MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 23 JUNE 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 May 2008, annual inflation increased by 7.0% on the CPI measure and by 5.9% on the core measure. Compared with April, consumer prices rose by 0.4 percentage points and core inflation by 0.2 percentage points. The main factor behind this negative development is the failure of food price inflation to moderate since March. Industrial goods and services inflation was up slightly in May, but much of this increase reflected rises in energy prices and it did not materially exceed earlier expectations. High food price inflation is a cause for concern, because the rate of increase in processed food prices has already returned to lower levels both in the euro area and the countries of the region, and food commodity prices have fallen overall since April. This suggests that country-specific factors may also have contributed to the rate of inflation becoming stuck at a high level. On balance, the disinflation process which began at the end of last year appears to have stalled, and upside risks to inflation have increased more recently.

Private sector earnings growth picked up in both manufacturing and services, according to seasonally adjusted monthly data. Bonus payments, higher-than-usual around this time of the year, accounted for most of the strong increase in the rate of earnings growth. The good news is, however, that the rate of regular pay growth in companies with more than 250 employees, broadly unaffected by changes in regulations, has fallen recently. But, overall, data for April suggest that the wage indices have not yet been declining as expected.

According to detailed data released by the CSO, Hungary's gross domestic product grew by 0.9% in 2008 Q1, after adjustment for calendar variations. The rate of export growth was slightly higher than expected, while investment and government consumption data were lower than the forecast. Basically, the released data were consistent with the growth path published in the May issue of the *Quarterly Report on Inflation*.

Financial markets

For most of May, pressures on global markets caused by turbulence in the US sub-prime market were abating. By contrast, international capital market developments have been dominated by rises in inflation expectations over the past few weeks. Although there has been a significant easing in world food prices since March, the rise in oil prices has continued uninterrupted, and trend inflation rates for May again caused negative surprises in a number of countries. Some observers argue that recent oil price rises have been driven by fundamental factors (supply has been slow to adjust, and the decline in demand has been hampered by government subsidies), and therefore, there is little prospect of a fall in prices. Until recently, the world's major central banks have focused on the downside risks to growth, but both the ECB and the Fed have now been placing greater emphasis on inflation in their communications. As a result, expectations of official interest rates in the euro area and the US have increased.

Expectations of the MNB's interest rates increased significantly. One month ago, the money market yield curve implied that the central bank base rate would rise to 8.75%. Today, yields imply a rise to 9.25%. Most of the shift in the expected path of interest rates occurred in two days. At the beginning of the month, in response to President Trichet's strong statement, euro-area short-term yields rose, with forint yields following suit, similarly to other currencies of the region. However, forint yields rose further on the following day, in contrast with the rest of the region. This was accompanied by rises in long-term yields and exchange rate depreciation, characteristic of shocks affecting risk premia.

According to the Reuters poll of economists, nearly every respondent expects rates to be raised at the Monetary Council's next meeting. The majority of analysts expect the current interest rate cycle to peak at 9%, in contrast with 8.5% a month ago. Inflation is expected to be 3.7% at the end of 2009 and 3.25% on average in 2010, significantly above the MNB's target.

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

Following discussion of the latest macroeconomic developments, the Council considered arguments for maintaining and for raising the base rate. Members agreed that the May projection was surrounded by a significant degree of uncertainty.

In the members' judgement, the prospects for growth had not improved materially recently. However, their views were divided on the disinflationary effects of the decline in domestic demand. Several members stressed that the downward impact on inflation of the contraction in demand could only unfold gradually. But some other members added that, even indirectly, signs of below-potential growth had not yet been detected based on measures of capacity utilisation and labour market statistics.

Several members noted that the disinflation process might falter, due to further rises in international commodity prices and the strengthening in global inflationary pressures, which might lead to a deterioration in the medium-term outlook for inflation. Other members, however, were of the view that in the current situation the rise in commodity prices, which reflected fundamental factors, was also fuelled by speculation. Consequently, the high volatility of prices and episodes of overshooting should be ignored, and it might be sufficient to incorporate the effect of commodity prices on the projection quarterly, at the time the *Reports* were updated. On another view, central banks of countries where demand was depressed, as the case was in Hungary, should respond in a different way to rises in commodity prices.

Members agreed that the price and wage trends, fundamentally influencing the outlook for domestic inflation, were surrounded by a significant degree of uncertainty. However, it was good news that, according to the latest data, services price inflation had been lower than earlier expectations. But developments in underlying inflation had not been clearly positive yet for the overall consumer price index. As regards the latest earnings data, several members noted that wage growth had fallen markedly in companies with more than 250 employees, which were affected less by the reduction in the informal sector, and therefore, reflected overall wage dynamics better. However, some members stressed that rapid wage growth was still inconsistent with poor economic performance, particularly as regards small and medium-sized enterprises. All this might point to structural problems and a lack of adequately skilled labour. As far as wage developments were concerned, it was argued that the effects on demand of the reduction in the informal economy had not yet been felt, but it might add to inflationary pressures from the cost side.

Council members judged that there had been rises in risk premia on forint assets and CDS spreads, due to the decline in investors' risk appetite. Several members warned that major central banks were making increasingly strong statements in response to global inflationary pressures, which had contributed to a rise in the forint yield curve. Some members thought that exchange rate and yield developments may have also been influenced by speculative capital flows. On another argument, a growing number of central banks in emerging Asian and Latin American countries had tightened monetary policy to address inflation concerns.

Strengthening the role of the inflation target as an anchor was the most important challenge for monetary policy, due to rises in imported inflation. The interest rate increases in the past two months and the tightening in monetary conditions could help to meet the inflation target. In this regard, some members warned that monetary policy should respond to inflation developments expected on a 5–8 quarter time horizon and that the prospects had not changed materially since May. It was also argued, however, that the interest rate increases so far in the current cycle would only succeed if significant achievements were made in reducing inflation. Members agreed that, if interest rates were to be maintained, the communication of the decision was a great challenge in view of the market's expectations. However, several others urged that the interest rate cycle should be slowed. The Council maintained its view that it should continue to pursue a tight monetary policy and it was 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. Six members voted to maintain the base rate at 8.50% and four members voted for a 25 basis point increase.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.50%	**6**	Tamás Bánfi, Péter Bihari, Csaba Csáki, Ilona Hardy, Júlia Király, Judit Neményi
In favour of raising the base rate to 8.75%	**4**	Ferenc Karvalits, György Kopits, Gábor Oblath, András Simor

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

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

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 21 July 2008. The minutes of that meeting will be published at 2 p.m. on 15 August 2008.