MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 20 JUNE 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

Following rises in the preceding two months, inflation again began to fall in May 2005: consumer prices were 3.6% higher on average than a year previously, core inflation being 2.1%. These declines in the annual price indices were caused mainly by the base effect; however, trend inflation developments were also a contributing factor. By contrast, the further acceleration in the rate of unprocessed food price increases over the past three months has put upward pressure on inflation.

The decline in the core measure of inflation which began in May 2004 continued in the month under review. Based on monthly price indices, which allow for a more detailed analysis, developments in core inflation in the past 18 months, and the three months to May in particular, reinforce the view that the negative inflation outturns in the early months of the year were caused, in part, by transient influences, although overall developments in supply and demand clearly imply a lower inflation environment.

In May 2005, the annual index of tradables prices did not rise, which had not occurred since 1992. In addition to the appreciation of the forint in 2004 and stabilisation of the exchange rate, disinflation of tradables prices may also be supported by historically low imported tradables price inflation, which is presumed to be closely related to the effects of strong import competition from Asia and the earlier relatively strong euro exchange rate.

Based on monthly developments, inflation of market services prices practically levelled off in May relative to April, fluctuating narrowly around 5% in the past six months. Developments in this price category may be influenced mainly by lower consumption growth relative to earlier years and by the slower-than-previous rise in wage costs.

The outturn for processed foods inflation was again negative in May, interrupting the increase in prices experienced in April. Declines in this price category since early 2005 may be explained by developments in the forint exchange rate in the past 18 months, the pick-up in competition since Hungary's EU accession and the fall in unprocessed food prices in 2004 H2.

Prices of unprocessed foods rose significantly in the three months to May, affected mainly by developments in the prices of seasonal foods. This rise in prices was not a regional phenomenon: unprocessed food prices did not increase in neighbouring countries (co-movements in unprocessed food prices in Hungary and its neighbours tend to be historically low). Shrinking domestic supply may have been in the background of this rise in prices, which low import competition, characterising this product category, failed to offset. However, the decline in pork prices, undisturbed for more than a quarter, gathered momentum in May, which had a countervailing effect.

The tobacco price increases, announced by manufacturers in May, were only slightly reflected in statistical data.

The slightly higher-than-expected outturn for the consumer price index in May was explained in large part by rising unprocessed food prices. The higher overall level of prices, caused by the increase in unprocessed food prices, is expected to persist over the remainder of the year; however, further shocks are unlikely to occur. One-off shocks from certain categories excluded from the core measure of inflation in May are only likely to put upward pressure on prices in 2005, and are not expected to affect the path of inflation over the longer term. Movements in expected oil prices in the last month, which were downwards in the near term and upwards in the medium term, are on balance an upward risk to inflation.

Partly offsetting these developments, modest growth in domestic demand, contributing to the low inflation environment, appears to continue. The latest developments in the labour market were supportive of low inflation from the cost side through lower cost-push inflationary pressure and moderating demand for labour. The April data for numbers in employment and February-April unemployment figures both suggest a decline in labour demand, as expected earlier.

According to the annual indices derived from seasonally adjusted data, the decline in private sector wage inflation continued. Weak labour demand, simultaneously increasing labour supply and the steady decline in inflation expectations may have been in the background of this fall in the rate of wage growth. However, the seasonal pattern of bonus payments in 2004 was different from that of previous years, which makes it more difficult than earlier to evaluate data.

GDP grew by 2.9% in 2005 Q1 year on year (by 3.5% after adjusting for leap year effects). Within this, the various components of GDP reveal contrasting developments. On the output side, growth in manufacturing value added was slightly lower than expected, which, however, was offset by better performance in the services sector and construction. On the expenditure side, the balance of risks to net exports and gross fixed capital formation is on the upside, consumption expenditure showing symmetrical risks.

Information available on business cycle developments (external demand, April industrial output and foreign trade data) are very contradictory – they do not rule out the possibility of a slight, and presumably only temporary, pick-up in the second quarter. Output and foreign trade data for April are evidence of faster growth following the slowdown in Q1; and imports began rising after a period of stagnation. Nevertheless, April data suggesting a pick-up may prove, in the main, transient. Recent information regarding external demand, a factor the most profoundly affecting domestic economic activity, appears to firmly corroborate this outlook. Accordingly, growth in Germany and the euro area may have picked up in Q1, but German imports saw a decline. Neither confidence indices nor the European Commission's economic projection for Q2 suggest a pick-up in business activity over the near term.

The government deficit was HUF 128 billion in May, which meant that the deficit in the first five months of the year amounted to more than 80% of the annual deficit in the forecast by the Ministry of Finance. There has been little change to the picture of factors pointing to a deficit significantly above target.

According to the Reuters survey, inflation expectations increased marginally in June, edging away a little from the MNB's May inflation projection. Median expectations of inflation were 3.9% for end-2005 and 3.5% for end-2006. All forecasters projected inflation to be within the Bank's target range in both 2005 and 2006.

Willingness to take risks internationally increased perceptibly in May, with a shift in investor demand towards higher-yielding emerging-market assets.

A number of factors played a role in the improvement in global investor sentiment. First, corporate bond spreads began falling after rising in the preceding two months, which improved assessments of higher-risk investments. Consistent with this, spreads in emerging markets fell somewhat. Second, although long-term US yields were virtually static at their April level, there was an improvement in market sentiment. An explanation for this is that investors attached greater likelihood than earlier to the US economy growing at its potential growth rate without an increase in inflationary pressure. Third, following rejection of the European Constitution by voters in France and the Netherlands, long-term euro yields fell, and the euro depreciated against the major currencies as well as against those of non-euro area Member States. As uncertainty surrounding the common economic policy of the EU was mainly in the background of the depreciation of the euro, the nearly 4% appreciation of the dollar against the euro in two weeks did not lead to a depreciation of emerging-country currencies, unlike in the preceding months.

Improved willingness to take risks triggered exchange rate appreciation and buying of bonds in the region. Hungary's underlying economic fundamentals continue to leave the exchange rate virtually unaffected – credit downgrade and risks to external and internal balance are mostly reflected in the persistently high long-term forward premium of around 200 basis points. The forint strengthened to EUR/HUF 247–248 from 255 at end-May. In early June, non-residents stopped selling forint assets which they had started in March: portfolio investments in the amount of nearly HUF 80 billion flowed into Hungary over a period of two weeks. Non-residents purchased short and long-term government paper alike, with the yield curve shifting lower by 30–50 basis points.

Accompanied by conducive market sentiment and exchange rate appreciation, expectations of further official interest rate cuts intensified. Whereas market participants expected only a 25 basis point reduction at end-May, a total 50 basis point reduction was priced into the yield curve at the beginning of June. According to the Reuters survey of economists, the overwhelming majority of analysts and dealers in the foreign exchange market expected a cut of 25 basis points in the base rate at the Monetary Council's meeting on 20 June. After stagnating in the March-May polls, the expected base rate for the end of 2005 and 2006 respectively fell by 33 basis points and 23 basis points on average. The interest rate expected for the end of 2006, at 6.3%, is 20 basis points lower than market expectations priced into the yield curve.

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

After considering the latest macroeconomic news and financial market developments, Council members discussed the opportunity of reducing the base rate by 25 basis points.

They agreed that economic data which had become available since the latest meeting did not materially alter the picture of the domestic economy. Both upside and downside risks to inflation were discernible, with certain contrasting factors offsetting each other. Inflation was likely to be stable close to target over the period ahead; in addition, overall, the inflation targets of 4%±1% and 3.5%±1% for end-2005 and end-2006 respectively could be met.

Several members of the Council interpreted it as an important news in respect of wage developments and the fall in inflation expectations that core inflation had been on a sustained downward trend in the past one year and appeared to have stabilised at low levels recently. They pointed to the fall in inflation expectations and the permanence of a low inflation environment as critical factors facilitating the continuation of the disinflation process. Although developments in the prices of unprocessed foods might increase CPI inflation, they would not affect the trend of inflation over the medium term and so, on the time horizon relevant for monetary policy, they would not put the end-2006 inflation target at risk. According to some views, more intense market competition resulting from Hungary's EU accession may have played a role in the apparently sustained fall in tradables inflation.

Demand factors, determining inflation, appeared to remain under control, contributing to meeting the inflation targets. First-quarter GDP data were consistent with the expected slowdown in consumption demand. Labour market developments were also judged to support disinflation: in addition to an easing in labour market tightness, wage developments also appeared to improve the prospects for a general and sustained adjustment in expectations to the low inflation environment. GDP data and developments in external equilibrium were fully consistent with earlier expectations.

Some members noted that the assessment of the outlook for general government finances had not altered. They stressed that the recent changes to the method of government accounting left the permanently high general government borrowing requirement unaffected. A view was expressed that, although no material change in the general government borrowing requirement could be expected in 2005, by taking one-off measures the deficit on an ESA basis could turn out to be close to target.

The strengthening of the dollar and oil price rises were likely to put upward pressure on inflation. The future outlook for business activity was an offsetting factor – no signs of a sustained upturn in Hungary's European trading partners had emerged as yet. However, as an effect of several factors, the deterioration in market sentiment since March had reversed in the past month. The markets' assessment of the future outlook for interest rates in developed markets was biased towards lower interest rate levels relative to earlier expectations, caused, among other factors, by weaker business prospects. This meant the attractiveness of higher-risk assets had also increased and, with the rise in risk appetite, risk premia had fallen in recent weeks. Based on this, confidence in the region, and in Hungary in particular, appeared to be stronger than in the preceding 2–3 months. Members of the

Council pointed to the slight pick-up in non-residents' demand for longer-term government securities and the increase in their holdings of forint-denominated paper as important developments.

Several members of the Council noted external factors which needed to be treated with caution. Although foreign investors' increased demand and the rapid build-up in household foreign currency debt reduced the country's dependence on portfolio capital inflows over the near term, volatility in global money and foreign exchange markets and uncertainty surrounding the assessment of US economic fundamentals had increased in recent months. Over the longer term, the danger remained that the Hungarian money and foreign exchange markets could react sensitively to adverse changes in the international investment climate, due to the existing risks to economic balance.

Council members attached different weights to the above arguments, but agreed that the improving prospects for a further fall in inflation, coupled with the positive change in the external environment, created a case for an interest rate reduction. However, several members stressed that, due to the existing uncertainties, an interest rate cut in excess of the proposed 25 basis points at the current meeting was not possible. In their view, a 25 basis point cut would be consistent with both the inflation targets and expectations.

The Chairman invited members to vote on the proposition that the base rate should be reduced by 25 basis points. The Council unanimously voted in favour of the proposition.

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
Judit Neményi
Tamás Bánfi
Dr. Péter Bihari
Vilmos Bihari
Dr. Csaba Csáki
Dr. György Kopits
Dr. Gábor Oblath

Dr. Ilona Hardy and Dr. Béla Kádár were 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 18 July 2005. The minutes of that meeting will be released at 2 p.m. on 12 August 2005