MINUTES

OF THE MONETARY COUNCIL MEETING

OF 27 FEBRUARY 2006

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 January 2006, the consumer price index increased by 2.7% year on year, down 0.6 percentage points on December. Core inflation rose by 0.5% in the year to January, after falling by 0.8 percentage points relative to the preceding month. The reduction in VAT rates was the primary source of the decline in the annual consumer price index. According to the release by the CSO, the constant tax price index – which tends to overestimate underlying inflation developments – rose by 4.0% year on year. Data on inflation performance are ambiguous: temporary shifts currently cannot be distinguished from lasting developments. The decline in tradables prices proved less than justified by the tax cut, which, however, may have been explained by the longer timeframe required by the VAT reduction to feed through to prices, rather than by a reversal in the trend in tradables price inflation. This hypothesis may be underpinned by the fact that processed food prices, which are basically unaffected by the tax cut, but – similarly to the case of tradables – are highly exposed to import competition, continued to decline strongly over the period. In January, however, inflation in market services prices, which had been high for a long period of time, moved against the earlier trend and declined sharply, possibly signalling improvement in economic agents' sentiment about future inflation developments. This view is also underscored by the MNB's survey, according to which households and firms' inflation expectations fell significantly in early 2006 relative to previous quarters. The February review of the November 2005 issue of the *Quarterly Report on Inflation* did not identify any material changes in the overall outlook for longer-term inflation developments. In the latest projection for end-2007, inflation is near the level implying price stability; however, upside and downside risks have both increased, after the incorporation of recent information.

Private sector wages grew by 6.9% in 2005. After adjusting for seasonal effects, nominal wage inflation has been moving downwards since early 2004, in line with gradually subsiding inflation expectations. As a consequence of the pick-up in industrial activity, growing labour supply and the continued slack demand for labour, wage-push inflation pressure was not discernible in the corporate sector in 2005. Real labour costs rose broadly in tandem with firms' productivity, suggesting much more balanced labour market developments compared with earlier years. However, the upward effect on wage inflation of the minimum wage increase in early 2006 represents a risk in the period ahead.

According to Ecostat's flash estimate, Hungary's gross domestic product grew by 4.1% in 2005 Q4. GDP growth was 4.1% in 2005 year on year (4.3% after adjusting for the calendar effect). Although the rate of growth slowed somewhat in 2005 Q4 relative to earlier quarters, it remained robust in comparison with the past few years. Looking forward, the prospects for economic growth have improved, due to slightly better economic conditions both abroad and at home. In the updated forecast, GDP continues to grow steadily at a rate above 4% in the next two years.

Retail sales are a reliable gauge of future developments in household consumption, the main component of domestic demand. Their volume rose by 7.8% in November, reflecting the recovery in retail trade which has been underway since mid-2004. This growth in retail sales volume may be explained by three factors: (i) the improvement in households' sentiment about economic activity, (ii) the fall in prices of certain products, particularly tradables and foods, and (iii) the continued expansion of consumer credit.

The vigorous trend rise in industrial and manufacturing output continued in December, after stalling briefly in November. As a result, output growth was 7.3% in 2005 as a whole. However, these developments should be treated with caution, given lower growth in manufacturing sales relative to output growth in December, explained by the slowdown in exports. Growth in foreign trade also slowed: the estimated trends of exports and imports

both grew at lower rates than in earlier periods. However, currently this development is viewed as temporary for two reasons. First, it did not correlate well with information received about lively economic activity in external markets. Second, industrial output and foreign trade data tend to be volatile in December.

The goods trade deficit amounted to EUR 2.8 billion in 2005, falling by more than EUR 1.1 billion relative to the previous year. Half of this improvement was attributable to the upward 'base effect' of one-off factors on imports in 2004. However, foreign trade developments in 2004–2005, and particularly the moderation in import growth, continue to be contradictory in respect of the internal consistency of GDP and financial accounts data, and thus caution is still required in evaluating the improvement in the trade balance.

The favourable international investor sentiment which characterised the start of the year continued in February. Emerging-country risk premia continued to decline from their historically very low levels. Particularly large volumes of capital flowed into emerging-country bond markets in the first half of the month, as investors seeking higher yields increasingly turned their attention to local currency-denominated debt of emerging countries, in response to low yields in major markets, narrow spreads on sovereign foreign currency debt and good performance of emerging-country currencies over recent months. The depreciation of the U.S. dollar and the expected tightening of monetary conditions in major markets did not cause a deterioration in investor sentiment about emerging markets. Data released over the past month have indicated improved economic prospects in Europe and the USA. Consequently, in market participants' view the tightening cycle may take longer than previously assumed. Based on the shape of the yield curve, the market expects the ECB to raise official rates by 25 basis points by March and by another 50 basis points by the end of the year. The market has also priced in a 25-basis point increase by the Fed at end-March and anticipates another 25-basis point increase by mid-2006, with the current tightening cycle expected to peak at 5%.

Despite the political uncertainties, the Central European region continued to attract investors; however, developments in Hungarian asset prices shifted away from those in other markets of the region. Whereas currencies in the neighbouring countries continued to appreciate and yields fell, the forint exchange rate fluctuated in a narrow range between 250.00–253.00 vis-à-vis the euro and long-term yields rose from their level in the preceding month. This weakening of forint-denominated assets relative to those in other markets of the region was closely related to the downward revision by the rating agency S&P of its outlook for Hungary's long-term foreign currency debt at end-January. S&P noted that it would go on to lower Hungary's rating, if no signs of a significant and sustained deficit and debt reduction strategy emerged after the general elections in April 2006. This announcement triggered a more than 1% weakening in the exchange rate and a 40 basis point rise in yields, which was only partially corrected even despite the very favourable regional climate for investments. The announcement by Moody's that it had lowered its outlook for Hungary's long-term debt on 22 February led to an immediate weakening of 1.5 forints vis-à-vis the euro. Explaining its move, Moody's referred to the failure of the two main political parties to show commitment to bring down the government deficit and implement reforms. The five-year forward premium five years ahead stabilised at a high level around 225–250 basis points. As the Polish forward premium had fallen significantly in the past three months, the gap between the Hungarian and Polish forward premia rose above 170 basis points, a historical high.

Non-resident investors stopped buying the forint spot at end-January. Earlier, purchases were presumably related to closing short positions against the forint taken in the final months of 2005.

Non-residents stepped up their purchases of government securities, with total holdings exceeding the preceding month's level (HUF 2,600 billion) by nearly HUF 100 billion. These

purchases were financed mainly by swaps, i.e. investors did not undertake exchange rate risks. The auctions conducted in 2006 to date showed that non-residents were willing to absorb increased supply in the primary market, but at a slightly higher level of yields.

Market participants' short-term interest rate expectations rose slightly during the month. Currently, the yield curve is consistent with a total interest rate increase of 25–50 basis points over the period to the end of 2007 and with another 25-basis point increase next year. According to the Reuters poll, market economists and currency dealers unanimously expect the Monetary Council to keep interest rates on hold in February. The average of analysts' forecast is around 6%, although expectations are widely dispersed.

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

After discussing the latest macroeconomic news and financial market developments, the only proposition offered to the Council was to leave the base rate unchanged.

Several members noted that, although recent developments in wages and surveys of households' inflation expectations pointed to weaker inflationary pressures, the inflationary effects of a necessary fiscal adjustment in the future due to the deteriorating fiscal position currently could not be estimated. The extent to which the VAT cut would affect developments in trend inflation could not be determined based on the January data, which added to uncertainty surrounding the evaluation of trend inflation. The projection close to target and higher uncertainty were two reasons to wait and see.

Members agreed that the recent stability of the risk premium and the exchange rate had been the result of a peculiar equilibrium: the effects of market risks due to the significant domestic imbalance and the favourable external financing environment had been offsetting. Several members stressed that, while the international climate for investments had become more favourable over the recent period, investors' assessment of risks associated with Hungarian investments had not improved, due to the existing risks to domestic economic balance. This had also been reflected by the depreciation of the forint relative to other currencies in the region and by the increase in the long-term interest rate premium. For this reason, in the future domestic markets might react very sensitively to a potential deterioration in the global investment climate.

Several members were of the opinion that the favourable outlook for inflation alone would allow for a modest interest rate reduction. Favourable developments in household savings and the fall in inflation expectations appeared to support this view. However, shifts in investor sentiment and the volatility of the interest rate premium which had been amplified by rating agencies' recent warnings currently called for caution by the Bank and, therefore, it was appropriate to keep the key interest rate unchanged. Accordingly, supporters of this view also did not make a proposal to change interest rates.

A debate developed among the members regarding the future path of interest rates. Several members took the view that the current high levels of real interest rates and the interest rate premium by international standards were justified by domestic risks to economic balance. They drew the Council's attention to the fact that in a historical perspective nominal and real interest rates had recently been very low in major international markets and that domestic yields only appeared to be high in this context. Others were of the view that forint interest rates were still higher than warranted and, consequently, the easing cycle since 2003 had not yet ended, with the outlook being highly dependent on the strengthening of market confidence. Signs of this had already emerged (e.g. purchases by non-residents of government

securities, the stability of the exchange rate); however, as the supporters of this view thought, an interest rate reduction would now be too early and would give a false signal to markets.

Members agreed that, due to the high government deficit and the deterioration in fiscal transparency, the vulnerability of the Hungarian economy had not diminished recently. Under the circumstances, monetary policy had to exercise particular care, after having contributed strongly to financial market stability by virtue of its predictability. Nevertheless, the real solution would be if credible adjustment measures were taken to strengthen fiscal discipline.

The Chairman invited members to vote on the proposition that the base rate should be left unchanged at 6.00%. The Council voted unanimously in favour of the proposition.

Votes cast by individual members of the Council

In favour of leaving the base rate unchanged at 6.00%	**13**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Péter Bihari, Vilmos Bihari, Tamás Bánfi, Csaba Csáki, Ilona Hardy, Béla Kádár, György Kopits, Judit Neményi, Gábor Oblath, György Szapáry

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

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

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 20 March 2006. The minutes of that meeting will be released at 2 p.m. on 14 April 2006.