MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 17 DECEMBER 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

The overall picture of the Hungarian economy has changed little since the Monetary Council's last meeting. In November, the annual rates of CPI and core inflation both accelerated to 7.1% and 4.6%, respectively, compared with the previous month. And the annualised monthly inflation rate – which best captures underlying developments – rose to 6%, after fluctuating between 3%–4% since the second quarter of the year. This increase largely reflected the recent food price shock. By contrast, the rates of industrial goods and services price inflation did not rise further, presumably in part because of weak domestic demand.

The rate of increase in processed food prices reached a new historical high in November. Nevertheless, inflationary pressure from food prices is expected to abate in the coming months. This view is supported by the fact that unprocessed food prices stopped rising in the month. But, due in part to the global nature of the price shock, the upward pressure on overall inflation generated by food prices may persist over the longer term, although perhaps slightly less so than in recent months.

Third-quarter economic growth was broadly as envisaged in the November issue of the *Quarterly Report on Inflation*. Hungary's GDP grew by 0.9% in 2007 Q3 relative to the same period of the previous year. The effects of subdued activity in the government sector and poor performance of a few sectors with a smaller weight (e.g. construction and agriculture) continue to be the main factors explaining slow growth.

Based on the quarter-to-quarter developments, economic growth appears to have passed a trough in Q2, in line with earlier expectations, and the economy began to recover slightly in Q3. The rate of decline in household consumption stopped increasing, which may be the strongest indication that a turning point was reached. However, there continues to be considerable uncertainty about how the incipient economic recovery will unfold.

Investment activity declined further in the first three quarters of 2007, following a sharp downturn in the previous year. However, this weakness was closely related to falling building activity, caused in turn by the absence of infrastructure investment by the government sector. In addition, there is increasing evidence of a slowdown in November in export-oriented manufacturing output, which had hitherto been the engine of economic growth. Foreign trade and industrial production both slowed in September–October, consistent with the turnaround in European business activity signalled by important business confidence indicators since the middle of this year.

Conditions in international financial markets remained uncertain. Market sentiment and price movements have recently been mainly driven by assessments of the potential effects on the United States and the world economy of the turbulence in the US mortgage market. Most of the renewed sell-off generated by heightened expectations of a recession in November was reversed in the first half of December, as very strong Q3 growth figures in developed countries were followed by the release of mixed economic news. There was some improvement in global willingness to take risk in asset classes other than mortgages. However, significant losses on sub-prime mortgage exposures were once again revealed by large investment banks. The spread between short-term interbank rates and government securities yields increased further in the dollar and euro-denominated markets. That reflected a growing loss of confidence in the financial sector. In a concerted action, developed country central banks announced the provision of additional liquidity support, in order to allay liquidity concerns.

In its statement accompanying the decision in December to reduce interest rates by 25 basis points, the US Federal Reserve pointed to uncertainty surrounding the economic outlook. US economic growth was slowing, reflecting the housing correction and the weakening of domestic demand. However, there was little change in the prospects for inflation: high energy and commodity prices continued to exert upward pressure on inflation. Markets expect the Fed to reduce the policy rate by another 100 basis points next year. After a tightening of monetary policy in the first half of 2006, the Bank of England and the Bank of Canada both lowered rates in December.

The European Central Bank left interest rates unchanged in December; however, the language of its communication was strong. Staff revised up their inflation projection and simultaneously revised down their growth projection. In the ECB's view, the risks to inflation were strongly on the upside in the short and medium term, and therefore the Governing Council discussed the case for an immediate interest rate increase, despite the median forecast of 1.8% inflation in 2009 being consistent with price stability. In November, the euro-area harmonised index of consumer prices rose to 3%, the highest level in several years. Although October industrial production data and forward-looking confidence indicators showed that growth was slowing in the region, the path of official interest rates priced into the market moved upwards, and was consistent with a 25 basis point interest rate increase next year, in contrast with expectations of a rate cut roughly a month before.

In emerging market countries, rises in risk premia and the strengthening of global inflationary pressures caused a shift towards monetary policy tightening. The Czech National Bank and the Bank of Poland both raised key interest rates by 25 basis points, as inflation had increased sharply throughout the region, pushed up by higher food prices. The forint exchange rate strengthened to levels around EUR/HUF 252 from EUR/HUF 258 characteristic at the time of the Monetary Council's November meeting. Movements in the currencies of the region were largely comparable, although the forint appreciated less strongly than, for example, the Czech koruna or the zloty. The Slovak koruna posted the smallest gain in the region, and the decision by the National Bank of Slovakia to leave interest rates unchanged may have contributed to this.

The Monetary Council's November decision did not come as a surprise to the market; however, the Bank's communication triggered a change in short-term interest rate expectations. In previous months, the Council's decisions to hold rates caused participants to bring the expected date of a rate cut forward by one month. But with the decision taken in November, markets and analysts alike now expect the base rate to remain unchanged over the next 3–4 months. There was little change in longer-term interest rate expectations: the yield curve is consistent with a total 50 basis point rate cut next year; and the consensus forecast is for the base rate to be reduced by 75 basis points. In December, the long-term forint premium eased back and the risk of default on Hungary's foreign currency debt fell.

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 the latest available data did not materially change the path outlined in the November *Report*, according to which the reduction in inflation was likely to take longer than previously thought, due to the sharp rises in food and materials prices. However, the most likely scenario was that the 3% medium-term inflation target could be met in 2009. Several members noted that although core inflation had continued to rise according to the latest data, this had been caused by higher processed food prices. The second-round effects of the food price shock had not yet been observed in the prices of other products and services. In addition, for several other members it was good news that unprocessed food prices had not increased further in November, which in turn would restrain processed food price inflation over time. It was argued that, given the ability of the agricultural sector to adjust its output to changes in prices very quickly, the correction of food prices could be faster than currently expected, if weather conditions were better in 2008 than they had been in 2007.

Council members were in agreement that anchoring inflation expectations continued to be a key task for monetary policy in the current environment and that 2008 wage developments would play a major role in this regard. For several members, the outcome of the wage negotiations was uncertain for the time being. They pointed out that the introduction of the minimum wage for skilled workers could have a negative effect on pay developments in the private sector. Others noted that the decline in corporate profitability would be able to effectively restrain wage growth and that employers' current wage offers were compatible with the Bank's inflation target. In addition, the modest rise in public sector wages could have a disciplinary effect on private sector wage growth. On another view, failure to reach a wage agreement could not be ruled out, but that could even help wage growth to moderate more rapidly, as suggested by past experience.

Several members noted that it would have a negative effect on both the short-term path of inflation and households' inflation expectations, if administered prices of certain services in 2008 were raised to the extent reported by the press recently.

Some members argued that, looking over the past several years, global inflationary pressures had not been as strong as they were currently, due to rises in international food and commodity prices. Uncertainty in international markets was acting as a drag on growth in the major economies, and consequently, central banks found themselves facing a particularly difficult situation. It was argued that all of this could exacerbate the problems caused by low growth and high inflation, already characterising the Hungarian economy.

Several members noted that, according to the evidence of third-quarter data, the slowdown in economic growth had been slightly stronger than expected and that the future outlook for the economy had deteriorated somewhat, due to the worsening in external business conditions. Moreover, developments in the major components of domestic demand and short-term indicators of economic activity had not yet suggested a clear turning point in the growth cycle. In this respect, some members noted that if the risks associated with the short-term path of inflation diminished, then monetary policy should pay more attention in the future to risks of a potentially sharp slowdown in the economy. By contrast, it was argued that although the influence of monetary policy on growth in Hungary was limited compared with other countries, the time it took for policy changes to feed through to inflation was relatively short, due to the important role played by the exchange rate channel. Therefore, under the current circumstances an accommodating monetary policy could pose a number of risks.

Members agreed that the international investment environment had not improved materially since September, due to the worsening of problems in the US mortgage market. Several members thought that, although domestic long-term forward and credit risk premia had fallen somewhat recently, there had been a sustained rise in the risk premia on forint-denominated assets. All this reduced the room for monetary policy manoeuvre. On another argument, tighter-than-expected interest rate policy and communication, rather than the rise in risk premia, may have played a role in the forint yield curve shifting upwards recently.

The overwhelming majority of members agreed that the Council would have scope for reducing interest rates further if future economic conditions reflected a reduction in the risk of higher inflation transmitted through expectations and an improvement in international investor sentiment towards the Hungarian economy.

After the discussion, the Chairman invited members to vote on the propositions. Eleven members voted to maintain the base rate and one member 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%	**11**	Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Béla Kádár, Ferenc Karvalits, Júlia Király, György Kopits, Judit Neményi, Gábor Oblath, András Simor
In favour of reducing the base rate to 7.25%	**1**	Tamás Bánfi

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

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 January 2008. The minutes of that meeting will be published at 2 p.m. on 15 February 2008.