessment of persistent imbalance. In this regard, Council members judged the latest movements in yields over five years as an important warning signal.

Raising additional points in relation to the assessment of prospective inflation, several members stressed the uncertainties surrounding the central projection: the Bank's conditional forecast was sensitive to assumptions, on the one hand, and the forecast distribution was also relatively significant, on the other. Consequently, considering the current picture, the point forecast showing a slight undershooting of the inflation targets did not allow robust conclusions to be drawn.

Other members pointed out that, amidst circumstances characterised by rising uncertainty, it was important to maintain the credibility of economic policy institutions, and of the Bank in particular – the major emphasis was now on stability, cautiousness and predictability.

Several members were of the view that the recent domestic economic developments would allow for a relatively larger interest rate cut, which, in turn, would benefit the real economy. However, in the current international climate and considering the future outlook, such an interest rate decision might also add to the uncertainties surrounding economic policy and, consequently, it might also prove less favourable for the government budget in terms of the ability to finance debt and the related costs.

In view of the above, while emphasising risks, some of the supporters of a 50 basis point rate reduction also judged a 25 basis point reduction to be reasonable.

Supporters of a 75 basis point interest rate reduction also attached great importance to preserving stability and maintaining the Bank's earlier cautious approach. In their view, however, caution did not determine the measure of a particular interest rate reduction. They argued that in light of the larger-than-expected decline in inflation in early 2005, and the inflation projection by Bank staff and information pointing to a stronger slowdown in domestic demand than forecast, the likelihood of disinflation being stronger than the target in 2005–2006 had increased. This risk of inflation turning out to be lower than the target was judged to be a new phenomenon in Hungary's inflation history, which might require an interest rate reduction in excess of 50 basis points to tackle. A 75 basis point reduction would be consistent with short-term interest rate expectations implied by the yield curve. Supporters of the alternative also stressed that a 75 basis point cut would not signal a departure from the Bank's cautious policy stance: it would not signal the beginning of a new policy regime, rather, it would be a sensible response to improved inflation prospects. Such a step would not take the market by surprise. They were of the opinion that a 75 basis point cut might lead to more favourable real interest rates for growth and put downward pressure on the increase in foreign currency debt fuelled by the interest rate differential. Finally, they perceived increasingly less room for reducing interest rates further, due to the disparity between the international interest rate cycle and the domestic disinflation trend.

The price index possibly falling to excessively low levels was judged by some as a clearly negative prospect in terms of potential demand pressures arising from real incomes, lower-than-planned budgetary receipts and financial stability.

Irrespective of their opinion on the possible measure of interest rate reduction, several members took a stand on the recent reform of the Stability and Growth Pact.

The majority of Council members acknowledged that, administratively, the reform might increase the probability of joining the euro area in 2010 by mitigating the risks to meeting the relevant Maastricht criterion. However, several members considered the political message of the reform as extremely dangerous and potentially damaging, which might lead to a further weakening of fiscal commitment by strengthening the illusion that there was increasing room for relaxing fiscal policy. Some members were of the view that such concerns were only exacerbated by risks arising from the electoral cycle. Due to the existing risks posed by the significant departure from the Convergence Programme, the new rules themselves would only slightly improve the prospects for adopting the euro in 2010. The reform had given slightly more room for manoeuvre to fiscal policy, which it would have to use to manage some of the existing risks and avoid increasing the deficit, in the interest of joining the euro area on the target date.

On balance, after considering the alternatives and key points, the Council was of the view that the risks posed by the international environment and by economic imbalance reduced the opportunity for a larger interest rate reduction, supported by domestic inflation and cyclical developments.

The Chairman invited members to vote on the propositions of a 50 basis point and a 75 basis point reduction in the base rate. Eleven members of the Council voted in favour of a 50 basis point reduction, while two members voted 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 30 March 2005.

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

Zsigmond Járai, Chairman of the Monetary Council
Henrik Auth
Péter Adamecz
Dr. György Szapáry
Dr. Ilona Hardy
Judit Neményi
Tamás Bánfi
Dr. Péter Bihari
Vilmos Bihari
Dr. Csaba Csáky
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 25 April 2005. The minutes of that meeting will be released at 2 p.m. on 6 May 2005