MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 26 FEBRUARY 2007

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 January 2007, the consumer price index rose at an annual rate of 7.8%. Core inflation was up 5.6% on a year earlier. Consumer prices increased by 1.3 percentage points and core inflation by 0.6 percentage points relative to December 2006, primarily due to the base effect of the VAT cut in January 2006. However, the month-on-month rate of core inflation, which better reflects underlying inflation developments, fell relative to the previous months. This implies the likelihood that much of the pick-up in inflationary pressures in mid-2006 may have been temporary. According to January data, tradables inflation (i.e. inflation of industrial products and processed foods) slowed significantly, which may suggest that the weakening of the forint against the euro around the middle of last year probably led to but a short-lived spike in inflation. There was a steep decline in the price index of market services; however, the month-on-month rates may overestimate the slowdown in underlying inflation, due to within-year seasonal fluctuations in price increases.

Inflation peaks at around 9% in the central projection in the November issue of the *Quarterly Report on Inflation*, i.e. above the level in the November forecast. It then slows sharply from the end of this year, with annual average inflation in 2008 easing back close to the medium-term target. After the first-round upward effects on prices of the Government's fiscal measures unwind, falling demand and loose labour market conditions are expected to put downward pressure on inflation. This steeper decline in inflation relative to earlier expectations may be attributable to shifts in the forecast assumptions towards a stronger EUR/HUF exchange rate and a significant fall in the world market price of oil. On the more distant horizon, this benign effect is amplified by an assumed lower increase in administered prices in 2008.

As in November, the Bank's February central projection is based on the assumption that expectations will remain well-anchored over the medium term and that the high rate of private sector wage growth in 2006 will adjust downwards, simultaneously with a moderation in domestic demand. However, the uncertainty surrounding price and wage coordination mechanisms remains significant, which is reflected in the distribution of risks around the central projection. This is a major source of upward risk for the next two years and has been aggravated by wage developments in the private sector in recent months and by the changes to plans to freeze government sector wages.

Whole-economy average earnings growth was 8.1% year on year in 2006. Here, private sector wages grew by 9.3% and government sector wages by 6.4%. Regular pay in the private sector has stagnated at the high levels seen in previous months. The sharp rise in December is attributable to bonuses, as employers probably brought forward payments in anticipation of increases in taxes in January, similarly to August; however, rising inflation expectations may also have played a role. Whereas domestic absorption slowed towards the end of the year, the rate of wage growth in the services sector continued to be well above that in manufacturing, which can be explained either by an increase in expectations or by a distortion caused by the termination of many disguised employment relationships. An alternative explanation could be that certain players in the private sector retrospectively compensated employees for some of their income losses following the fiscal austerity measures.

According to provisional data, the slowdown in the rate of economic growth which started in early 2006 continued towards the end of the year. Hungary's gross domestic product grew by 3.2% in Q4 relative to the same period in 2005 (growth was 3.4% after adjusting for the calendar effect). That was 0.5 percentage points lower than in the previous quarter. In contrast with Q3, the seasonally adjusted quarterly indices that better capture trend developments also fell in the final quarter. This reinforces the Bank's view that the adjustment of domestic absorption to the Government's measures aimed at rebalancing the economy, announced in the summer, already started in 2006 Q4. Consistent with this, the decline in retail sales growth – closely related to household consumption – which began in October continued. The total volume of retail sales grew by 0.9% in November and by 0.7% in December (by 1.4% and 3.2% respectively after adjusting for the calendar effect). However, December's figure may reflect one-off factors (e.g. rises in pharmaceutical sales). Taking this into account, there appears to be a general slowdown in sales.

The Bank's expectations for 2007–2008 of a widening wedge between the path of GDP growth and potential output in Hungary due to a decline in domestic demand have remained unchanged. The persistently benign external economic conditions and increasingly more optimistic European forecasts continue to stimulate Hungarian export growth. However, the favourable external business environment is likely to provide less impetus to the Hungarian economy than during earlier economic upturns, presumably due to country-specific factors. For example, manufacturing investment fell back in previous quarters, thereby opening up a gap with other countries in the region where investment growth remained strong.

According to preliminary December 2006 foreign trade statistics, exports and imports of goods rose by 13% and 11%, respectively, at current prices and measured in euro terms, relative to a year earlier. Both exports and imports rose robustly in 2006 compared with 2005: exports grew by 15.7% and imports by 13.4% in euro terms, which was consistent with the buoyant expansion of industrial output and the stronger-than-expected rise in European demand. Although weakening in January, the questionnaire-based indices available on external market conditions remained at historically high levels; and the German market, crucially important for Hungarian goods exports, showed no sign of deteriorating. Continued robust business activity in Hungary's trading partners may contribute to external demand remaining strong in 2007.

The cash-based government deficit amounted to HUF 196 billion in January, much higher than the deficit on a proportional basis; however, it was consistent with the forecast in the November issue of the *Report*, which took into account that government expenditure tended to be higher in the first month of the year, due to seasonal effects. Recent budgetary processes have remained consistent with the forecast in the November *Report*, according to which the deficit on an ESA 1995 basis is expected to be around 6.5%, i.e. falling within the 6.1%–7.7% risk band.

Investor risk appetite in financial markets has remained high in recent months. The latest economic data have reinforced the improvement in market sentiment about current and prospective business conditions in major industrialised economies. However, whereas in December and January the markets expected inflationary pressures to increase in the United States and the Fed to tighten policy due to higher-than-expected growth, concerns about rising inflation abated in February. All these developments signal a turnaround in sentiment. Accordingly, US markets significantly revised their expectations of an interest rate reduction down and long-term yields rose in December and January, which led to a slight sell-off in emerging markets. By contrast, risk-free returns fell in February, with global risk appetite rising again. And although emerging country risk premia, already at very low levels, remained fairly constant (JP Morgan's EMBI Global stabilised at around 170 basis points), premia fell across a wide spectrum of risk categories in credit markets.

As regards official interest rates that are crucially important in terms of global liquidity, markets are confident that the tightening cycle in Europe will continue in March. Much higher-than-expected quarterly growth figures released for 2006 Q4, as well as statements by ECB officials reinforced these expectations. The shape of the yield curve suggests that the market expects official euro rates to be raised yet again following the widely anticipated increase at the Governing Council's meeting in March. In the US, market participants expect a slight monetary easing this year, due to robust growth and moderate inflationary risks. However, the outlook for economic activity and interest rates in the US remains the most important source of risk. The Bank of Japan raised rates in February. Any further tightening will only pose a risk to emerging markets, if substantial holdings of emerging market assets, built on the existing interest rate differentials and financed by borrowing in the Japanese yen, begin to unwind due to a reversal in the downward trend of the currency.

Movements in forint asset prices in February reflected the improvement in sentiment towards Hungary. Whereas the exchange rate weakened together with other currencies of the region during the sell-off in emerging markets at the end of January, in February the forint performed much better, in tandem with the Slovak koruna, than the Polish zloty or the Czech koruna. Demand was high at government securities auctions, and non-resident investors' holdings continued to rise. Following the fall in January, non-residents' exposure to exchange rate risk increased by nearly HUF 180 billion in February. The long-term forward premium edged down slightly (the five-year ahead five-year forward premium eased to levels around 170–180 basis points); however, credit default swap prices showed no sign of a reduction in default risk.

Market participants expect the base rate to remain unchanged over the months ahead, due to the temporary pick-up in inflation. However, longer-term expectations are for official interest rates to fall. Based on the shape of the yield curve, participants have priced in a 25–50 basis point reduction for this year and another 50 basis point reduction for the next. Economists' interest rate expectations polled by Reuters barely changed in February: the consensus forecast is for the base rate to be 7.0%–7.25% in December 2006 and 6.00% at end-2008.

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

Following the discussion of the February update of the *Report*, the proposals offered to the Council were to maintain interest rates or raise them by 25 basis points.

Members agreed that there remained significant uncertainty around the central projection in the *Report*. Among the upward risks, the danger of an increase in inflation expectations and its effect on wage agreements were given special attention. The high rate of earnings growth at the end of 2006, particularly in the services sector, pointed to the existence of such risks. The majority of members noted that, in this regard, the agreement concluded on government sector wages might have a demonstrative effect, which could also be interpreted as an easing of earlier intentions to freeze wages in the sector.

Several members arguing for maintaining rates pointed out that the pick-up in wage inflation was an existing risk; however, wage data for 2006 may have been distorted by the changing seasonal pattern of bonus payments due to increases in tax and contribution rates, as well as by the one-off effects of the tightening in labour market regulations. Consequently, the underlying developments could not be assessed accurately at present. For these members, one reason for maintaining a 'wait-and-see' approach was that the subdued outlook for growth in the private sector could have a moderating effect on pay rises at the beginning of the year, and moreover, it was conceivable that the current risks would not materialise. In this regard, wage developments over the coming months might be of crucial importance. Some members emphasised that the forecast contained downside risks, in addition to the risk of an increase in inflation expectations. The downward effect on inflation of the decline in domestic demand, which Bank staff assumed with a considerable degree of caution due to a lack of past empirical data, might actually be stronger than in the inflation projection.

Members arguing for maintaining rates attached much importance to the fact that the central projection had been changed considerably on the relevant horizon relative to November, and that it had been revised down to a level consistent with the inflation target. The strengthening of the exchange rate had played an important role in this, which had been due mainly to earlier policy tightening and the improvement in sentiment about domestic economic conditions. These, in turn, could be expected to have a downward effect on inflation over a sustained period.

Members supporting an increase in interest rates stressed that private sector wage growth had exceeded the Bank's earlier expectations for several months now; and the outlook for government sector wages had changed unfavourably. In addition, inflation could peak at a higher level in 2007 due to greater-than-expected increases in administered prices earlier in the year, which might also contribute to a rise in inflation expectations and a build-up of inflationary pressure. These members thought that based on the developments of the past few months the risk of an increase in inflation expectations had reached a level where the Bank should act by raising interest rates.

Another argument for raising interest rates was that the current central projection for inflation had become more consistent with the target relative to November, explained by the assumption of a stronger exchange rate in the forecast than before. But because exchange rate volatility was expected to remain in the future, the downward revision of the forecast should be treated with care. This caution was justified, for example, by the fact that international investors' risk appetite, currently at its highest level over a lengthy period, had played a role in the recent strengthening of the exchange rate. However, positive market sentiment towards forint-denominated investments at present might change quickly in response to (i) a rise in yields on the major currency assets, (ii) an increase in geopolitical risks or (iii) mounting concerns about the implementation of fiscal measures.

After the discussion, the Chairman invited members to vote on the two propositions. Eight members voted to maintain the base rate and four members voted for a 25 basis point increase. Based on the votes cast, the Council left the base rate unchanged at 8.00%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.00%	**8**	Péter Bihari, Vilmos Bihari, Csaba Csáky, Ilona Hardy, Béla Kádár, György Kopits, Judit Neményi, Gábor Oblath
In favour of raising the base rate to 8.25%	**4**	Péter Adamecz, Henrik Auth, Tamás Bánfi, Zsigmond Járai

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

Zsigmond Járai, Chairman
Henrik Auth
Péter Adamecz
Dr Tamás Bánfi
Péter Bihari
Vilmos Bihari

Dr Csaba Csáky
Dr Ilona Hardy
Dr Béla Kádár
Dr György Kopits
Judit Neményi
Dr Gábor Oblath

Péter Tabák, Head of Department at the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 26 March 2007. The minutes of that meeting will be released at 2 p.m. on 13 April 2007.