MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 JULY 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 June 2006, the consumer price index rose by 2.8% year on year. Core inflation was up 1.3%, reinforcing the picture of faster-than-expected rises in inflation, for which May's data provided early evidence. The trend inflation indicator, which is based on month-on-month percentage changes in the CPI and eliminates the effects of the indirect tax increase in early 2006, rose gradually from a low level in 2005 to above 4% in 2006. Indicating the brisk pace at which inflation has been rising recently, virtually all of the important components of core inflation picked up. Processed food prices have risen significantly in the past two months, and the latest data suggest that the decline in market services price inflation, which had been observed in 2006 to date, may prove less pronounced than previously thought. In contrast with the previous quarter, industrial goods prices did not fall much in Q2. In addition, short-term developments in inflation have recently been influenced unfavourably by items excluded from the core measure of inflation. Rises in unprocessed food prices proved greater and more sustained than expected, and motor fuel prices continued to increase as well.

The slowdown in the robust growth rate of industrial output, observed in 2005, continued in May; however, this mainly affected the industries producing for the domestic market, while manufacturing firms producing for exports continued to register strong sales growth. Hungary's foreign trade grew at a stable rate (exports rose by 20.6% and imports by 19.7%), which was comparable with the growth rate recorded in Q1. Consequently, the slowdown in April is seen as temporary and may be attributed to the noisiness of the time series. The goods deficit was some EUR 100 million lower in January-May 2006 than in the same period of 2005, explained (i) by the uninterrupted expansion of exports, led by the recovery of external business activity, and (ii) by moderating import growth, consistent with the slowdown in domestic demand. Uncertainties remain regarding the health of domestic economic activity: while the drop in domestic demand and the slowdown in industrial output growth suggest that a near-term trend reversal may be in prospect, foreign demand and thus exports continue to show few signs of a considerable slowdown. This dual process may be further aggravated by the weaker exchange rate providing a boost to exports and by the recent fiscal measures acting as a drag on domestic demand.

Labour market statistics for March-May reflected rising activity and employment, with the seasonally adjusted unemployment rate falling. Despite this, however, it still remains to be seen whether employment will rise or stagnate in the near future. Private sector earnings data for May point to lower wage inflation in the short term. An explanation for this is that the shock caused by the minimum wage increase early in the year was followed by a somewhat stronger-than-expected correction, with the services sector being the most affected. Overall, the immediate effects of the minimum wage increase and the subsequent correction both proved stronger than thought earlier. However, these are seen as transient effects and are unlikely to influence longer-term developments.

The decline in investors' risk appetite in international financial markets continued over the period to end-June, followed by a correction in July. In addition to further rises in interest rates in major markets, global geopolitical risks and uncertainties in Central and Eastern Europe continued to increase. All of this contributed to the forint exchange rate weakening to a historic low in the domestic market at end-June, and to significant rises in government securities yields and in spreads on foreign currency-denominated debt.

At its policy meeting in July, the Governing Council of the ECB left key European interest rates unchanged, in line with expectations. However, the markets used the Council's communication of its action to price in another rate increase for the beginning of August. Earlier, participants expected the ECB to raise interest rates by 25 basis points each quarter; however, a rate increase in early August would signal a departure from this path. Acceleration of the tightening cycle and the continued strength of business indicators raise the possibility that the ECB's current tightening cycle may peak at a higher level than 3.5%, priced into the current yield curve. In the US, the FOMC raised the federal funds rate for the sixteenth time in a row at end-June. The markets expect another rate hike in the following two months, with the current tightening cycle possibly peaking at 5.5%. With this, the nearly one-year long rise in US long-term yields, which has affected emerging country assets negatively, may come to an end. However, new macroeconomic data could prompt sharp market reactions, especially if they point to an increase in upside risks to inflation, and so to further potential interest rate rises. In July, the Bank of Japan also raised interest rates and abandoned its zero interest rate policy which it had pursued for five years.

The escalation of the Middle-East conflict was another source of uncertainty for markets. As an effect, there was a shift in investors' demand towards lower-risk assets. Funds withdrawn from equity markets were transferred mainly to government paper and US dollar-denominated assets, which led to a fall in long-term yields in major markets and dollar appreciation in the first part of July. Another consequence of increasing geopolitical risks was the rise in commodity prices. The spot price of Brent crude oil surged to historic highs, close to 77 dollars per barrel. Market participants are focusing on the inflationary risks of oil prices possibly sticking at high levels, rather than on the risks that they would rise even further, which, in turn, may lead to intensifying expectations of interest rate hikes around the world.

Political risks in Central and Eastern Europe increased, with market sentiment towards the entire region deteriorating. Investors judged the outcomes of the Czech and Slovak parliamentary elections held in June as unfavourable. In Poland, the Prime Minister and the Minister of Finance resigned in July. Investors now expect interest rates to be raised in all three countries. The Slovak koruna came under selling pressure, in addition to the Hungarian forint and the Polish zloty. The National Bank of Slovakia attempted to put a brake on the depreciation of the koruna by intervening in the foreign exchange market (Slovakia has been a participant in ERM II since November 2005). But despite the heavy intervention, the currency weakened to levels below its central parity.

In Hungary, the weakening of the forint continued even after the increase in official interest rates in June, with the exchange rate falling to a historic low of 285.00 against the euro by the end of the month. Over June as a whole, the forint lost over 7% of its value. The exchange rate underwent a correction in July, after Parliament passed a bill containing tax increases and the President of the Republic gave his approval. The weakening was accompanied by an unprecedented scale of selling of the forint by non-resident participants. The Bank estimates that, initially, the bulk of this was related to equity sales and hedging forint exposures and, later, increasingly to taking positions against the forint. The outflow of funds slowed down in early July, with non-residents once again emerging as net buyers of shares. However, their holdings of Hungarian government securities were little affected during the period of exchange rate weakness.

The uncertainty about the forint also spread over to the government securities market. Yields continued to rise in the second half of June, with the middle of the yield curve shifting up by 100 basis points. Due to dwindling demand, the Debt Management Agency sold lower quantities of treasury bills and bonds than announced in advance of the auctions. However, long-term yields fell by nearly 50 basis points over the period to mid-July, simultaneously with the strengthening of the exchange rate. The forint depreciation caused expectations of interest rate rises to increase significantly. The market priced a 8.25% year-end official interest rate into the yield curve in early July. That was 175 basis points higher compared with a month earlier. A group of market participants expected the Bank to raise interest rates at its meeting on 3 July. Some interpreted the reference to 'raising the base rate gradually' in the press release on the meeting as implying that the Bank would implement a series of interest rate increases in steps of 25 basis points. Simultaneously with the exchange rate appreciation in July, market expectations of interest rate rises waned. Currently, the yield curve is consistent with a 7.5% and a 7.75% base rate at end-2006 and end-2007 respectively. According to the latest Reuters survey, the majority of market economists and currency dealers expect the Monetary Council to raise interest rates by 25 basis points at its meeting on Monday, with a minority expecting a 50 basis point increase. Analysts' forecasts are for the exchange rate to appreciate to EUR/HUF 270.00 by end-2006 and to EUR/HUF 260.00 by end-2007.

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 raise the base rate by 50 basis points.

Members agreed that inflation was now on an upward trend, and that the most recent data appeared to confirm this view. Most of the components of core inflation pointed to higher inflation in the period ahead, which helped to sustain this unfavourable process. The risk had increased that one-off price rises, related to the budgetary adjustment, might precipitate an increase in inflation expectations and, as a consequence, inflation might be propelled onto a higher path. The sustained weakness of the forint added to this risk.

In the Council's evaluation, the current monetary conditions would not allow the Bank to reach the 3% inflation target in 2008. For this reason, there was a need to raise the central bank base rate further, as the Bank had announced.

Members also agreed that, in addition to the above considerations, raising the Bank's key policy rate was also made necessary by the fact that major central banks continued their tightening cycles, which had weighed on investors' willingness to take risks in recent months and had triggered official interest rate increases by a wide range of emerging country central banks. Increased political uncertainty in countries of the CEE region had also acted to reduce investor demand for Hungarian financial assets.

For some members, the supporting argument for a 50 basis point rate increase was the Bank's commitment to low inflation in the current circumstances. Others noted that, at a time when investors' mood was changing rapidly, a higher interest rate premium could mitigate the risk of wider swings and therefore it could have a stabilising effect on domestic financial markets.

Several members were of the view that falling forint demand, the increased volatility of the currency and rises in yields in major foreign exchange centres might even justify a 75 basis point rate increase; however, that would be inconsistent with the Bank's proclaimed gradual approach, and so it would undermine interest rate policy credibility. The forward-looking nature of inflation targeting made it possible for the Bank to alter the central bank base rate in a series of steps at its pre-announced meetings each month.

As for the future outlook, it was argued that the developments in emerging markets in recent months, and in particular the assessment of risks associated with forint-denominated investments, had changed favourably, which helped to meet the inflation target, independently of the Bank's interest rate move. On another view, the correction in financial markets in recent weeks appeared to be relatively weak, and a number of factors continued to add to risks.

There was agreement that, in line with the Monetary Council's policy statement of 3 July, it was prudent to increase the base rate gradually, in a series of steps. This would not only increase predictability for investors but might also minimise the risks of a potential overshooting. There was a debate, however, on how to interpret the tightening cycle in the domestic environment. Members agreed that, due to its openness, the Hungarian economy was highly exposed to external shocks and, therefore, the volatility of the interest rate premium did not allow for a degree of predictability which characterised the tightening cycles of developed country central banks. For this reason, the actual size of interest rate moves might change from one meeting to the next, and moreover, leaving the base rate unchanged for 1–2 months would not contradict the announced interest rate cycle. Some members were of the view that future interest rate rises could be decided after the effects of the fiscal measures had been evaluated more accurately and a full-round inflation projection had been produced.

The Chairman invited members to vote on the proposition that the base rate should be raised to 6.75%. The Council voted unanimously in favour of the proposition.

Votes cast by individual members of the Council

In favour of raising the base rate to 6.75%	**12**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Tamás Bánfi, Vilmos Bihari, 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 Tamás Bánfi
Vilmos Bihari
Dr Csaba Csáki
Dr Ilona Hardy
Dr Béla Kádár
Dr György Kopits
Judit Neményi
Dr Gábor Oblath
Dr György Szapáry

Álmos Kovács, State Secretary of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 28 August 2006. The minutes of that meeting will be released at 2 p.m. on 8 September 2006.