MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 26 NOVEMBER 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

Upside risks to consumer price inflation have increased since the Council's last policy meeting. The annual rates of CPI and core inflation, at 6.7% and 4.4% respectively, were both higher in October than in the previous month, and the annualised monthly inflation rate – which best captures underlying developments – accelerated to 5% in September-October, after fluctuating between 3%–4%.

The recent increase in inflation largely reflected higher food price inflation and, to some extent, rises in a number of administered prices. There are growing signs that the substantial increases in food prices may be a factor slowing the decline in inflation over a prolonged period. One explanation is that price rises are only partially ascribed to the (presumably temporary) effects of this year's drought – to a large degree, they are related to an international food price shock triggered by surplus demand at the global level.

At the same time, inflation of other important components of core inflation has not yet accelerated further, consistent with the negative output gap caused by slowing economic activity. Private sector wage growth appears to have moderated slightly in September. After adjusting for the changed seasonality of last year's bonus payments and the effects of efforts to reduce the informal sector, the rate of wage growth fell to around 7% in the month. This was closely related to lower wages in manufacturing, while wage growth stagnated at a relatively high level in the service sector.

News on domestic economic growth was somewhat less benign than expected. According to the CSO's preliminary estimate, Q3 GDP growth slowed to 1%. Short-run dynamics, however, suggest that the economy may have reached a turning point during the quarter, in line with the Bank's earlier expectations, and that growth is unlikely to slow further. The downward trend in retail sales volumes slowed in Q3, which may also point to a turnaround in domestic demand. There is, however, considerable uncertainty as to whether or not this turnaround will be sustained for long.

Recent developments in international economic activity suggest that economic growth will recover very slowly from its current low level. Although export-led industrial production and goods trade performed very well in Q3, the September numbers showed signs of a slight slowdown. Important euro-area confidence indicators also pointed to downside risks to external business activity, given the continuous deterioration in European business expectations in recent months.

In financial markets, investor sentiment deteriorated strongly. The turmoil caused by problems with US sub-prime lending and mortgage-linked structured credit products intensified again in November. Several large US banks reported significant losses on their exposures. Continued lack of confidence in the interbank markets and the wide spread between short-term interbank rates and government securities yields both suggest that market participants face the prospect of further losses. The prolonged period of turbulence may add to concerns that all of this might also affect the real economy. Due to the continued re-pricing of risks, credit spreads and risk premia on emerging market debt once again rose back to, and slightly above, levels experienced during the sell-off in August. There was also a significant increase in volatility in global equity and currency markets, accompanied by further declines in yields on government bonds in developed countries.

Uncertainty surrounding the interest rate policies of developed country central banks also increased. Although Q3 GDP growth in the United States (3.9%) and the euro area (2.6%) was favourable, forward-looking indicators in both regions point to a slowdown in activity in the fourth quarter. The US Fed revised down its growth projection for next year, and forecast uncertainty increased. Coupled with the crisis of the sub-prime mortgage market, this caused a shift in market expectations towards looser monetary conditions, despite the increases in energy and food prices pointing to higher inflationary risks. At end-October, the Fed reduced interest rates by 25 basis points and judged that the upside risks to inflation were roughly balanced with the downside risks to growth. Nevertheless, expectations of another cut in US interest rates intensified. Markets expect dollar interest rates to fall by 75 basis points over the next six months. The ECB left interest rates unchanged in November, as information which had become available confirmed that the outlook for inflation was subject to upside risks. European long-term inflation expectations implied by market prices have risen significantly in recent months. Despite strong statements by senior ECB officials, markets expect interest rates to remain on hold in the short term. However, a rate cut is priced into the yield curve over the medium term.

The external environment had negative effects on forint-denominated assets. After the general sell-off in August, forint assets and other emerging market currencies strengthened in September. However, in October-November forint assets underperformed other assets in the region and more risky emerging market assets in general. This widening gap was closely related to unfavourable assessments of economic fundamentals (i.e. the external balance and growth), with the importance of these in investment decisions increasing particularly strongly in a highly volatile market environment. The deterioration in sentiment was also reflected in rising default premia and long-term forward premia. The exchange rate of the forint depreciated by 2% since the Monetary Council's October meeting. Non-residents' exchange rate exposure fell gradually. Expectations of interest rate cuts over the longer-term fell. The market has priced in a 25 basis point reduction for the coming three months. The yield curve is consistent with a 6.75% base rate at the end of 2008, up 25 basis points compared to October. Analysts' medium-term interest rate expectations rose similarly. According to the latest Reuters poll, the consensus forecast is for the base rate to be 6.50% at the end of 2008. Surveys of economists and foreign currency dealers indicate that the overwhelming majority of respondents expect the Council to maintain interest rates at its November meeting.

2 The Council's assessment of current economic conditions and the 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, or to reduce them by 25 basis points.

Council members agreed that, although the fall in inflation would take longer than expected due to the sharp rises in food and energy prices, the most likely scenario was that the 3% medium-term inflation target could be met in 2009. In this respect, it was good news that the partial wage adjustment in the private sector had already started, according to the data for recent months. Based on Q3 data, the slowdown in economic growth seemed to be slightly stronger than expected, and the recovery was likely to be more modest than previously thought, due to the prospective slowdown in external economic activity. These factors, in turn, would help to bring down inflation over the medium term. Members were in agreement that monetary policy should take particular care to prevent a rise in inflation expectations above the level consistent with price stability.

There was, however, a range of views about the assessment of risks around the central inflation projection. Members agreed that an increase in inflation expectations was the most important upside risk. The bad news was that there was a clear slowing in the disinflation process, due to the stronger-than-expected rises in food and energy prices, which could easily have an impact on expectations through households' inflation perception. Several members judged that wages had so far adjusted mainly through bonuses, and the outcome of next year's wage negotiations was uncertain, particularly in the light of employees' more resolute stance recently. In this regard, an easing of monetary policy would pose additional risks. Several other members, however, were of the view that, based on the latest data, labour market conditions had eased further and the fall in corporate profitability would be able to effectively control the outcome of wage negotiations. For this reason, they assigned a lower probability to the risk that firms would restore their profitability rapidly through significant price increases.

Several members were of the view that weaker economic performance would have a stronger-than-expected downward impact on inflation. On another view, however, the adjustment of the private sector so far had mostly been moderate, despite the significant slowdown in growth. In addition, this slowdown could be linked to sectors where the tools of monetary policy were limited to have a countervailing influence. Several Council members thought that, due to a deterioration in economic prospects, the risks around the inflation projection had become more evenly balanced over recently.

Members were in agreement that, with the worsening of problems in the US mortgage market, there had been a significant deterioration in the international investment environment and a considerable increase in financial market uncertainty. All this reduced the room for monetary policy manoeuvre. Several members pointed out that sentiment towards Hungary had deteriorated, which contributed to the rise in the risk premium for holding forint-denominated assets. However, members had differing views about the durability of the rise in the risk premium. Some members thought that, with the expected reduction in the government deficit and the pick-up in economic growth, country-specific risks were likely to recede. On another view, however, there now seemed a great likelihood that investors' willingness to take risks globally had fallen relative to previous years, and a turnaround could not be expected over the short term. Several other members emphasised that it was too early to tell how long the rise in the risk premium would last, as uncertainty around the future outlook for the international financial markets remained.

The risk premium on forint-denominated assets was influenced by the degree of success in implementing the fiscal adjustment measures. In 2007 and 2008, the adjustment process was expected to proceed as envisaged in the programme, but several members were of the view that the social and political debate on the structural reforms had increased the medium-term risks associated with the feasibility of adjustment in 2009.

Members were unanimous that there would be a case for a reduction in rates, if domestic economic conditions suggested that the risk of higher inflation transmitted through expectations was diminishing and international financial market sentiment towards the Hungarian economy improved further.

After the discussion, the Chairman invited members to vote on the propositions. Nine members voted to maintain the base rate and three members voted for a 25 basis point reduction. Accordingly, the Council left the base rate unchanged at 7.50%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.50%	**9**	Vilmos Bihari, Csaba Csáki, Ilona Hardy, Béla Kádár, Ferenc Karvalits, Júlia Király, György Kopits, Gábor Oblath, András Simor
In favour of reducing the base rate to 7.25%	**3**	Tamás Bánfi, Péter Bihari, Judit Neményi

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

András Simor, Chairman	Ferenc Karvalits
Tamás Bánfi	Júlia Király
Péter Bihari	György Kopits
Vilmos Bihari	Judit Neményi
Csaba Csáki	Gábor Oblath
Ilona Hardy	
Béla Kádár	

Tibor Erhart, Deputy Head of Department of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next policy meeting on 17 December 2007. The minutes of that meeting will be published at 2 p.m. on 11 January 2008.