MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 26 MAY 2008

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

The domestic economy

In April 2008, annual inflation increased by 6.6% on the CPI measure and by 5.7% on the core measure. Compared with March, the consumer price index fell by 0.1 percentage point, while core inflation rose by 0.4 percentage points. A reversal of the recent decline in food price inflation was the main factor behind the increase in trend inflation. By contrast, there was a slight drop in industrial goods and services inflation in April. The outlook for future inflation did not change materially compared with March.

According to preliminary data released by the CSO, Hungary's gross domestic product grew by 0.9% in 2008 Q1 compared with the same period of 2007, after adjustment for calendar variations (GDP growth was 1.6% on an unadjusted basis). This rate of growth was lower than the market expected.

The recovery in foreign trade and industrial production since the end of last year appears to have slowed significantly in March. According to preliminary data released by the CSO for March 2008, exports and imports of goods, measured at current prices, were up by 3.9% and 3.1%, respectively, on a year earlier, but more than 10 percentage points lower than the rise in January–February. The volume of industrial production grew by 4.3% in March compared with a year earlier. And, based on trend estimates, industrial and manufacturing output have both been slowing recently. Construction output fell by 12.6% compared with March 2007. The rate of growth of contracts for construction output, a relatively good predictor of production 8–10 months ahead, fell significantly, suggesting that the performance of construction in 2008 may have weakened. Taken together, the short-term prospects for growth have deteriorated somewhat recently.

Whole-economy gross average earnings grew by 9.9% in March 2008 compared with the year earlier level. Within this figure, government sector earnings grew by 12.7% and private sector earnings by 9.0%. The different timing of 13th month bonuses from the earlier practice continued to account for most of the strong increase in the rate of earnings growth. Looking at private sector wage developments, the seasonally adjusted data appear to confirm the assumption that the sharp rise in wages in the first two months of the year may have been caused by one-off factors, such as the increase in the guaranteed minimum wage and the change in the pattern of pay rises. Overall, the downward adjustment of wages is likely to continue, albeit at a somewhat slower pace than expected earlier, which may be associated with further reductions in employment levels.

Financial markets

The external financial market environment has been very benign for the risk premium on forint assets since the bailout of Bear Stearns in mid-March. Supported by fresh capital raised by investment banks and the measures taken by central banks, investors almost completely priced out the probability of a banking crisis in the United States and Europe. Bank CDSs have fallen significantly since mid-March, and interest rate spreads have also eased substantially in the US dollar interbank markets. With concerns about financial stability fading, better-than-expected GDP data were released in the US, the euro area and Japan. As a result of these influences, the start of an interest rate tightening cycle in the United States by the end of the year has been priced into forward rate agreements. In the euro area, the majority of investors also expect official interest rates to be maintained this year.

Current market expectations about global economic growth and financial stability are optimistic. However, this benign outlook is surrounded by a number of significant risk factors. First, based on historical observations, the fall in the real value of US house prices may continue for years, which, in turn, may increase the number of defaulted loans and restrain consumption growth. Second, the uninterrupted rise in oil prices may cause persistently high inflation, and while the tax rebates granted by the government will stimulate economic growth in the second half, their effect will wane by 2009, and economic activity may be beginning to slow again. Third, the IMF has estimated the financial sector's total losses stemming from the US sub-prime mortgage crisis to be USD 1,000 billion, with the amount of losses recognised so far not being anywhere near as much as that. This points to the possibility that financial institutions' balance sheets will cause negative surprises beyond the losses reported by banks so far.

The forint strengthened by nearly 9% from its low reached in March. The exchange rate was last at levels around EUR/HUF 245 before the disruption of the US sub-prime mortgage market began. However, yields in the government securities market have not eased back to levels seen before the turbulence in February; and benchmark yields are now 100–200 basis points above their pre-crisis values. This degree of deviation between the two markets has not been observed in the past.

Increasing risk appetite, positive sentiment about Central and Eastern Europe due to Slovakia's prospective EMU entry, interest rate increases by central banks and those implied by market expectations, improving domestic equilibrium indicators and technical factors may have been behind the forint's appreciation. It is also conceivable, however, that the fact that there are no limits to exchange rate appreciation after abandonment of the fluctuation band may also be playing a greater role, amidst conditions marked by improving sentiment at the global level. The drop in the risk premium is supported by the CDS spread halving from its peak reached in March and by low implied volatilities. From the market's perspective, the MNB's commitment to reducing inflation is now much more obvious in the light of the recent interest rate increases and further tightening priced into the market in response to strong statements by the central bank. Currently, the yield curve is consistent with a 25 basis point increase in rates over the period to the third quarter of 2008. According to the Reuters poll of economists, the majority of respondents think that the Monetary Council will raise interest rates by 25 basis points at the end of May.

The sustainability of the recent exchange rate appreciation is questioned by the fact that it has been caused in part by technical reasons, i.e. speculative demand for the forint related to options written near the bottom of the currency's fluctuation band in the period of the flexible peg regime. More recently, market assessments have frequently cited technical factors in explaining the possible causes.

Yields in the Hungarian government securities market have not yet reflected the marked fall in the risk premium on forint assets. This may also support the view that the exchange rate appreciation may have occurred on technical grounds. Each month since February, non-residents have been net sellers in the government securities market. And it is quite unlikely that yields will fall significantly, if non-resident investors do not return to the market. But it may also be the case that yields on government securities have not been falling because of the rise in the liquidity premium. However, the fact that swap rates have also stabilised at high levels recently, appears to contrast with this view.

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

Following discussion of the latest macroeconomic developments, the May issue of the Bank's *Quarterly Report on Inflation* and financial market conditions, the Council considered arguments for reducing, for maintaining and for raising the base rate. Members agreed that the May projection, according to which inflation might be above target over the period to 2010 assuming unchanged monetary conditions, should be the starting point for the interest rate decision.

In members' judgement, the prospects for growth continued to be unfavourable and no signs of a marked turnaround had emerged as yet. Several members stressed that the contraction of demand could contribute to mitigating the second-round effects of the recent cost shocks; retail turnover was falling and consumer credit growth had stalled in recent months. However, some other members added that the downward effect of the negative output gap on inflation might be more muted than assumed. Others emphasised that despite the decline in domestic demand, wage and services price inflation had resumed rising and had not confirmed the favourable developments observed towards the end of 2007.

Members agreed that there had been a marked deterioration in the inflation outlook in the period since the publication of the February *Report*. Several members noted that the rise in international commodity prices and global inflationary pressures played a major role in this development, which, however, could be even more sustained than assumed in the May *Report*. Some members judged that there were fundamental factors behind the rise in oil prices, and therefore, the recent sharp rises could not be viewed as temporary in nature. Others stressed that the trend rate of food price inflation could rise above previous levels, due in part to the increase in demand for land.

For Council members it was good news that the risk premium on forint assets and CDS spreads both had fallen recently, simultaneously with an improvement in investor sentiment towards the region. On another view, the monetary policy decisions of the recent past could also be a factor explaining the decline in the risk premium. However, some members pointed out that due to the volatile conditions in financial markets, the fall in risk premia had so far been only temporary and a longer period of time would be needed to assess these events accurately. Other members emphasised that technical factors rather than an improvement in economic fundamentals may have played a role in the recent favourable financial market developments.

In members' judgement, enhancing the role of the central bank inflation target as an anchor was a key task for monetary policy. Increases in the central bank base rate in the past two months suggested a tightening in monetary conditions, but more time was needed for the disinflationary effects of the measures to work through. The appreciation of the forint had in part reflected the steps taken by the Bank recently. For this reason, some members thought that maintaining the base rate could ensure the degree of policy tightening required in order to meet the inflation target. It was also argued that the projection was for inflation to possibly ease back close to the target in 2010, which could even provide an opportunity for the Bank to ease policy.

Several members pointed out that central bank policy tightening could result in real economic sacrifices in the near term. Several others, however, argued that the positive welfare effects of low inflation would clearly offset the short-term real economic sacrifices associated with disinflation. On another argument, the real economic costs of maintaining price stability would be substantially lower as well, in addition to the improvement in credibility. Monetary Council members thought that it was necessary to maintain a tight monetary policy and they were ready to take the necessary steps, if the inflation target was put in jeopardy.

After the discussion, the Chairman invited members to vote on the propositions. Eight members voted to raise the base rate by 25 basis points, three members voted to maintain the rate at 8.25% and one member preferred a 25 basis point reduction.

Votes cast by individual members of the Council

In favour of reducing the base rate at 8.00%	**1**	Tamás Bánfi
In favour of maintaining the base rate at 8.25%	**3**	Csaba Csáki, Béla Kádár, Judit Neményi
In favour of raising the base rate to 8.50%	**8**	Péter Bihari, Vilmos Bihari, Ilona Hardy, Ferenc Karvalits, Júlia Király, György Kopits, Gábor Oblath, András Simor

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

András Simor, Chairman
Tamás Bánfi
Péter Bihari
Vilmos Bihari
Csaba Csáki
Ilona Hardy
Béla Kádár
Ferenc Karvalits
Júlia Király
György Kopits
Judit Neményi
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 23 June 2008. The minutes of that meeting will be published at 2 p.m. on 11 July 2008.