MINUTES

OF THE MONETARY COUNCIL MEETING

OF 18 DECEMBER 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 policy 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 November 2006, the consumer price index rose at an annual rate of 6.4%. Core inflation was up 4.6% on a year earlier. Both indices increased by 0.1 percentage point relative to October. The annualised month-on-month rates of core inflation fell after rising steeply in the spring and summer months of the year. But the increase in VAT rates in September may have prompted a change in the timing of pricing decisions. This in turn is an uncertainty factor in judging the extent to which this decline may be sustained. Consequently, the data for October and November may be biased downwards, due to retailers possibly bringing forward price increases.

Tradables price inflation continued to slow in November, and the monthly rate of change in prices was practically flat. An important development in relation to October was the slowdown in services price inflation. The price index for market services now appears to have returned to the 6%–8% range characteristic of earlier years. Looking at the components excluded from the core measure, unprocessed food prices rose once again, mainly on account of individual factors (e.g. sharp increases in fruit and potato prices). This may feed into core inflation through rises in processed food prices later on.

The November issue of the *Report* only contained assumptions for administered prices. And although the fog has dissipated since then, conclusive judgements can only be expected in the near term in certain cases. Overall, taking into account the uncertainty surrounding the applications by households for means-tested government subsidy, the increases in gas and district heating prices in 2007 may prove stronger and, particularly in the case of the latter, more prolonged than assumed in November. In addition, the rises in long-distance transport prices and in public transport fares administered by local authorities, as well as in water and sewage disposal fees may turn out to be higher than previously expected. Another area of possible uncertainty is the scale and accounting treatment of a variety of new user charges to be introduced in health services (e.g. fees for medical prescriptions, hospital inpatient treatment and office visits).

Hungary's GDP growth slowed to 3.8% in 2006 Q3. In analysing the data, consideration must be given to the fact that the CSO recently made substantial methodological changes, which resulted in an increase in both the level and dynamics of GDP. The dual nature of Hungarian economic growth became even more pronounced in Q3: led by strong international economic activity, industrial output and net exports grew at robust annual rates, in contrast to domestic absorption which practically stagnated over the past two quarters.

The bulk of the rapid expansion in net exports in 2006 may be related to the strong performance in the first half, as according to data for more recent months, there has been little improvement in the monthly balance outcomes. The dynamics of consumers' expenditure stagnated in Q3; however, the 1.6% rise in household consumption growth is low compared with previous years. After the decline in Q2, the latest indications from fresh data do not imply an upward correction in corporate sector investment. Consequently, the wide gap between firms' favourable external sales and output data, and declining investment activity remained.

The generally positive sentiment has been maintained in international financial markets, with the majority of emerging country currencies appreciating and asset price volatility remaining low globally. According to the latest data, manufacturing growth in the United States may be beginning to stall, on the heels of the downturn in the real estate market. But growth in the services sector continues at a brisk pace, and the labour market has not yet shown signs of a slowdown. A modest deceleration in US economic growth remains the most likely scenario, which has so far led to a fall in the path for US dollar interest rates priced into the yield curve, and consequently, in financing costs, which has been coupled with a significant weakening of the dollar.

The ECB's decision in December to raise interest rates by 25 basis points broadly met expectations. The Bank's President warned of the existence of upward risks to inflation. Meanwhile, the ECB revised up slightly its forecast for growth next year and revised down its inflation projection. The interest rate path priced into yields did not change materially – the market expects the ECB to raise rates by another 25 basis points in 2007 Q1. However, the path for official interest rates thereafter is surrounded by uncertainty.

Economic growth in other countries in the CEE region in Q3 continued to be much stronger than in Hungary. In the Czech Republic and Poland, GDP grew by 5.8% and 9.8%, respectively, with fixed investment and exports rising rapidly in both countries. The Slovak koruna appreciated by nearly 9% relative to its ERM II central parity, which the National Bank of Slovakia might use as an excuse to put off raising rates, despite inflation rising faster than expected and economic growth continuing apace. The markets in Poland expect the monetary authorities to tighten policy in early 2007. But in the Czech Republic interest rates are likely to be maintained at 2.5%, as the appreciation of the exchange rate may help keep inflation low.

Associated with the benign international and regional investment climate, market sentiment remained firm in Hungary. The forint exchange rate strengthened further by 2%. Non-residents' forint exposure barely changed, but their holdings of government debt securities surged by around HUF 70 billion. Purchases at auctions and in the secondary market have been confined to the 2–3 year maturity bucket, suggesting that the fiscal path for the next two years is credible for market participants, and consequently, they expect official interest rates to be lowered next year. However, there have been little changes in both benchmark yields and the interest rate path priced into yields, despite purchases of securities and the appreciation of the exchange rate. This may have been related in part to the market's belief that, once the current tightening cycle has ended, interest rates will not be eased for a couple of months. A decline in yields may have also been retarded by the significant increase in net bond issuance by the Government in November. For the first time in a half year period, the five-year ahead five-year forward premium has fallen to below 200 basis points in recent days, which may be regarded as an early indicator of an improvement in the market's approach to the longer-term sustainability of the fiscal consolidation programme. Nevertheless, Hungarian long-term interest rate premia are still considerably higher than those in other countries of the region.

Following the MNB's policy decision in November to leave rates unchanged, the market priced in a probability that interest rates could be lowered in 2007, expecting a total 50 basis point easing over the course of the year. Analysts polled by Reuters do not anticipate a change in official rates in the near term: the first cut is expected for mid-2007, and the average expectation is for rates to be 7.1% at year-end, slightly lower than the 7.3% priced into the yield curve.

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

Following the discussion of the latest macroeconomic news and financial market developments, the only proposition offered to the Council was to maintain interest rates.

Members agreed that the stronger-than-expected rises in prices administered by the central and local government authorities could raise the profile of consumer price inflation originally expected to peak in the first half of 2007. But monetary policy was not able to directly offset this using the tools available to it. Several members noted, however, that, by their nature, government services influenced the public's perception of inflation significantly, and consequently, the sharp increases in prices in a number of cases added to the danger of further rises in general inflation expectations. It was also argued that this risk was exacerbated by the sharp depreciation of the forint earlier in 2006, in contrast with the stable exchange rate movements of previous years. By contrast, several members thought that, under a benign scenario, administrative price increases would only provide a one-off boost to inflation in 2007. They added that the exchange rate had strengthened further recently, which, if it persisted, could influence developments in trend inflation positively on the 2008 time horizon relevant for monetary policy.

Several members were of the view that the arguments advanced at the Council's November meeting for maintaining interest rates at their current level still held. Whether inflation expectations were to change for the worse had yet to be confirmed. The November inflation numbers and anecdotal information on wage rises next year might suggest that inflation expectations were anchored to the extent necessary.

By contrast, other members thought that the most important argument advanced last month for raising rates, i.e. the risk that wages and inflation expectations both could increase on the back of the one-off price and cost shocks still held, and that it was too early to draw firm conclusions about the extent to which that risk could materialise. The Council could have reacted to the expected adverse second-round effects of higher inflation caused by the Government's measures at the time of publication of the November inflation projection by raising rates. However, after the decision to keep policy on hold by a narrow vote, an interest rate increase could rather lead to uncertainty in the absence of significant new information which could influence inflation risks.

As for the evaluation of current financial market conditions, members of the Council noted that the latest rate increase by the ECB and changes in expectations for the future path of official interest rates at home and abroad had led to a fall in the excess return on forint assets vis-à-vis the euro. Nevertheless, this had not yet resulted in a deterioration in assessments of forint-denominated investments, as the improving international climate and favourable assessments of the implications of fiscal consolidation for economic balance over the short term had offset the effect on the exchange rate of the relative fall in returns.

Members agreed that, as long as there remained great degree of uncertainty surrounding future developments in inflation expectations, the Council should take particular care to head off second-round inflationary effects caused by the significant one-off price increases before they materialised.

After the discussion, the Chairman invited members to vote on the proposition that the base rate should be maintained at 8.00%. The Council voted unanimously in favour of the proposition.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.00%	**13**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáky, 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 Péter Bihari
Dr Csaba Csáky
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 22 January 2007. The minutes of that meeting will be released at 2 p.m. on 16 February 2007.