MINUTES

OF THE MONETARY COUNCIL MEETING

OF 21 FEBRUARY 2005

Publication date: 2 p.m. 19 March 2005

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 rate-setting 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

In January 2005, consumer price inflation was 4.1%, with core inflation and the constant tax price index at 3.8% and 3.1% respectively. The decline of 1.4 percentage points in annual consumer price inflation relative to December 2004 partly reflected the base effect of indirect tax hikes in early 2004 and the faster pace of disinflation since the second half of last year, led by the strong exchange rate and import competition.

Disinflation in the core measure of inflation since 2004 has played a dominant role in the decline in consumer price inflation. After adjusting for seasonal variation, monthly core inflation moved below the historically low 3%–4% band, where it had fluctuated for a period, falling to less than 1 per cent in January 2005. As seen last year, disinflation mainly affected the prices of tradables, processed foods and alcoholic drinks, particularly influenced by the strong exchange rate and import competition.

In the February projection, disinflation gathers momentum throughout the forecast period, if monetary conditions prevailing in January 2005 remain unchanged and other – technical – assumptions are met. Under the current assumptions, the forecast is for the consumer price index to be 3.6% at end-2005 and 3.4% at end-2006. During 2005, the majority of the expected decline in the index is likely to stem from the indirect tax increases in early 2004 dropping out of the index; however, macroeconomic developments and certain other factors also point to lower inflation. In 2006, the slowdown in consumer price inflation is expected to mainly affect product groups outside the core measure of inflation. The risks to the central inflation projection are broadly symmetrical in both 2005 and 2006.

Hungary's gross domestic product grew by 4.1% in 2004 Q1–Q3. On the production side, this growth was driven mainly by robust manufacturing activity, while the contribution of market services to growth was more modest. Agriculture grew at a rate exceeding 30 per cent over the period. This meant that the sector added nearly 1 percentage point to economic growth, despite its relatively low share in Hungary's GDP.

On the absorption side, fixed investment made the greatest contribution to growth. Although it grew at a more subdued rate than previously, household consumption also played a major role, due to its significant share in GDP. The contribution of net exports to growth was slightly negative, mainly on account of strong imports in the first half, according to national accounts figures.

Growth in the main items on the absorption side is likely to have slowed in the final quarter of 2004. On the production side, manufacturing may have grown at a quicker pace, but the sector's share of value added in the total economy only slightly exceeds 20 per cent; and value added in the other economic sectors is presumed to have grown at a slower rate. On the whole, although its rate is likely to have slowed somewhat from 2004 Q3 to Q4, annual average GDP growth may have reached 4%.

Judging from the recent conjunctural developments, GDP is expected to grow by 3.8% and 3.6% in the next two years. Potential growth in the economy, at 3%–4%, is likely to be slightly below GDP growth. The output gap, which measures the difference between actual and potential output, is expected to gradually shift from slightly negative to positive. Owing to this, demand-pull inflationary pressure will slowly arise, mainly from 2006.

Household consumption expenditure growth was 3.8% in Q4; thus spending by the sector was more modest after rising robustly in the period 2001–2003. However, even this slower rate of growth outpaced the forecast in the November *Report*. At the time of the *Report*, household spending growth was expected to slow more strongly, due mainly to the sector's slower wage income growth and higher financial savings. However, propensity to consume stabilised at a high level, both historically and by international standards.

In 2005, real income growth is expected to gather pace, while nominal wage inflation will slow somewhat, as the effects of the indirect tax increases unwind. Due to consumption smoothing, households' spending is likely to rise more slowly relative to their real income. However, easing liquidity constraints and the development of the financial infrastructure (for example, the expansion of foreign currency lending) point to higher consumption growth. Consequently, the consumption-to-real income ratio is now expected to ease at a relatively slow pace in both 2005 and 2006.

The decline in corporate investment in 2004 Q2 proved only temporary: growth resumed at a robust rate in Q4. This came as a surprise compared with the cyclical slowdown emerging from the assessment of other news, and developments in output in particular. Although corporate investment had been on a clear upward trend since the recovery started in 2003, it had shown fairly high volatility. Developments in capacity utilisation suggest lower fourth-quarter growth, as evidenced by business confidence surveys conducted in the period. However, on the average of 2004 corporate investment growth may have significantly exceeded the outturns for earlier years.

Consistent with the external business cycle and prospects for growth, corporate investment activity is expected to remain robust, particularly on account of the ongoing substitution of labour with capital in manufacturing. However, the salient growth rate recorded in 2004 Q3 is unlikely to be sustained over the short term. The investment/capital ratio has been rising steadily from its relatively low level in 2002–2003, moving towards levels typical of earlier years. On the whole, corporate investment is expected to rise robustly, increasing by 6%–7% in 2005–2006.

According to partly preliminary trade data, goods exports picked up again in the fourth quarter. This is consistent with the rising momentum of industrial exports in the same period. Import growth continued to slow down. Consequently, the trade deficit may have been lower in 2004 relative to the forecast in the November *Report*.

Although information currently available is contradictory for the short term, the recovery of external markets is expected to gather strength in the long run, which is likely to be supported by the expected lower world market price of crude oil relative to earlier years. This continues to ensure good sales opportunities for Hungarian exporting firms: Hungary's export market share is likely to increase further over the longer term. The real effective exchange rate based on unit labour costs, an indicator of exporting firms' competitiveness, is forecast to appreciate only slightly, so export growth – which is expected to be around 10%–12% – is likely to slow down only marginally. The share of components of aggregate demand with a lower import content is likely to rise, which foreshadows lower import growth relative to export growth, and imports are expected to grow by less than 10% in both years. This structural shift may raise the contribution of net exports to growth.

According to information currently available, the general government borrowing requirement as a proportion of GDP may remain stable in 2005. In addition to a slower increase in capital expenditure, the corporate sector borrowing requirement as a percentage of GDP is not expected to increase further; and net financial savings of the household sector may rise modestly. The external financing requirement may fall by 0.6 percentage points as a proportion of GDP. Nevertheless, although the surplus on the capital account may rise, the current account deficit is expected to increase to EUR 7.7 billion. In 2006, contractionary fiscal policy will be a precondition for reducing the external financing requirement. Private sector financing capacity is likely to remain level as a proportion of GDP.

According to data released by the CSO, gross wages in the private sector were 9.4% higher in December 2004 than a year previously. The seasonally adjusted data continue to suggest that private sector wage inflation fell slightly in 2004 H2, following the sharp upturn in the early part of the year. Although the December figures for both manufacturing and market services are extremely noisy, private sector wage inflation is expected to decline slowly over the long term.

Information currently available provides evidence that labour market tightness continued to ease in the final months of 2004. The slowdown in the growth rate of labour use and in that of wage growth both point to a further easing of labour market tightness.

The international investment environment developed very favourably in the past month, and the decline in investors' risk appetite early in the year proved only temporary.

Foreign investors stepped up their long forint positions in the past month, reversing the downward trend which began in August. The larger part of this increase was related to spot buying of the forint, which served to finance purchases of government paper and equities. Non-residents' holdings of Hungarian government securities rose by HUF 65 billion in one month. Additionally, in February, their equity holdings also rose, after stagnating since early November.

The forint depreciation which began in mid-November stopped in the second part of January, and was followed by an appreciation: the exchange rate first strengthened near to EUR/HUF 244. Then, in the wake of the much lower-than-expected inflation data for January, it continued to appreciate to EUR/HUF 243.

As a combined effect of the exchange rate appreciation and the positive inflation surprise, expectations of an imminent official interest rate reduction intensified. The market priced a 7.25% year-end interest rate into the yield curve. The Reuters consensus forecast put the central bank base rate at 7.5% for December 2005. The overwhelming majority of market participants expected a 50 basis point cut in the base rate before the Monetary Council meeting, although some analysts did not rule out an even larger reduction.

Long-term yields declined sharply, reaching an 18-month low. However, this decline was due mainly to a fall in short-term interest rate expectations – implied forward rates remained practically unchanged. In consequence, the long-term forward premium did not fall from its high level in the preceding month.

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

Council members unanimously saw that there was an opportunity to reduce the central bank base rate.

In view of the proposals set forth, the Council considered the alternatives of a 50 basis point or a 75 basis point reduction in the base rate.

Supporters of a 75 basis point reduction referred to a combination of several positive factors. They argued that the events pointing in the same direction may have synergic effects. This provided an incentive to reduce interest rates in excess of the market's expectations.

Their main argument was that the January inflation outturn, causing a reassessment of future prospects, had been much more benign than expected. Although the Council had expected disinflation to be robust in the early months of 2005, the actual data were evidence of an even sharper slowdown in inflation. This pronounced disinflation, well outpacing expectations, was driven partly by structural factors and partly by the base effect, and was reflected in a decline in core inflation as well. Some members attributed part of those structural background developments to Hungary's EU accession, in addition to the effect of monetary policy.

They were of the view that the reassessment of prospective inflation also justified a revision of the Council's earlier commitment to reduce interest rates in smaller steps, and provided an adequate basis for a larger interest rate cut at the current meeting. The fan chart of the inflation projection showed that inflation was likely to be below target in both 2005 and 2006. Expected inflation had fallen considerably relative to the previous forecast – mainly due to endogenous factors rather than to technical reasons. Consequently, a larger interest rate reduction was now a possibility, according to the logic of the inflation targeting system.

It was also argued that, with an unchanged nominal interest rate level, one should expect real interest rates to increase, consistent with the prospects for disinflation. As the outlook for inflation did not justify monetary tightening, it was also not reasonable to tighten monetary conditions through an increase in real interest rates either.

Several members shared the view that modest wage growth had also contributed to disinflation: whereas in 2004 the annual average price index had risen by 2 percentage points relative to the previous year, wage inflation had dipped by 2.5 percentage points at the whole-economy level – nominal wages had not adjusted to the higher rate of inflation, thus contributing to the disinflation performance. According to this view, wage inflation had stopped rising further in 2004, and price increases had proved only temporary and had not fed through to expectations, in which, apart from the rightful criticism of fiscal policy based on other considerations, public sector wage policy – unlike the experience of previous years – undeniably had played a major role.

Another factor supporting an interest rate reduction was that the international investment climate appeared to remain very favourable, which might also affect forint-denominated investments: investors' global optimism quelled concerns over economic imbalance. This was evidenced by the rise in non-residents' long forint positions after a protracted period. The yield curve also shifted lower, although longer term forward rates did not indicate a decline in fundamental risks. Over the short term, brisk activity on the options market may have contributed to optimism reflected in market developments, but the effect of trade in options was neutral over the longer term.

Members supporting a 75 basis point reduction viewed such a decision as a recognition of the disinflation process and as the maintenance of the Bank's earlier cautious approach to interest rate setting. A nominal interest rate level of 8.25%, containing a significant real interest component, would continue to signal the caution of monetary policy, which was still needed.

Supporters of a 50 basis point reduction were of the opinion that an interest rate reduction of over 50 basis points might be detrimental to credibility reflected in longer-term yields. They emphasised that the interest rate reduction should also serve to maintain the confidence of buyers of government debt in monetary policy.

They pointed out that the failure of forward premia to move lower despite the decline in yields was an indication of the persistence of risks to economic balance: no significant improvement was expected in fundamentals. The impact of fiscal policy on demand might be slightly expansionary in 2005. Indebtedness was believed to continue increasing: total debt might rise above the threshold set in the Maastricht Treaty.

With regard to the outlook for inflation, members emphasised the conditionality of the MNB's latest inflation projection. Recent monetary policy decisions would mainly affect the 2006 inflation outturn; however, in 2006 the projection was only slightly below the target, which – taking into account the uncertainties surrounding the projection – was a less obvious signal. They also noted that the balance of risks to inflation arising from exchange rate movements was on the upside.

The greater-than-expected increase in yields in developed markets might be a source of risk for emerging markets through a change in the direction of capital flows.

In view of the above, supporters of a smaller interest rate reduction were of the opinion that, while keeping the earlier cautious approach, at the current meeting there was a case for reducing interest rates by 50 basis points, without risking the loss of credibility.

Supporters of both alternatives noted that monetary policy also had a major part in disinflation reflected by the January inflation outturn. It was a common view that the assessment of Hungary's economic fundamentals had not changed – no improvement had occurred and nor was any significant improvement expected for 2005. However, the markets appeared to accept this situation for the time being. Members also agreed that there were endogenous risks to the future path of disinflation: nominal wage expectations would not necessarily adjust to the acceleration of disinflation. Nominal wage expectations, based on the inflation path expected earlier, might prove exaggerated: the rate of real wage growth might turn out to be excessively high, which would entail adverse consequences for external equilibrium, on the one hand, and might slow disinflation, on the other. Therefore, they stressed that disinflation might be permanent only if other economic processes also adjusted.

The Chairman invited members to vote on the propositions of a 75 basis point and a 50 basis point reduction in the base rate. Six members of the Council voted in favour of a 75 basis point reduction, while two members voted in favour of a 50 basis point reduction. Based on this majority vote, the Monetary Council decided to reduce the central bank base rate by 75 basis points with effect from 22 February 2005.

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

Zsigmond Járai, Chairman of the Monetary Council
Péter Adamecz
Dr. György Szapáry
Vilmos Bihari
Dr. Ilona Hardy
Dr. Béla Kádár
Dr. György Kopits
Dr. Gábor Oblath

Henrik Auth was not present at the meeting

Dr. Tamás Katona, Political State Secretary of the Ministry of Finance, and Péter Tabák, Head of Department of the Ministry of Finance, were present as the Government's representatives.

The Council will hold its next rate-setting meeting on 29 March 2005. The minutes of that meeting will be released at 2 p.m. on 15 April 2005