MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 23 MAY 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 April 2005, consumer price inflation was 3.9%, with core inflation and the constant tax price index at 2.6% and 3.7%, respectively. Over the past few months, the prices of a few components of core inflation have risen. This has contributed to the increase in the annual consumer price index, in addition to rises – explained by price developments in the world markets – in other price categories exogenous to monetary policy. However, the decline of 0.2 percentage points in the core measure of inflation relative to March also confirms that inflation has recently been falling steadily.

The strong disinflation process in the period from 2004 H2 to February 2005, which was evidenced by negative monthly core inflation rates in the first few months of 2005, partially reflected transitory factors. Taking this into account, the MNB had been anticipating the upward adjustment in prices seen in the past two months. Despite rising monthly inflation data, the Hungarian economy continues to be characterised by a much lower inflationary environment than in earlier years, caused by the persistence of simultaneous and synergic factors over the past twelve months, such as the sustained strength of the forint, slackening domestic demand, intensifying market competition, falling inflation expectations and the disinflationary effects of slower corporate sector wage growth.

GDP grew by 4% annually in 2004. Economic growth is likely to have slowed in 2005 Q1. This is suggested by slower growth on the production side earlier in the year and in expected near-term developments in the sub-components of domestic absorption. For example, retail trade data reflect a slowdown in consumption; moreover, the decline in capacity utilisation seen over the past year may impede further growth in fixed investment. The upward base effect on first-quarter GDP growth from last year's extra day due to the leap year may bias GDP growth in 2005 Q1 downwards and, to a lesser extent, also affect the annual growth figure in 2005. The leap-year effect may have contributed a few tenths of one percentage point to last year's 4% GDP growth and may reduce this year's expected economic growth comparably.

Business cycle developments suggest that the rate of economic growth may turn out to be 3.5%–3.6% in both 2005 and 2006 – and it may be lower by a few tenths of one percentage point in 2005 due to the leap-year effect. Against the background of potential economic growth in the range of 3%–4%, the output gap may narrow and, consequently, the role of demand-pull inflationary factors is likely to diminish, with no additional inflationary pressure expected from the demand side.

After the slowdown towards end-2004, which will presumably prove to be temporary, corporate investment activity is expected to grow at a rate of around 4% in 2005. In 2006, fixed investment growth is expected to be above 6%, consistent with external demand and growth.

On a national accounts basis, Hungarian imports and exports grew by 14.0% and 15.7%, respectively, in 2004. Net exports improved, due particularly to end-year developments, while the terms of trade deteriorated: the increase in import prices outpaced that in export prices by 0.7%. Based on monthly foreign trade data on a current price basis, exports of goods developed consistently with external demand: the trend has flattened out since 2004 Q3, and export growth is likely to weaken steadily in 2005 Q1. The trend of goods imports has been downwards or flat since 2004 H2, which may be explained by slowing growth in the factors of domestic absorption (e.g. household consumption and investment) with high import content. Looking ahead, after stalling for a couple of quarters, Hungarian export companies' external market share is expected to revert to its long-term upward trend established by trade integration. As a result of the corporate sector's response to the adverse shock from external demand, the unit labour cost based real exchange rate, perhaps the best gauge of competitiveness, is expected to stagnate. Exports may expand by 8%–10% in both 2005 and 2006. As the weight of components with lower import content is becoming increasingly dominant within aggregate demand, the role of gross capital formation within the latter is likely to remain balanced. The contribution of final consumption to growth is expected to stabilise at lower levels relative to previous years. Import growth is forecast to amount to between 8%–9% in 2005–2006. Although exports are likely to continue rising robustly despite the temporary slowdown in external demand, the contribution of net exports to growth is expected to diminish as a result of the gradual recovery in domestic absorption.

After salient increases in 2002–2003, household consumption expenditure growth slowed considerably in 2004. Nevertheless, at 3.5% the rate still well exceeded most expectations. The stagnation or slight fall in the real net wage bill last year foreshadowed much lower consumption relative to the actual outturn, but this may have been offset by increases in household real incomes from other sources.

Data received early in 2005 suggest continued easing of labour market tightness. Growth in labour demand has slowed gradually since mid-2004. In recent months, private sector labour usage has stalled, wage inflation has slowed and the unemployment rate has continued to rise. This stagnation in labour usage is explained by a slowdown in the growth rate of labour demand, which is in line with signs of weakening business activity. The fall in wage inflation may signal the beginning of adjustment in corporate sector wages to the lower inflation environment.

Corporate sector wages grew by 5.3% in March, suggesting that wage inflation fell more strongly than previously expected. However, the seasonal patterns in bonus payments introduce a substantial downward bias in the actual data – regular earnings, which better reflect longer-term developments, rose by 6.5% in the month. On the whole, both indicators signal a decline in wage inflation and reinforce the picture of a lower inflation environment.

The real value of household disposable income is likely to fall in the period ahead, in line with the slowdown in wage inflation. And, taking all this into account, household consumption demand is also expected to slow to 2.7%–3% on the forecast horizon.

In the latest issue of the *Quarterly Report on Inflation*, Bank staff project a low and stable inflation environment for the period to December 2006. The projection is based on the assumption that, on the forecast horizon, the central bank base rate is maintained at 7.5% and the exchange rate remains at EUR/HUF 248, both unchanged from their levels in April 2005, in addition to other assumptions of a technical nature. As an effect of partly transitory effects, core inflation is expected to decline further in the early part of the forecast period, then trend inflation is likely to approach its long-term path. Under the above assumptions, the consumer price index is projected to be between 3%–3.5% at both end-2005 and end-2006. Here, the effect of the slowdown in core inflation is stronger relative to the previous projection. By contrast, the components exogenous to monetary policy have an upward effect on the Bank's current projection.

In 2005, Hungary's external financing requirement may fall by 0.5 percentage points as a proportion of GDP; however, the current account deficit may rise to EUR 7.5 billion, associated with an increase in the capital account surplus. The general government borrowing requirement may increase slightly as a percentage of GDP. Due to a slow increase in capital spending, the corporate sector's net borrowing requirement is not expected to grow further as a proportion of GDP, and household net financial savings may rise modestly. In 2006, a reduction in the external financing requirement is conditional on the contractionary effect on demand of fiscal policy at the entire general government level, as the private sector's financing capacity is unlikely to change significantly.

Changes in the international investment climate have been erratic in recent weeks, and this situation is expected to continue over the next couple of months. The balance of risks is asymmetric: in the countries in the region which are currently facing general elections in the near future investors do not expect measures to be taken which would cause any tangible improvement in economic balance. This, coupled with the uncertainties surrounding the French national referendum on the EU Constitution, may prompt investors to adopt a 'wait-and-see' attitude. Higher risks and rising dollar interest rates have reduced the attractiveness of positions taken in high-yield currencies, including forint-denominated investments.

The forint has depreciated by 1% since the latest Council meeting. The weakening of the currency has been associated with massive sales by foreign investors, while demand for forints by domestic investors, who are less sensitive to interest rate and exchange rate movements, has been unable to fully offset this development. As a consequence, equilibrium in the foreign exchange market has developed amidst purchases of the forint by domestic export firms, which are much more sensitive to exchange rate movements, and by speculators. Sales of forints by foreign investors have been linked, in large part, with hedging against exchange rate risk and a decline in their short-term asset holdings. Non-residents' government securities holdings fell by HUF 50 billion.

The five-year forward premium five years ahead rose to 198 basis points, close to its highest level to date since the band shift. This increase in the long-term forward premium shows that, with the unwinding of the bullish trend in emerging markets, investors have recently become much more cautious with regard to risks associated with regions, and individual countries in particular, as well as to their future prospects.

Higher risks have reduced expectations of further official interest rate cuts. Based on the shape of the yield curve, the market expects a total reduction of 25 basis points at the Council's next four rate-setting meetings. According to evidence of the Reuters poll, analysts are divided in respect of the expected interest rate path up to end-2006. One group of forecasters expects the reduction to amount to 25 basis points at most this year, forecasting a base rate of around 7% for December 2006, in line with the level implied by the yield curve. The other group anticipates further gradual interest rate cuts, with the base rate standing at 6.5%–7% at end-2005 and 6%–6.5% at end-2006. Half of the analysts expect the base rate to be maintained, while the other half expect it to be reduced by 25 basis points.

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

After considering the latest macroeconomic news and financial market developments, Council members discussed opportunities to reduce the central bank base rate. In addition to the alternatives of either reducing the base rate by 25 basis points or maintaining it at its current level, a 50 basis point reduction was also proposed.

While the supporters of a 25 basis point reduction recognised the risks, in their evaluation the environment for interest rate policy was determined by the future prospects for disinflation. They attached special importance to the fact that the macroeconomic developments projected for the period ahead would contribute to further consolidation of the low inflation environment over the coming 18 months. In their view, it was important news that although certain assumptions (e.g. the exchange rate, interest rates and oil prices) on which the Bank's inflation projections were based had shifted towards higher inflation since February, the central inflation projection fell as an effect of fundamental factors. They stressed the role of cost and demand side inflation developments which facilitated the rapid fall in the core level of inflation.

They were of the opinion that the slowdown in wage inflation, labour market adjustment and developments in productivity were supportive of the positive outlook for future inflation. The environment for growth was also conducive: the slowdown in economic growth, in Hungary and abroad, also had the effect of strengthening disinflation. Weaker external demand kept imported inflation in check. The slowdown in domestic economic growth and the more favourable pattern of growth also pointed to continued disinflation. Some members were of the view that the recent developments in the output gap might even have a stronger disinflationary effect than assumed.

Some members emphasised the role of monetary policy in successful disinflation, in addition to the benign external environment. In accordance with the experiences of small, open economies which had adopted the inflation targeting regime, the influence of exchange rate volatility on inflation weakened and the role of expectations increased as the credibility of the regime grew over the period of a couple of years.

Supporters of an interest rate reduction generally agreed with the assessment Bank staff had provided in the *Report* regarding the prospects for inflation and the factors determining its future course. Based on this view, they agreed that the logic of inflation targeting called for an interest rate reduction. Looking at the forecast in the *Report*, which had been based on the assumption of unchanged interest rates and exchange rates at their April levels, as well as taking into account the time horizon of the monetary policy transmission mechanism, the risk of undershooting the inflation target could have increased further in the absence of an interest rate cut.

The majority of members arguing for an interest rate cut expressed the opinion that, due to the perceived uncertainties and risks, there was a case for a reduction of 25 basis points in the base rate.

Supporters of a decision to maintain the base rate at its current level also admitted that developments in the prospects for inflation were favourable in respect of meeting the inflation targets, but placed greater weight on upside risks.

As an open economy, Hungary was always dependent on the market's judgement. Consequently, developments in global investor attitudes were an important risk factor. Although this was not a sudden development, confidence in emerging markets had been slowly eroding since early March. In addition, Hungary carried excess risks, which resulted in a significant risk premium compared with other countries of the region. Despite the positive shifts in the outlook for factors influencing inflation, there were no significant changes in the country's economic fundamentals. The risks posed by imbalance remained. Uncertainties surrounding the feasibility of the fiscal targets and the convergence programme raised serious doubts in investors' minds.

Supporters of a decision to maintain the base rate at its current level attached importance to evaluating the assumptions on which the inflation projection was based. They were of the view that there were upside risks in the projection in respect of its important parameters.

According to the arguments for a 50 basis point reduction, while external uncertainties had not increased, the outlook for future inflation had improved. In the current inflation projection, the shift relative to market expectations was greater than compared to the February forecast. Consequently, market expectations might change significantly in the future. The prospects for inflation, therefore, justified a larger interest rate reduction.

The Chairman invited members to vote on the propositions that the base rate should be maintained, reduced by 25 basis points or reduced by 50 basis points. Eight members of the Council voted in favour of a 25 basis point reduction, four voted in favour of maintaining the base rate, and one voted in favour of a 50 basis point reduction. Based on the majority of votes cast, the Council decided to reduce the central bank base rate by 25 basis points with effect from 24 May 2005.

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

Zsigmond Járai, Chairman of the Monetary Council
Henrik Auth
Péter Adamecz
Dr. György Szapáry
Dr. Ilona Hardy
Judit Neményi
Tamás Bánfi
Dr. Péter Bihari
Vilmos Bihari
Dr. Csaba Csáky
Dr. Béla Kádár
Dr. György Kopits
Dr. Gábor Oblath

Álmos Kovács, Deputy State Secretary of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 20 June 2005. The minutes of that meeting will be released at 2 p.m. on 8 July 2005