MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 25 SEPTEMBER 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 August 2006, consumer prices rose at an annual rate of 3.5%. Core inflation was up 2.4% on a year earlier. Both indicators increased significantly, by 0.5 percentage points relative to July. Data for recent months overall provide evidence of a discernible rise in inflation: the seasonally adjusted month-on-month rate of core inflation was 8%–9% in August, in contrast with around 2% characteristic of 2005. Even after eliminating the sharp spike in certain processed food prices in the month, the trend rate of inflation is estimated to be in the range of 6%–7%.

A pick-up in inflation has been observed in every key component of the CPI recently. The strongest increase was in tradables prices in August, partly reflecting the weaker exchange rate over the past few months. Processed food prices have also been rising rapidly, in addition to tradables prices, with the very robust increase in unprocessed food prices during the first half playing a role, among other factors. Services price inflation too has accelerated, which may reflect increased inflation expectations. Overall, the latest inflation data appear to reinforce the view in the *Quarterly Report on Inflation* that significant inflationary pressure may be building up going forward.

Private sector wage inflation picked up in July: gross average earnings rose by 7.4% relative to a year previously. In contrast with the marked correction in subsequent months following the wage shock at the beginning of the year, outturns for the past two months were once again evidence of a pick-up in the rate of earnings growth. Irregular pay (i.e. bonuses) in services, affecting the majority of service providers, accounted for the largest part of the rise in wage inflation. However, the good news is that the latest numbers appear to confirm that the feed-through from the statutory minimum wage increase early in the year was weak.

According to the detailed data, Hungary's GDP grew by 4.1% in Q2, after eliminating the calendar effect, and was up 0.2% on the provisional estimate. Looking at the recent pattern of growth, net exports continued to be the most important component, as was the case in previous quarters. The contribution of net exports to GDP growth has been rising continuously since 2003, reflecting the combined effect of (i) strongly benign external business conditions and (ii) the depreciation of the unit labour cost based real exchange rate since 2005.

Household consumption growth continued to slow mildly in Q2, though it remained a material contributory factor to economic growth. It should be noted, however, that the sharp deterioration in consumer confidence since May is only marginally reflected in second-quarter data. The 3.6% drop in gross fixed capital formation may have been closely related to a downturn in private sector investment activity. And while the decline in housing investment was consistent with the August projection, the behaviour of the corporate sector was a surprise. However, against a background of continued strong growth in industrial output, confirmed by July's data, as well as in exports, the fall in firms' investment activity is believed to be temporary.

July output data do not point to a slowdown in industrial activity. Lively exports, coupled with the robust expansion of domestic sales, explain output growth of more than 10% over a year earlier. Based on the volume of new orders, strong industrial activity is expected to remain in the second half, although the share of domestic sales within growth is likely to increase. According to July data for foreign trade, export growth continued to be significantly faster than import growth. But the effects of these favourable developments on the trade balance have recently been offset in part by a substantial deterioration in the terms of trade. Nevertheless, the current rate of export growth looks set to fall in the future, particularly in the light of the slight softening in European business indicators.

Recently, there has been little evidence of any major trend developing in financial markets. Great uncertainty over growth prospects in the United States and the Fed's interest rate policy has remained, with the effect that market participants have taken a 'wait and see' approach. One major source of risk is the significant slowdown in economic growth caused by the downturn in the real property market, another being the pick-up in inflation and further monetary policy tightening. But the chance that interest rates will be raised has eased somewhat, due to recent inflation data meeting expectations and the fast decline in materials prices. The market currently expects a 25 basis point cut in US interest rates over the period to the middle of next year, which is consistent with the slowdown in the rate of growth, rather than with a recession.

As was expected, the Governing Council of the ECB left key European interest rates unchanged in September, but with a direct hint that rates would be raised in October. Bank staff have revised up their forecast of economic growth and inflation both for this year and next; and the latest macroeconomic data appear to corroborate this view. Market participants are confident that rates will be raised by 25–25 basis points in October and then in December; however, they have not priced in further tightening for next year.

Emerging markets were also characterised by a cautious mood, with market indicators of risk barely changing. Participants who rearranged their riskier investments into lower-yielding liquid assets during the selling wave in May-June began to return in September. However, any sustained rise in demand for higher-yielding assets requires that investors attach a lower probability than currently to the two negative scenarios about economic growth and the path of interest rates in the US materialising. In the absence of such a reappraisal of prospects, in the short term asset price movements are likely to be sideways within a narrow range, showing no clear trend; and any bad news could give rise to vulnerabilities in emerging markets.

Investor's perception of risks in the CEE region overall took a negative turn, explained by increased uncertainty surrounding the adoption of the euro. Whereas previously investors had doubts about Hungary's target date for adopting the euro, in recent weeks there has been an increase in risks to the convergence processes in the Czech Republic, Poland and Slovakia, due to a deterioration in the fiscal outlook. Because of the postponement of euro adoption, a large group of market participants is confident that the rating agency Moody's will shortly downgrade Hungary's debt rating; however, there is a division of views with regard to the size of such a move. Earlier, Moody's upgraded the rating of countries in the region, due to their convergence to the euro area.

The forint strengthened by a total 2% against the euro following the Monetary Council's interest rate increase in August. This was greater than appreciation both of other currencies in the region and higher-yielding emerging country currencies over the same period. Based on the market's reaction, the rate increase fully met expectations. As an effect of the Hungarian Government's adjustment measures, a number of investment banks issued buy recommendations on the forint; however, non-residents' exposure to exchange rate risk barely changed, i.e. the improvement in assessments of future prospects was not associated with significant capital inflows. The domestic political crisis which broke out in mid-September added to the markets' unease, as investors believed the implementation risk of budgetary adjustments might increase. Fitch lowered Hungary's debt to negative, due to the risk that the reform programme could be diluted, and S&P indicated that it would downgrade if the plans to reduce the deficit were abandoned. All this resulted in exchange rate weakening and a rise in yields.

Expectations of an interest rate increase, priced into the yield curve, practically remained unchanged in the past month. Based on the shape of the curve, the market expects a 7.75% and an 8% base rate at end-2006 and end-2007, respectively. According to the Reuters poll, analysts' expectations of an interest rate hike increased: they expect that the base rate will be raised to 8% by the end of this year and that it will peak at 8.15% on average.

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

The Council discussed data which had become available since the August issue of the *Report* and information received about financial markets. The majority of members judged that inflationary pressure was building up in the Hungarian economy, as evidenced by the August inflation figure and Q2 wage statistics. A broadly shared view of the Council was that this development may have been linked in part to a weaker exchange rate compared with the previous year and in part to a deterioration in inflation expectations. Developments in the forward price of vehicle fuel which had been more favourable than expected could only partly offset rises in medium-term upside risks to inflation.

The Council also discussed how investors' assessments of risks associated with Hungarian government securities and the forint exchange rate had changed recently. Based on the evaluation of data, the majority of members drew the conclusion that investors' perception of risks to the Hungarian economy had probably been increased by the domestic political events of the past couple of weeks. Generally, for members the explanation for this was that investors believed it was less certain than before whether the convergence programme could be implemented.

Members were unanimous that, in the circumstances, a tightening of monetary policy was warranted.

Propositions to raise interest rates by 25 basis points and by 50 basis points both were put to the Council.

The overwhelming majority of members argued for a 50 basis point rate increase. Some decision-makers thought that, for the time being, the worsening in the inflation outlook did not justify changing rates or raising them by more than 25 basis points, but because the risk to the implementation of budgetary adjustments had increased, and in consequence the required risk premium on forint investments had risen, a more decisive action was needed. In a market environment which had become more uncertain, the Monetary Council should give clear guidance in order to preserve investor confidence.

Other members explained the need for a 50 basis point rate increase by referring to a build-up in inflationary pressure and the rise in risk premia caused by the September domestic political events. Several members judged that a precondition for bringing the current tightening cycle to an end was that expected movements in inflation over the medium term should be around the 3% target. As there had not been any favourable turn in the inflation outlook or investors' mood since the Council's assessment of conditions in August, slowing the tightening cycle would be premature. In the current circumstances, raising rates by less than 50 basis points would lead to uncertainty and suggest that commitment to the inflation target was waning.

Two Council members argued for a 25 basis point interest rate increase. While not disputing the necessity of raising rates at the current meeting due to the worsening in investors' assessments of risk, they judged that in the situation a 25 basis point increase would be sufficient. One member argued that the effect on inflation of the interest rate increases over recent months could not be measured accurately, and so it would be justified to slow the tightening cycle. In addition, investor sentiment for Hungary was likely to improve again, which might receive a boost from the expected approval of the Convergence Programme by the EU and from the likely improvement in equilibrium indicators in 2007. Furthermore, in relation to the outlook for inflation and the economy, the MNB's forecasts underestimated the restraining effects of fiscal measures on growth, and so they overestimated future inflation. For this reason, the danger was that policy could be tightened excessively. On another argument, there was no reason to raise rates as needed in a single step – if judged necessary, the Council would have the opportunity to decide further rate increases during the remainder of the year.

After the discussion, the Chairman invited members to vote on the two propositions. Eleven members voted for a 50 basis point increase and two voted for a 25 basis point increase. Based on the votes cast, the Council raised the base rate to 7.75%.

Votes cast by individual members of the Council

In favour of raising the base rate to 7.50%	**2**	Péter Bihari, Béla Kádár
In favour of raising the base rate to 7.75%	**11**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Tamás Bánfi, Vilmos Bihari, Csaba Csáky, Ilona Hardy, 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 Péter Bihari
Dr Csaba Csáky
Dr Ilona Hardy
Dr Béla Kádár
Dr György Kopits
Judit Neményi
Dr Gábor Oblath
Dr György Szapáry

Péter Tabák, 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 24 October 2006. The minutes of that meeting will be released at 2 p.m. on 10 November 2006.