MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 25 APRIL 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 no less than twice a month, according to a previously-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

I. Macroeconomic and financial market developments

The information received over the last month characteristically indicate increasing and persistent disinflation. Although the March CPI turned out to be somewhat higher than expected, this difference fundamentally results from items exogenous to core inflation. Due primarily to the very rapid decrease in the February data, aggregate *2005 Q1 core inflation* remained below the level expected in the Inflation Report published in February. While earlier disinflation seemed to be stronger primarily in products subject to exchange rates (tradables and processed food), the 2005 Q1 data also indicate steadily slowing inflation in the field of market services most sensitive to domestic inflation pressure, and this may suggest permanence in disinflation. The reason for this may be the labour market's increasing adjustment to inflation and a slowdown in household consumption demand. It is important to note, however, that there are also transient factors underlying the first-quarter (particularly February) slowdown in core inflation, which cannot be expected to persist over the longer term.

The most recent data, recorded in February, reinforce the picture that *developments in gross wages paid in the private sector* are adjusting to the lower inflation environment. In addition to declining inflation expectations, a cyclical downturn in productivity and rising labour reserves may both play a role in the deceleration of wage growth. Most recent data suggest that — in addition to the market services sector — wages are definitely growing more slowly in manufacturing as well. In connection easing labour market tightness, however, the simultaneous rise in the number of new jobs and dismissals in several sectors (including machinery and equipment as well as trade) gives rise to some uncertainty and may suggest increasing frictional unemployment.

In keeping with the MNB's earlier expectations, a moderate increase in the volume of *retail trade sales* suggest a slowdown in growth in consumer demand in 2005. Within sales, a major slump in the growth rate of sale of furniture and other household articles may relate to the change expected in household investment this year.

The most recent data on *industrial production* (from February 2005) reveal that growth will slow even faster than expected. The data available on the first two months of 2005 indicate a definite drop in the manufacturing boom in terms of sales as well as new orders. The fact that the fastest decline was reported in the export of machines and equipment suggests that this slump can be ascribed to external cyclical factors. This is substantiated by European confidence indicators, which reflect an unfavourable turn in the external cyclical outlook, as well as the unfavourable data published on the German industrial output and export orders.

Risks to stability have not eased. The government budget deficit continues to be a predominant factor in the high external imbalance.

Up to mid-April, the international financial markets were characterised by price stabilisation and a slight increase in risk appetite. Investors' concern that — as a result of inflationary risks — monetary tightening would gather momentum and reduce global liquidity has eased slightly. However, investors remained cautious in emerging markets. Thus, the Central European region was also characterised by investors biding their time and moderate changes in asset prices.
Mid-April saw another unfavourable turn in global investor sentiment. This time the underlying reason was primarily the deterioration in the US growth outlook. Investors reduced their risk exposure in major equity markets and emerging markets alike, and increased demand for US government securities. The macroeconomic data disclosed in the euro area in the past few weeks were also less favourable than expected. Investor scepticism regarding the EU institutions also increased. The latter is explained by the amendment of the Stability and Growth Pact, the postponement of the codification of a directive on services, and the doubtful results of the French referendum on the European constitution at the end of May.

Worsening global sentiment resulted in a depreciation of Central European currencies. The exchange rate of the forint against the euro dropped to 250 forints, a low-point for the last several months. Hungary was the only country in the region where yields on government securities rose, probably due, amongst other things, to the replacement of the Minister of Finance and publication of a projection for a high general government deficit for April. Following a minor rise in early April, expectations of base rate cuts declined in the middle of the month and a more conservative approach was adopted for the short term. The market priced a total base rate cut of 50 basis points into the yield curve for the next three or four rate-setting meetings. At the moment, it is not possible to gauge the extent of deterioration in international investor sentiment cannot; however, risks suggest further decline in market sentiment. In a regional context, investors perceive major risks in the Czech government reshuffling, the Polish general elections and Hungarian fiscal developments.

II. Assessment of the current economic conditions and interest rate decision by the Council

Council members unanimously saw an opportunity for the reduction of the central bank base rate.

In view of the proposals set forth, the Council considered the alternatives of a 25 and a 50 basis point cut in the base rate, with due deliberation of the arguments for and against such reductions. Supporters of a 25 basis point reduction in the base rate were of the opinion that the current international uncertainty did not allow for a larger move, but that conditions did not completely preclude a reduction in the rate.

Some of the supporters of a 25 basis point cut agreed with the idea that domestic disinflation alone would allow for a reduction of 50 basis points. They argued that inflationary expectations were on the decline, households' consumption demand was expected to fall, and wage inflation seemed to be slowing persistently. The fact that core inflation kept falling despite rise in the CPI last month was considered as a significant indication of persistent and sustainable disinflation. In their assessment, demand and supply developments both supported disinflation in the core level. However, it was also considered likely that certain transient factors also contributed to the first-quarter (particularly February) slowdown in core inflation, which could not be expected to continue over the longer term. Such transient effects include the intensification of market competition in the wake of accession to the EU, with a one-off fall in domestic price level due especially to alignment between the relative prices of the new member states. This can only reduce inflation temporarily, although such adjustment may take a longer period of time.

Over and above the favourable domestic disinflationary outlook, it was, however, stressed that uncertainty regarding domestic equilibrium developments and the international cyclical and financial market trends had not declined recently.

Crucial domestic fundamentals have not improved materially: no noteworthy change for the better has been seen in the external imbalance or the general government deficit. It seems likely that the deficit objective set for the general government cannot be achieved, although the market has already included some of the budgetary problems in its prices and this explains why the replacement of the Minister of Finance did not triggered any major shift in the market. Replacement of the Minister of Finance undoubtedly added a further uncertainty factor to the assessment of the Hungarian macroeconomic conditions, as reflected by yield rises. The uncertainty surrounding the fiscal outlook has not declined, and the credibility of fiscal policy remains weak. Last month also saw the international economic environment grow more unfavourable. In addition to inflationary risks in the US, uncertainty regarding the US and European recovery grew. Investors may act with more circumspection, and this may result in weakening interest in emerging markets. As a first sign of this trend, risk premia in the region increased. Although in certain respects membership in the EU provides an umbrella, in a regional comparison the Hungarian economy seems to be the most vulnerable. Under these circumstances, it is insufficient to acknowledge only disinflation, as the external environment must also be taken into consideration.

Several Council members pointed out that when the inflation outlook is assessed, the 2006 inflation target must be considered, as the central bank has weak influence on 2005-end inflation. As prospects are far more uncertain over a longer horizon, increased care needs to be taken and the principle of gradualism applied when the base rate is cut. Attention was called to the fact that the inflation report to be published in May 2005 may give a comprehensive, updated assessment and further information on the 2006 inflation outlook and the achievability of the inflation targets.

Having considered the factors involved, supporters of the 25 basis point base rate cut came to the opinion that — with a view to the uncertainty of the capital market conditions and the risks that may arise from an eventual change in the international business environment — it is impractical to further increase uncertainty by cutting the base rate to a surprising degree.

Several Council members mentioned the increase in the credibility of the central bank as a major achievement of the past one and a half years. In their opinion this was one of the reasons why disinflation continued after the one-off price-raising effect of the hike in the value added tax. The economic actors considered the rise in the price index as temporary and accepted the central bank's rate cuts performed in a period of higher CPI as credible measures. As a result, disinflation was able to continue in 2005, opening up the opportunity for further cuts in the base rate. Council members thought it was important to reinforce these achievements and sustain economic participants' confidence, in order to maintain disinflation.

Based on the above, they considered a 25 basis-point cut in the base rate as a moderate decision that can reinforce the Council's credibility.

As arguments in favour of a 50 basis-point base rate cut, it was mentioned that inflation had definitely declined and that adjustment in wage growth had strengthened persistent disinflation. However, in the projections relevant to the end of 2005 and 2006, there is a strong probability that the inflation outcome will be lower than targeted in both years. According to the logic of inflation targeting, in order to avoid inflation which is lower than targeted, a more substantial reduction in the base rate is justified at this rate-setting meeting.

The Chairman invited members to vote on the propositions of a 25 basis point and 50 basis point reduction in the base rate. Twelve of the Council members voted for a 25 basis point cut in the base rate, and one member voted for a reduction of 50 basis points. Thus, by majority vote, the Monetary Council resolved to reduce the central bank base rate by 25 basis points with effect from 26 April 2005.

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

Zsigmond Járai, governor
Henrik Auth
Péter Adamecz
Dr. György Szapáry
Dr. Ilona Hardy
Judit Neményi
Bánfi Tamás
Dr. Péter Bihari
Vilmos Bihari
Dr. Csaba Csáki
Dr. Béla Kádár
Dr. György Kopits
Dr. Gábor Oblath

Dr. Tibor Erhart, 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 23 May 2005. The minutes of that meeting will be released at 14:00 on 10 June 2005.