MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 21 MAY 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 April, the year-on-year rate of consumer price inflation slowed slightly, which had not been the case for over a year. Prices rose by 8.8% in the twelve months to April. This was down 0.2 percentage points on the rate in March. On the core measure, the annual inflation rate fell by 0.2 percentage points to 5.9%. The seasonally adjusted month-on-month rate of core inflation showed a marked slowdown, particularly as compared with the jump in the index in March. The inflation measure, calculated by removing the effects of rises in excise taxes and VAT, and the introduction of medical visit fees, is the most reliable guide to underlying inflation developments. It stood at 3.5% in April, in contrast with levels close to 5% in the first quarter.

The slowdown in inflation across a broad spectrum of prices did not come as a surprise, but with regard to its core measure, the strong, albeit temporary, contribution from declines in the prices of a number of products amplified the extent of the slowdown. First, due to a shift in the seasonality of clothing prices, the index for March picked up sharply before falling back to a strikingly low level in April. Second, services price inflation was very subdued, explained by an unusually significant drop in domestic holiday prices. After eliminating this effect, services price inflation remained in the 5%–7% range observed since mid-2004, although it has moved close to the lower end of this band recently.

In the May issue of the *Quarterly Report on Inflation*, the forecast was for consumer price inflation to begin to slow from 2007 Q2, and then to meet the target on the horizon relevant for monetary policy. However, inflation is now projected to fall less quickly over the period to the end of next year, relative to the February forecast. One reason for this is the rapid increase in oil prices observed in recent months, which, looking forward, is likely to generate stronger inflationary pressure than in recent years, due to the reduction in gas price subsidies. The rapid rate of private sector wage growth is another factor pointing to higher inflation. The very high rates of wage growth in recent months – only the smaller part of which may be accounted for by the reduction in the informal sector – is highly unlikely to be consistent with price stability over the medium term.

Wage data for March had negative implications for inflation. Total gross wages were 10.2% higher than in March 2006; and gross average wage growth, excluding bonuses, stood at 11.7%. The slight difference between the two pieces of data means that the adjustment of wages through a drop in bonuses clearly has not yet occurred. The rate of total gross pay growth in the private sector reached 9.5% in Q1. Wage growth has been somewhat more moderate in manufacturing; and annual rates in market services have been robust, particularly in the light of recent developments in productivity.

This strong wage growth has occurred against the backdrop of slack demand for labour. The number of unemployed fell in January-March, reducing the unemployment rate to 7.5%. There appears to be a turnaround in developments in activity and unemployment at the end of 2006, with a drop in both indicators, presumably due to lower willingness to take jobs. In addition, employment has also fallen in recent months, which may reflect a decline in labour demand. The most likely interpretation is that the labour market has been showing signs of a slowdown in economic activity since the end of 2006. On the one hand, deteriorating prospects for higher net real wages and finding employment are providing less incentive to seek or take a job. On the other hand, rising labour costs have a dampening effect on the demand for labour. However, a smaller part of the flow of unemployed persons towards the economically inactive may be closely related to the increase in the number of people taking early retirement in the government sector.

Hungary's GDP grew by 3% in 2007 Q1 relative to the same period of 2006. That was in line with the path assumed in the *Report*, but was significantly above market expectations. Although the rate of economic growth continued to slow in a year-on-year comparison, it has not fallen quarter on quarter since 2006 Q4. Two factors may be behind this, in addition to uncertainty about seasonal adjustment. One is the correction to earlier stagnating or declining business investment, which would be in line with the pick-up in imports of machinery and transport equipment in January-February and the continued heightened expectations about external economic activity. Second, the response of household consumption to the decline in real incomes may be more prolonged over time, and moreover, the recent decline in real incomes has been more modest, due to strong rises in wages. This stands in contrast with the observed slowdown in retail sales which began in mid-2006 and continued into the first few months of 2007.

The latest news on industrial production growth has cast a shadow on the picture of slightly improving business activity. In March, there was a clear slowdown in the rate of output growth. Domestic sales levelled out and export growth showed obvious signs of moderating from its previous historical highs. The softening in production growth seems to be at odds with continued strong business activity in Europe, and is not paralleled by Hungary's competitors in the region. Furthermore, anaemic production growth, standing in contrast with buoyant external activity and developments in the CEE region, is clearly adverse news, and presumably reflects the worsening competitiveness of Hungarian exports. This deceleration may be consistent with the fact that last year the expansion of production capacity failed to keep pace with rising external demand and the increase in capacity utilisation in the export sector. This may point a lower rate of potential GDP growth.

The projection for economic activity is conditioned on strong external business performance and weaker-than-expected domestic demand in 2006 H2. In the May central projection, the Hungarian economy slows down sharply in 2007, mainly due to the decline in household consumption. With the fading of the effects of fiscal measures, the economy recovers slightly and the contribution of domestic components to growth is set to be stronger. As in previous years, export growth remains robust, fuelled by the benign external environment. Households are projected to continue to smooth their consumption, meaning that the decline in consumers' expenditure in 2007 will be less sharp than that in disposable income. Over subsequent years, household income is expected to rise again, with the rate of consumption growth picking up. After the drop last year, investment is forecast to rise gradually, but a strong rebound is not expected over the period to 2009, despite the increased use of EU funds.

The international investment environment continues to be favourable: markets have exhibited low volatility over the past month. Reflecting investors' high risk appetite, the sell-off in March was reversed quickly, and equity prices in both developed and emerging markets have rallied in the past two months. Led by strong demand for risky assets, a number of emerging country currencies appreciated against the world's major currencies in early May. Risk premia stabilised at very low levels, but the prolonged bull market has raised concerns of a major correction.

Although the picture painted by the latest data on business activity in the Unites States was mixed, the numbers did not reinforce earlier fears which led to the sell-off in March. As an effect of lower-than-expected headline and core inflation data for April, worries about inflation abated. In May, the Fed maintained its target for the federal funds rate. The accompanying statement of the decision stressed inflation risks, but also noted the slowdown in growth at the beginning of the year and the correction in the real estate sector. All this matched the market's expectations, and consequently, the yield curve was little changed. Participants still expect a maximum 25 basis point cut in rates this year.

Euro-area economic data continue to reflect strong activity. The economy grew by 3.1%

annually in the first quarter, exceeding economists' forecasts. Labour market data and forward-looking indicators both point to stable growth. In May, the European Central Bank left key interest rates unchanged. However, based on the bank's communication, the market is confident that interest rates will be raised by 25 basis points in June. The ECB perceives upside risks to inflation over the medium term, and the risk of wage inflation in particular. The markets have partly priced in another interest rate hike in the second half of the year.

The external investment environment remained benign. For most of the period, the exchange rate fluctuated in a narrow band between EUR/HUF 245–250 characteristic of mid-March. An optimistic mood prevailed in the Central and Eastern European region in early May. And the latest increase in official rates in Slovakia contributed to the stabilisation of the exchange rate of the koruna. Market participants expect the Czech National Bank to raise rates in the summer. In mid-May, sentiment about the region deteriorated somewhat. Concerned first by domestic political problems in Turkey, and then by a portfolio shift away from emerging country assets, investors reduced their exposure to the CEE region, and the forint weakened to levels above EUR/HUF 250. Similarly, the zloty and the Slovak koruna both depreciated. In the period, the forint suffered the most significant losses compared with other currencies of the region. This may reflect the greater vulnerability of forint-denominated assets.

Foreign investors' exposure to exchange rate risk was falling gradually from the end of April, which may have been associated with the closing out of long positions in the forint. Nevertheless, their holdings of Hungarian government securities rose slightly in May after the sharp drop in April, implying that profit-taking following the significant fall in recent months may have ended. However, weak investor interest at the bond auctions in May points to lacklustre demand for Hungarian government securities at the current level of yields.

Following the recovery in mid-May from the declines earlier in the month, yields in the government securities market are now broadly at their levels as at the time of the Monetary Council meeting in April. Short-term yields continue to be consistent with a 100–125 basis point reduction in interest rates this year. Whereas in April the majority of market economists expected rates to be lowered in May, they became less confident about their views by mid-May, in the face of (i) the April inflation figure meeting expectations, (ii) GDP data being higher than expected, and (iii) the forint depreciating. According to the results of surveys conducted by Reuters and portfolio.hu, a slight majority of analysts and currency dealers alike expect the base rate to remain on hold in May, with the minority expecting a 25 basis point reduction. This downward revision of short-term expectations of a rate cut is also reflected in money market prices: forward rates imply a 25–50 basis point reduction over the period to the end of the summer. Better-than-expected data on growth, the government budget and foreign trade may have contributed to the five-year ahead five-year forward premium easing to 140 basis points from 150 basis points in April.

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

Following discussion of the latest macroeconomic news and financial market developments, the proposals put to the Council were to maintain interest rates, to reduce them by 25 basis points or to reduce rates by 50 basis points.

Arguments in support of maintaining rates were advanced, as follows. In the May the *Report* projection, the path of inflation on the horizon relevant for monetary policy was higher than in the forecast in February, and was likely to return to the 3% target somewhat later. Although the upward revision to the projection mainly reflected the higher forecast for energy prices and so it was believed to be a temporary factor, with its effect unwinding by

2009, the uncertainty around the central projection pointing to higher inflation should not be ignored. Nevertheless, the probability of extreme movements had diminished somewhat.

Data released after the *Report* had been finalised reinforced the view that developments in nominal wages represented upside risks to inflation. It could reasonably be assumed that the changes in tax rules and the tightening of tax audits must have been factors influencing the faster-than-expected rise in private sector wages. However, wage growth had been even stronger in recent months, above the estimated effect of those measures. The rate of wage growth was likely to slow, because of the slowdown in economic activity; however, there remained a significant risk that rises in wages would translate into cost-push inflation pressure. The expected rise in energy prices would lead to higher inflation expectations. However, in view of the information currently available, it could not be ruled that the offsetting effect of the deceleration in domestic demand on the developments discussed above would be weaker than expected.

Those members who preferred a reduction in interest rates put forward the following arguments. Recent developments in wages could be interpreted mainly as a single event, a change in regulations or a one-off compensation, and there was insufficient evidence that wage developments in recent months reflected wage inflation being stuck. And with the expected deterioration in economic conditions and the associated slackening in demand, downward effects on inflation could be intensifying. Expected developments in core inflation suggested that there might be a transition to a lower inflation environment over the forecast period. Due to demand constraints, future rises in energy prices would put downward pressure on demand, and they were less likely to have a lasting impact on inflation expectations. As the outlook for inflation was improving, the Council now would take advantage of the opportunity that the decline in the required risk premium had created.

After the discussion, the Chairman invited members to vote on the three propositions. Seven members voted to maintain the base rate, five members voted for a 25 basis point reduction and one member voted for a 50 basis point reduction. 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%	**7**	Péter Adamecz, Henrik Auth, Péter Bihari, Béla Kádár, Ferenc Karvalits, György Kopits, András Simor
In favour of reducing the base rate to 7.75%	**5**	Vilmos Bihari, Csaba Csáky, Ilona Hardy, Judit Neményi, Gábor Oblath
In favour of reducing the base rate to 7.50%	**1**	Tamás Bánfi

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

András Simor, Chairman
Henrik Auth
Péter Adamecz
Dr Tamás Bánfi
Péter Bihari
Vilmos Bihari
Dr Csaba Csáky
Dr Ilona Hardy
Dr Béla Kádár
Ferenc Karvalits
Dr György Kopits
Judit Neményi
Dr Gábor Oblath

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

The Council will hold its next policy meeting on 25 June 2007. The minutes of that meeting will be released at 2 p.m. on 13 July 2007.