MINUTES

OF THE MONETARY COUNCIL MEETING

OF 20 OCTOBER 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 September 2008, the annual rates of increase in the Consumer Price Index and core inflation were 5.7% and 5.1% respectively. Compared with August, the CPI fell by 0.8 percentage points and core inflation by 0.7 percentage points. The trend inflation indicator, which captures longer-term price developments, was at a historically low level in the month. This reflected a significant drop in processed food and services price inflation, attributable in part to movements in the prices of individual products.

In Q3, the outturn for the Consumer Price Index (6.3%) was broadly in line with the Bank's forecast. By contrast, core inflation was slightly higher at 5.6%. Processed food price inflation exceeded expectations, even allowing for the correction in September following an increase in the summer. The failure of tradables price inflation to ease back as anticipated may be an indication that domestic firms used a weaker exchange rate in setting their prices, as opposed to the EUR/HUF 232 exchange rate assumed in the August issue of the *Quarterly Report on Inflation*. Services price inflation, at 6% in the quarter, rose much less sharply, which suggests that the effect of the negative output gap may have been stronger than expected.

According to Labour Force Survey data, the whole-economy seasonally adjusted employment rate was 7.6% in August 2008. Activity, employment and unemployment all stagnated compared with the previous month. Overall, employment is expected to fall in the period ahead, reversing the slight increase in earlier months.

Business confidence indicators (IFO, Business Climate Indicator, European Sentiment Indicator) published in September 2008 suggested a weakening in the outlook for economic activity in the euro area compared with previous months. According to the ESI for Hungary, sentiment among domestic firms continued to deteriorate. In the CSO's preliminary release, industrial output, adjusted for working day variations, was down 1.2% in August from a year earlier. The performance of the Hungarian industrial sector weakened significantly compared with the first four months of the year, consistent with developments in business activity elsewhere in Europe.

Financial markets

There have been significant disturbances in international financial markets in recent weeks, which, coupled with a decline in investors' willingness to take risk, have contributed to the sharp falls in equity markets. The effects of the crisis on emerging market economies, including Hungary, have been increasingly severe.

In addition to enhancing liquidity, the crisis management measures taken by central banks of developed countries included (i) bank capital increases crucial to preserve financial stability, and (ii) the introduction of insurance schemes for customer deposits as well as interbank market liabilities. The Fed, the ECB, the Bank of England, the Bank of Canada, the Swiss National Bank and the Sveriges Riksbank announced a concerted interest rate reduction of 50 basis points, in order to boost liquidity in the interbank markets. Furthermore, the ECB, the Bank of England and the Swiss National Bank announced tenders of US dollar funding at fixed interest rates for full allotment, to address the problems arising in the EUR/USD market; and the Fed announced that it would expand its swap line with central banks to provide US dollar liquidity. The Swiss National Bank will

provide a EUR/CHF swap line to the ECB, to enhance European banks' Swiss franc liquidity. The ECB announced that it would expand the range of eligible collateral for its liquidity-providing operations to include dollar, pound sterling and yen-denominated bonds issued in the euro area. In the US, the first details of the USD 700 billion financial rescue plan were released, according to which the government would inject USD 250 billion into troubled US financial institutions. The value of insured retail deposits was increased; and a government guarantee was announced on banks' new subordinated debt issues. In a number of EU Member States, governments announced guarantees on certain new debts of banks.

The actions taken by central banks and governments to address the turmoil have so far been insufficient to lead to a turnaround in the global money and capital markets. Equity prices have fallen by some 25% in developed countries since the end of September; and emerging markets have experienced even sharper declines. Demand for short-term US Treasury securities has remained strong, causing yields to fall to around 0. Despite the significant efforts to enhance liquidity, interbank dollar interest rates are now some 500 basis points higher, and euro interest rates have moved similarly recently. Due to the extremely low level of willingness to take risk, associated with deep mistrust, banks have been reluctant to lend in the interbank market.

The almost complete erosion of risk appetite and the dislocation in money markets have both had an impact on emerging markets. Currencies of developing countries depreciated sharply, with a number of central banks (for example, of Brazil, Mexico, South Korea and Romania) intervening in the foreign exchange market to arrest the decline in the value of their currencies. Implied spreads to the dollar and the euro fell significantly, due to the drying-up of FX swap markets. Yields and CDS prices both surged to very high levels, and in some cases to historical peaks.

Hungarian 5-year sovereign CDS prices have risen sharply recently, and the BUX index has declined by 30% since September. In addition, government securities yields have risen to unusually high levels at every maturity, accompanied by a dramatic fall in demand in the secondary market and at auctions.

The domestic FX swap market has been struggling with severe operational problems. Interest rate spreads, implied by swap rates, fell to negative territory both against the dollar and the euro for several days, causing serious difficulties for Hungarian financial institutions. Domestic banks traditionally satisfy their foreign currency needs in the swap market, and therefore, the drying-up of activity in the market exposed the Hungarian financial markets to severe risks. Liquidity problems and diminishing risk appetite have also been detected in the spot foreign exchange market: the forint exchange rate against the euro weakened from EUR/HUF 240 at the end of September to EUR/HUF 265–270. Since the end of September EUR/HUF volatility, implied by option prices, has risen strongly. Non-residents' net forint purchases declined by HUF 700 billion and the total amount of their outstanding swaps rose by HUF 200 billion. Very few of the respondents to the Reuters poll answered the question about their expectations of the exchange rate at the end of November and the end of 2008. In both cases, they expect the exchange rate to be EUR/HUF 256, albeit the forecasts are widely dispersed.

The domestic authorities have been attempting to calm the market and help it to return to normal conditions by implementing a series of measures. In line with the recommendation of the European Union, the upper limit of guarantee provided by the National Deposit Insurance Fund for customer deposits was raised to HUF 13 million. Amidst gradually worsening domestic money and capital market conditions, the Magyar Nemzeti Bank

announced further actions. As a first step, it introduced two-way FX swap tenders, in which the Bank plays an intermediary role by matching excess forint and euro funds offered by banks. Later, the Bank introduced an overnight FX swap facility for domestic banks. This was facilitated by an agreement between the MNB and the ECB. In order to restore normal liquidity conditions and the smooth functioning of the government securities market, the MNB reached an agreement with primary dealers. Under the agreement, market makers provide continuous quotes for securities with more than three months residual maturity, and increase their holdings of government paper by an agreed amount over the period to the end of 2009, and the MNB undertook to conduct auctions for the purchase of government securities. In addition, the Bank assists primary dealers in financing purchases of the required amounts of government securities by introducing two new lending facilities. Two-week loan tenders for full allotment at fixed interest rates will be invited weekly; and six-month loan tenders for pre-specified allotment amounts at variable interest rates will be conducted on a regular basis.

The information content of indicators used to measure interest rate expectations may be heavily biased during times of extreme market stress: therefore, they should be treated with caution. A 50–75 basis point increase in official interest rates is priced into the latest FRA prices. However, there is a high probability that, in the current circumstances, high FRA rates do not accurately reflect interest rate expectations, as the market has been reported to be illiquid by participants. Respondents to the Reuters poll do not expect the base rate to change over the period to the end of the year.

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, members of the Council agreed that the outlook for inflation had improved recently, due to the worsening prospects for the global economy. They noted that the uncertainty characterising global money and capital markets had spilled over to Hungary. In addition to the macroeconomic problems of the past and the high level of debt, the country's economic integration also added to its vulnerability. Consequently, in the current circumstances the greatest challenge facing economic policy was to preserve financial stability.

There was agreement that the actions taken by the Bank had helped to reduce rollover risk in the domestic money and capital markets. On one argument, risk and liquidity management practices of European financial institutions affected the financial markets of highly integrated economies. Several members stressed that psychological factors had also contributed to the turbulence in domestic markets and that supporting market sentiment was a particularly important task for policy. Disturbances in sub-markets might spill over to other markets, due to their interdependence. Therefore, government interventions were required all over the world to address operational problems. In this regard, several members noted that the Hungarian government had far fewer tools at its disposal than governments of larger countries; however, cooperation with international institutions, especially with the International Monetary Fund and the European Union, might help to mitigate risks to financial stability.

Members judged that the decline in foreign currency lending by commercial banks would pose a severe problem. Although in recent years the Bank had repeatedly warned about the risks inherent in foreign currency loans, their share could only be reduced gradually.

However, the Bank's actions and the agreement with the International Monetary Fund might help to maintain the smooth functioning of the money and foreign exchange markets, which, in turn, might also improve the prospects for banks' foreign currency lending business.

Council members were in agreement that monetary policy should maintain a wait-and-see approach, due to the uncertainty characterising global financial markets. Several members stressed that, despite the financial turbulence, there was no need for an unexpected interest rate increase now, as such a move would exacerbate the current problems. Others, however, warned that the Monetary Council should stand ready to implement a larger interest rate increase, if necessary.

Members judged that the domestic macroeconomic environment was generally supportive of disinflation, due to the deterioration in the outlook for growth. Some members thought that the global financial crisis could have a negative effect on world output growth. On another argument, the corporate sector's access to external finance had become restricted and less EU funds could be drawn down, due to a lack of own resources.

Members agreed that the external conditions for meeting the inflation target had improved, as the sustained rises in commodity and food prices had been reversed. However, they were divided on the question of assessing inflation expectations. Several members emphasised that inflation expectations may have fallen in response to the latest negative economic news, as confirmed by market analysts revising down their forecasts. The recent drop in inflation and firms' backward-looking pricing behaviour may also have contributed to a fall in inflation expectations. Other members, however, were of the view that the problem of expectations continued to pose a challenge to monetary policy.

After the discussion, the Council voted unanimously to maintain the base rate.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.50%	**11**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, György Kopits, Judit Neményi, Gábor Oblath, András Simor

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

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

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 24 November 2008. The minutes of that meeting will be published at 2 p.m. on 12 December 2008.