MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 SEPTEMBER 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

Annual CPI inflation eased to 8.3% in August, down 0.1 percentage point on the July figure. At 5.3%, the annual rate of core inflation was 0.3 percentage points lower than in the previous month. However, the month-on-month price indices barely reflected this deceleration in inflation; and the August figure increased the upside risks relative to the Bank's latest projection. The annualised month-on-month rate of inflation had been fluctuating between 3% and 4% since May, before edging up to close to 4% in August. This slight rise was mainly attributable to higher processed food price inflation during the month, with other components of trend inflation remaining broadly stable. Posing further upside risks to inflation, other components of trend inflation showed little or no easing, despite the exchange rate remaining strong near the bottom of the intervention band since end-2006 and economic growth falling below its longer-term potential rate.

Looking at the prices of items excluded from the core measure, inflation of processed food prices rose sharply in the month. This marks the beginning of the negative inflation shock, also reflected in the Bank's latest projection, which has been triggered by increasing excess global demand and this year's drought. The bulk of price increases is expected to take place in the coming months, and this is likely to feed through to processed food prices, transmitted by other food items from earlier stages of the production process. At the same time, dairy product prices rose sharply in August already, even exceeding the Bank's expectations, due mainly to the change in the EU's agricultural policy.

2007 Q2 GDP grew by 1.2% relative to the same period of the previous year, down 0.2 percentage points on the preliminary estimate. This slowdown in growth was mainly accounted for by the curtailment of activity in the public sector. Other major components of domestic use (e.g. household consumption expenditure and gross fixed capital formation) stagnated. Although the continued benign international environment contributed positively to net exports, the difference between export and import growth narrowed relative to previous quarters. On the output side, the decline in the performance of the government sector, agriculture and construction was dominant, offset in part by continued robust growth in manufacturing. The sharp reduction in social benefits and the slowdown in net exports came as a negative surprise and were not in line with the projection. Developments in household consumption expenditure and the slight turnaround in investment activity, on the other hand, proceeded largely as the Bank expected.

The picture painted by data for July (the latest available) was one of continued growth led by buoyant international activity. Industrial production (particularly in the export sector), orders for industrial exports and foreign trade picked up in the month. Looking at the sectoral breakdown of industry, this growth in production for exports was broadly based, and could not be linked to the outstanding performance in any one sector.

Whole-economy gross wages grew by an annual rate of 10% in July relative to a year earlier. Within this figure, private sector wage growth was 10.8%. Both the short and long-term dynamics of the trend indicators, which best capture the underlying developments, suggested that wage adjustment was underway, consistent with the Bank's projection. Much of this adjustment, however, has so far occurred through cuts in bonus payments, with regular pay growth showing little sign of any slowing yet.

According to Labour Force Survey data, the unemployment rate stopped falling in May-July, and employment as well as activity stagnated. Based on Q2 data in a sectoral breakdown, employment in the private sector rose slightly relative to Q1. Here, the trend growth in numbers employed in manufacturing – a sector recently influenced favourably by external recovery – continued. The number of employees in market services, however, remained broadly static.

Financial markets have recently been characterised by a high degree of uncertainty. Asset prices show increased volatility. Confidence among market participants has not yet been restored, as uncertainties still remain in respect of the scale of exposures to the mortgage and credit derivatives markets, where prices have tumbled recently. US investment banks, reporting their third-quarter results the earliest, incurred lower-than-expected losses; however, banks and investment funds' portfolios may contain significant unrecognised losses. Despite the provision of additional liquidity by central banks in the euro and dollar interbank markets, short-term yields are considerably higher than those on comparable government securities, reflecting banks' lack of confidence in each other, on the one hand, and increased demand for risk-free assets, on the other. Due to the drying-up of liquidity in the markets for bank paper, a UK mortgage institution was only able to access liquidity support from the Bank of England at a penalty rate, which further eroded sentiment and ultimately led to a run on deposits.

In the face of market turbulence, the US Fed reduced its target for the federal funds rate by 50 basis points to 4.75%. In the bank's judgement, growth was moderate in the first half of 2007, but the tightening of lending conditions may intensify the housing correction and restrain economic growth. Markets responded positively to the reduction in dollar interest rates, with demand for risky assets picking up. Although US macroeconomic data released in recent weeks painted a fairly negative picture about the real estate and labour markets, other, mainly forward-looking, indicators from the remaining sectors of the economy reflected healthy growth. Despite the current inflation risks, the markets expect a further 25–50 basis point reduction in rates.

At its policy meeting in September, the Governing Council of the ECB left interest rates unchanged at 4%. The bank's decision to hold rates did not come as a surprise given the turbulent market conditions. The ECB noted that medium-term growth prospects in countries of the euro area were favourable and upside risks to inflation remained; however, due to the uncertainty caused by financial market volatility and the repricing of risks, there was a case for waiting for more data. The markets expect the ECB to raise interest rates further over the period to the end of the year.

In September, the reversal of the significant weakening in high-yielding currencies between the end of July and early August continued. The simultaneous depreciation of the Japanese yen pointed to a build-up in carry trade positions. The softening in emerging market risk premia also reflected an increase in investors' appetite for risk. The forint appreciated, strengthening to EUR/HUF 251 after the reduction in US rates. But despite improving global sentiment, higher volatility of forint-denominated asset prices may remain.

In Central Europe, the National Bank of Poland and the Czech National Bank both raised interest rates. The NBP explained its widely expected move by (i) faster growth than the economy's potential rate, (ii) the very tight labour market, and (iii) the inflationary effects of fiscal policy's inclination towards easing. The move by the CNB, however, was something of a surprise, although the bank stated that this move was consistent with the recent tightening cycle. As an effect of these steps, the forint's spread relative to other currencies of the region fell.

The sharp sell-off of the forint by non-residents, which was seen in the previous two months, did not continue in September. Investors' behaviour in the foreign exchange market was broadly neutral. However, their holdings of government securities fell, explained by lower demand at the auctions, in addition to sales in the secondary market. Non-residents sold off their holdings mainly at medium-term maturities; at longer maturities they were net buyers, and so they extended the duration of their portfolios. The five-year ahead five-year forward premium once again fell below 150 basis points.

Improving risk appetite, exchange rate strengthening and the aggressive rate cut in the United States all heightened expectations of a reduction in official interest rates in Hungary. The yield curve is consistent with a 7.00% and a 6.25%–6.50% base rate at end-2007 and end-2008 respectively. This is in line with the recent Reuters consensus forecast. According to the poll, all respondents expect the MNB's Monetary Council to reduce the base rate by 25 basis points at its September policy 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, to reduce them by 25 basis points, or to reduce them by 50 basis points.

Members judged that recent domestic activity data were in line with the central inflation projection. As was the case in earlier months, the majority of members thought it was likely that, after the unwinding of the supply shocks hitting Hungary, inflation would revert to levels consistent with price stability.

Several members noted that inflation could be in line with the projection if expectations did not become stuck at a high level. In this regard, private firms' wage-setting in 2008 would be a key piece of information. Moderation in wage growth to the level consistent with price stability was a precondition for the significant disinflation expected for 2009. It was also argued that the Monetary Council's credibility influenced expectations, and thus the interest rate decisions and their communication over the following months could be a factor in the wage bargaining process. On another view, in its communications the Council needed to pay increased attention to upside risks to inflation caused by excessive rises in wages relative to productivity growth. One member thought that the slowdown in economic growth left firms with less room to raise prices, which could act to reduce the rate of wage growth. Some other members held the opinion that the current monetary conditions were already tight and, beyond that, monetary policy did not have a material influence over expectations. There was a range of views in the Council regarding the extent of the disinflationary impact on prices of the increase in the output gap.

Those members who supported a reduction in interest rates noted that the inflation projection could well be around the Bank's target on the time horizon relevant for monetary policy. The majority of members preferring a rate cut emphasised that the international investment climate had been benign over recent weeks, risk premia on forint assets had fallen back to their levels in May-June and, as implied by the yield curve, market participants expected the Bank to reduce rates more rapidly over the next two years. For several members it was favourable news that international investors made a distinction between risky corporate loans and emerging country sovereign debt, in favour of the latter. Consequently, a decline in global risk appetite would have less of an influence on the risk premium on forint investments. On one view, liquidity moving out of the mortgage market could find its way to emerging market investments. Several members judged the Fed's interest rate cut and the ECB's decision to postpone a rate increase as giving the MNB more room to manoeuvre.

Those Council members who voted for maintaining rates noted the importance of recent disturbances in international financial markets. Closely related to the problems facing the US mortgage market, one of the key risks was that persistent processes may have started, the effects of which on the financial infrastructure and the economy were not yet well understood, and therefore, the ultimate impact was also unclear. Members arguing for leaving rates on hold also said that future developments in domestic inflation were fairly uncertain, because of doubts about whether and how inflation expectations were anchored, which were mainly related to the uncertain outcome of the wage negotiations and the potential pass-through of higher food prices.

After the discussion, the Chairman invited members to vote on the propositions. Two members voted to maintain the base rate; eight members voted to reduce it by 25 basis points; and one member voted for a reduction of 50 basis points. Accordingly, the Council reduced the base rate to 7.50%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.75%	**2**	Ilona Hardy, Júlia Király
In favour of reducing the base rate to 7.50%	**8**	Péter Bihari, Vilmos Bihari, Béla Kádár, Ferenc Karvalits, 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
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 29 October 2007. The minutes of that meeting will be published at 2 p.m. on 9 November 2007.