MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 18 JULY 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

Consumer prices were 3.8% higher in June than one year previously, with a year-on-year core inflation rate of 1.9%. Whereas the outturn for the latter was mainly in line with expectations, price increases in categories excluded from the core measure of inflation, notably unprocessed foods and vehicle fuel, turned out materially higher than projected earlier.

In Q1, household consumption expenditure grew at a rate of 2.0% (2.4% in seasonally adjusted terms). This rate was even lower than last year's figure, which was recently revised down by the Central Statistical Office, indicating a considerable slowdown in expenditure growth. The rise in unemployment may also have reflected a stronger emphasis on precautionary motives, which – simultaneously with a constraint on consumer demand – may have played a role in the higher-than-expected outturn for household financial savings in the first quarter. Although the time series are extremely noisy, retail sales data for March-April, which point to a slight pick-up in turnover, contribute somewhat to the picture of expected future developments in consumption.

Adjustment by the corporate sector to the low inflation environment appears to be continuing. According to March-April wage data, average wages grew at a slightly lower rate relative to the moderate growth estimate in the Bank's latest *Quarterly Report on Inflation*. This falling wage growth may have been caused by continued weak demand for labour and the apparent increase in the supply of labour as well as by the gradual decline in inflation expectations. Rising participation rates, accompanied by static employment, and modest demand for labour, have led to a stronger-than-expected increase in the unemployment rate in recent months.

Output and foreign trade data for the period March-May contain evidence of steady gains in corporate performance, with manufacturing functioning as the backbone of growth in recent months. This robust activity in manufacturing is consistent with the increasingly robust rise in new orders for manufacturers' output over the past few months. However, the strong improvement in industrial output in the three months to July is unlikely to continue over the coming months, as it is considered, in part, to be a correction to the slow increase in the first quarter. This view is further corroborated by available information, which provides a contradictory picture of business activity in Hungary's major trading partners.

Judging from available information, the Government's prospective measures will have a considerable impact on future inflation developments. Accordingly, in 2006 the officially announced reduction in VAT rates is expected to result in a lower CPI relative to the earlier projection for a transient period. The 5 percentage point reduction in the maximum VAT rate, offset by increases in other indirect taxes in certain areas, is likely to temporarily reduce the CPI by 1–1.5 percentage points in 2006 as a result of direct, technical effects, depending on the degree of adjustment by the corporate sector and the strength of market competition. However, the reduction in VAT and the planned increase in the minimum wage, also announced by the Government, are likely to put indirect upward pressure on inflation over the longer term. In addition, prospective fiscal easing, which will mainly affect households in the form of changes to personal income taxes and the family benefit scheme, to be implemented in 2006–2007, may generate demand-pull inflationary pressure in 2007.

Government deficit data for June suggest that the risk of a higher borrowing requirement relative to the forecast in the latest *Report* has increased further. The risk that this year's deficit might rise above the official target stems from a combination of expected higher government expenditure and lower-than-projected VAT receipts.

In 2005 Q1, Hungary's external financing requirement was somewhat more favourable than expected. This lower external borrowing requirement was caused, in part, by higher net financial savings of households. However, in terms of risk perception, the structure of financing has shifted in an unfavourable direction, as non-debt generating financing has fallen near to 40% as a proportion the total.

In addition to the favourable international investment climate, moves in the forint market were shaped by strong global purchases of bonds in June and a subsequent market correction in July. In market participants' assessment, the outlook for future inflation has improved, while fiscal prospects have worsened, coupled with a slight improvement in external balance. Against this background, long-term forward premia have fallen, although the comparable fall in Polish premia also reflects the dominant role of the external environment.

Willingness to take risks around the world has increased in recent weeks. Market volatility has fallen and risk indicators, relevant for forint-denominated assets, have stagnated or improved slightly. The effects on financial markets of the terrorist attacks in London have been limited, as international investors' risk appetite remained unaffected.

Euro yields have stabilised at historically low levels, as the prospects for growth continue to be the major risk to the region. At end-June, the market began to price the possibility of an interest rate cut into short-term yields. This, however, was priced out of the market by mid-July. Investors expect the current level of key interest rates to be maintained over the coming months. Sovereign yield spreads across euro area countries have continued to widen.

The Fed raised its target for the federal funds rate by another 25 basis points at end-June. In its statement, which was nearly identical to the May press release, the FOMC provided a positive assessment of economic conditions and raised the prospect of gradual tightening. Despite the continued rise in costs of dollar-based financing over the recent period, investors have not reduced their exposure to emerging markets; however, their demand for forint-denominated government paper has fallen considerably in July relative to the preceding month. Associated with a benign international environment, the exchange rate has appreciated towards EUR/HUF 246, the highest level in three months.

The long-term forint forward premium has fallen to 165 basis points from 200 basis points two months earlier. Analysts' consensus forecast is for the central bank base rate to be 5.75% at the end of 2006, which is 50 basis points lower than in the June Reuters poll, while their expectation for the exchange rate has remained practically unchanged.

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. Based on the external environment which was judged to be exceptionally favourable, the case of a 50 basis point reduction was also considered; however, due to concerns over economic balance and rising uncertainties in certain areas, arguments in favour of leaving interest rates unchanged were also put forward.

Of the various pieces of information which had become available since the previous rate-setting meeting, several members noted the continued decline in core inflation. The path of core inflation over the period of one year and the fall in inflation expectations were judged to be clearly reassuring. Developments in the prices of goods included in core inflation were also considered to be supportive of general disinflation. This was seen as a factor contributing to the reduction in inflation expectations. Fresh economic data appeared to corroborate the view that moderate consumption growth as well as wage and employment adjustment in the labour market might be expected to remain important factors in the current economic environment, facilitating the maintenance of low inflation. Based on the outlook for economic activity in Europe, neither external demand nor imported inflation threatened to increase inflationary pressure. However, the widening gap between the consumer price index and core inflation due to food and energy prices was noted as a risk representing a degree of uncertainty about the currently benign outlook for inflation.

In the Council's evaluation, the favourable international investment environment, characterised for a longer period by a steadily strong risk appetite, and the recent improvement in risk assessment in the region and Hungary in particular, were positive signs. Several members emphasised that, for the first time after a protracted period, the fall in long-term yield spreads had also played a role in the decline in long-term forint yields. This contributory factor alone would not rule out an interest reduction of more than 25 basis points.

Some members noted Hungary's lower-than-expected external financing requirement and households' higher net financial savings in 2005 Q1 as favourable developments.

There was unanimous agreement that the expected outturn for the fiscal position and its effect on market sentiment were the most important risk factors. Several members stressed that a rate cut of more than 25 basis points was not appropriate at the current meeting; and they also raised the possibility of leaving interest rates unchanged.

The Government's announced plan to lower VAT rates was also considered. Members of the Council were of the view that the prospective measures might push the consumer price index significantly below the target in 2006, following which inflation might return to its original path in 2007. On this view, members agreed that monetary policy should continue to monitor developments determining inflation over the medium term and that it should not react to short-term effects on the price index. They were of the opinion that, even in the current favourable environment, certain risks stemming from developments in global financial markets and internal balance should be taken account of. Consequently, close attention should be paid to risks arising from a potential deterioration in risk appetite when taking monetary policy decisions. Although the market's initial reaction was favourable, in some views the Government's announced fiscal measures would not reduce uncertainty surrounding the assessment of the medium-term outlook for economic balance.

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. Ilona Hardy
Judit Neményi
Tamás Bánfi
Dr. Péter Bihari
Vilmos Bihari
Dr. Csaba Csáki
Dr. Béla Kádár
Dr. György Kopits
Dr. Gábor Oblath

Dr. György Szapáry 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 22 August 2005. The minutes of that meeting will be released at 2 p.m. on 9 September 2005.