MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 OCTOBER 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 September 2006, the consumer price index rose at an annual rate of 5.9%. Core inflation was up 4% on a year earlier. Consumer prices increased by 2.4 percentage points and core inflation by 1.6 percentage points relative to August. The sharp rises in both indices in the month were largely anticipated, due to the increases in VAT and excise tax rates as well as households' higher energy bills for September; however, the rate at which prices rose exceeded market expectations. Month-on-month annualised changes in the rate of core inflation, calculated by stripping out seasonal effects, offer the most reliable guide to underlying inflation developments. The value of the index was above 10% in September, providing evidence of a discernible rise compared with the very high outturn for August, even under the assumption that retailers had passed the entire increase in VAT on to customers.

As was the case in August, the September data showed that the rise in inflation affected a very broad range of products and that it should not be associated with a single component of the index. Services price inflation rose further in September, with the month-on-month rate climbing to 10%, up from the 6%–8% rate characteristic of earlier periods. Higher energy prices and rising inflation expectations may have played a role in the increase in services price inflation. The month-on-month percentage change in tradables prices was 5% for the second consecutive month, which was mainly attributable to the persistent weakness of the exchange rate. The only good news on the inflation front was the significant fall in vehicle fuel prices – the annual price index for September would have been 0.5 percentage points higher had vehicle fuel prices remained unchanged.

Private sector wage inflation advanced to 10.7% in August, with the monthly increase in the annual earnings index exceeding 2%. The data suggest that employers may have brought forward bonus payments, due to official rises in contribution rates effective from September: the monthly rate of increase in bonuses in both manufacturing and market services was the highest in August compared with previous years. In addition, the pick-up in wage inflation has also been reflected in average earnings data calculated excluding bonus payments for recent months.

Hungary's GDP grew by 4.1% in Q2, after eliminating the calendar effect, and thus showed little evidence of a slowdown in economic growth. Robust expansion of exports continued to form the backbone of growth. Nevertheless, analysis of the components of domestic absorption shows that household consumption growth slowed for the second quarter in a row. This is slightly surprising, as strong wage growth, static financial savings and declining home construction overall would imply higher growth. Whole-economy investment also dropped off, with the rate of decline in corporate sector investment particularly surprising.

July output data suggest that brisk business activity may have continued in the third quarter. Historically, exports by industry and domestic sales (up 13% and 5%, respectively, in July) are characterised by high rates of growth. Based on the volume of new orders, none of these areas shows signs of slowing. Economic growth has been robust and the short-term outlook reassuring, consistent with recent foreign trade data. Imports and exports grew by 16% and 14%, respectively, in the first eight months of the year, and consequently, the trade deficit was significantly lower, by some EUR 500 million, relative to the same period of 2005. These encouraging developments are mainly attributable to strong business activity in Europe, and particularly to the favourable pattern of growth from the perspective of Hungarian exports, as well as to the buoyancy of investment.

Hungary's seasonally adjusted external financing requirement is equal to its combined current and capital account deficit. After adjusting for seasonal and one-off effects, its value showed a slight deterioration in 2006 Q2 relative to the previous quarter, reaching 6.5% of GDP. The

alteration in the scheduling of EU transfers resulted in EUR 300 million lower capital transfers relative to the previous quarter, which accounted for the slight increase in the external financing requirement. The financing pattern of the current account deficit developed unfavourably in Q2. There was a decline in the inflow of direct investment capital and non-residents reduced their holdings of shares by EUR 400 million, simultaneously with a fall in corporate fixed investment. As a result, the proportion of debt finance increased.

The cash-based deficit of general government amounted to HUF 70 billion in September, in contrast with HUF 143 billion in the forecast of the Ministry of Finance. According to the detailed data, tax revenues exceeded projections in virtually all of the major tax categories. There are significant upside and downside risks to the level of deficit expected for year-end (10.1% of GDP); however, the balance of risks is mainly on the downside.

Recently, there has been a favourable turn in investors' mood in international financial markets. The price of Brent crude oil has fallen below USD 60 per barrel from its peak level of nearly USD 80, breaking the upward trend which began three years ago. The significant drop in oil prices since early August greatly contributed to reducing uncertainty about the sudden slowdown in US economic growth and the possible rise in inflation. Following a decline in late September, long-term dollar yields rose slightly, the currency strengthened and stock indices surged to historical highs. In October, the Governing Council of the ECB raised key European interest rates by 25 basis points to 3.25%, and simultaneously it referred to the existence of upward risks to inflation. Market participants expect the ECB to raise rates again in December; however, they do not anticipate further rate increases next year. Nonetheless, recent statements by the Bank's senior officials point to further policy tightening, due to inflation risks and the benign prospects for growth in the euro area.

The correction in emerging markets following the selling wave in May-June continued. Risk premia fell, and investors gradually stepped up their exposure to risks. The market's positive attitude outweighed concerns over rising political risks in the CEE region. Slovakia's risk assessment improved, as uncertainty about the new government's economic programme faded. The central banks of the Czech Republic and Slovakia both increased rates at end-September, due to risks of higher inflation; and markets also expect the Polish authorities to raise rates soon.

There was a significant positive turn in the Hungarian investment climate in October, to which domestic factors also contributed, in addition to the international environment. Earlier, uncertainty ahead of the local elections and the Prime Minister's vote of confidence in Parliament had increased the risk premium required on forint-denominated assets. But after the Prime Minister won the vote and the ECOFIN Council approved the Hungarian Government's convergence programme, the forint appreciated quickly and long-term yields fell. Associated with strong turnover, the exchange rate strengthened to EUR/HUF 263.00, a four-month high, to which technical factors, such as triggers for stop-loss orders on open short forint positions and knock-out levels for options, also contributed. The appreciation of the forint in the period exceeded that of other currencies in the region. Foreign inventors' exposure to the forint increased rapidly, a smaller part of which was related to purchases of government paper and shares.

The interest rate increase by the MNB in September met expectations, and consequently, the interest rate path priced into yields remained practically unchanged after the decision. Short-term expectations of a rate increase intensified during the period of exchange rate weakening, which the market did not price out of the yield curve even after the exchange rate strengthened, due to the higher-than-expected inflation numbers. According to the Reuters poll, the level of official interest rates expected for end-2006 rose by 50 basis points to 8.25%–8.50% in one month, while for end-2007 it remained unchanged at 7.25%–7.50%.

The overwhelming majority of analysts expect the Monetary Council to raise rates by 25 basis points at its policy meeting in October.

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

Following the discussion of macroeconomic data which had become available recently and information received about financial markets, propositions to maintain interest rates, as well as raising them by 25 basis points or 50 basis points were put to the Council.

Members agreed that the markets' attitude to risks related to forint-denominated investments had improved. Investors' generally greater risk appetite and the fall in the implementation risk of the Government's stabilisation package perceived by the market had both played an important role, in addition to the Bank's interest rate increases over the recent period. During the discussion, members held a range of views over the extent to which this favourable process could be maintained.

In particular, there was active debate on conclusions that could be drawn from consumer price and wage data for the most recent months.

Of those members arguing for an interest rate increase, several were of the view that the sharp rise in core inflation, adjusted for one-off effects, and the pick-up in wage inflation over the past few months now suggested it was highly likely that the inflation target could not provide an anchor for domestic economic agents' inflation expectations to the extent necessary. This explained the increase in expectations. For another group of members arguing for a rate increase, firm conclusions could not yet be drawn based on actual inflation data; however, rapidly rising inflation had added to the risk of a sustained increase in inflation expectations. Such a development carried the danger that the significant one-off price and cost shocks this year and over the near term could result in a persistently higher inflation path.

Several members cautioned that the recent favourable developments in the external environment should not spawn overly optimistic expectations. They noted that although the risk premium on forint investments had fallen, it still remained high. Currently, it was not possible to judge to what extent the appreciation of the forint over recent months would continue. Foreign investors' risk appetite might react sensitively in the future to changes in interest rate policies in major markets. This, in turn, might lead to increased volatility in Hungarian markets which were highly dependent on foreign investor demand. Some members were of the view that, due to its unfavourable composition, the benign effects of the fiscal adjustment programme on economic imbalances could only be limited, and therefore it might also have a smaller downward effect on the risk premium than could be justified by the reduction in deficit.

Members arguing for a 50 basis point rate increase thought that the coordinating role of the inflation target should be reinforced and real economic agents' inflation expectations brought down by sending a decisive interest rate signal. However, the majority view was that, based on the conclusions that could be drawn from actual data, a more measured response would be to increase interest rates by 25 basis points.

Members arguing for maintaining interest rates at their current level pointed out that a number of one-off factors had played a role in inflation and wage growth increasing over recent months, and so they contained only limited information about the future. Of the longer-term factors influencing inflation, not only the possible future changes in inflation expectations, but also the dampening effect on inflation of the fall in demand was uncertain.

In the current situation, the effects of the recent rate increases could not be evaluated accurately either, which might justify to adopt a 'wait-and-see' approach. Members arguing for maintaining interest rates at their current level also noted that the chance of implementing the fiscal adjustment package had improved. As a consequence of the rapid fall in the external financing requirement, Hungary's dependence on inward portfolio investments might cease, which itself could help the forint to appreciate. Given the much stronger role of the exchange rate channel than that of the interest rate channel in the monetary transmission process, policy tightening could be achieved through a more measured increase in the base rate, were this scenario to materialise. Amidst these circumstances, therefore, it would be prudent to delay a further increase in interest rates.

After the discussion, the Chairman invited members to vote on the three propositions. Three members voted to maintain the base rate, seven members voted for a 25 basis point increase and two voted for a 50 basis point increase. Based on the votes cast, the Council raised the base rate to 8.00%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.75%	**3**	Tamás Bánfi, Péter Bihari, Judit Neményi
In favour of raising the base rate to 8.00%	**7**	Péter Adamecz, Vilmos Bihari, Csaba Csáky, Béla Kádár, György Kopits, Gábor Oblath, György Szapáry
In favour of raising the base rate to 8.25%	**2**	Zsigmond Járai, Henrik Auth

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 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 20 November 2006. The minutes of that meeting will be released at 2 p.m. on 8 December 2006.