MINUTES

OF THE MONETARY COUNCIL MEETING

OF 22 AUGUST 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

The consumer price index was 3.7% higher in July than one year previously, edging down by 0.1 percentage point relative to the preceding month. Core inflation, which declined to 1.6% year on year, was mainly responsible for this fall in overall inflation. The disciplinary effect of import competition on domestic prices in a stable exchange rate environment and the modest increase in consumption demand both contributed to the lower outturn for core inflation. But developments in price categories excluded from the core measure of inflation were largely offsetting. First, vehicle fuel prices rose in conjunction with the increase in the world market price of crude oil. Second, unprocessed food prices continued to move higher, although at a more modest pace than in earlier months, in which seasonal food prices continued to play a dominant role. Consequently, in June the inflation process retained its dual nature seen in recent months, with the gap between the consumer price index and core inflation continuing to widen.

Private sector wages rose by 7.4% in June 2005 relative to the same period a year previously. Although the increasing noisiness of the time series renders the assessment of data increasingly difficult, after adjusting for seasonal patterns and the changed seasonality of bonus payments, the month-on-month trend continues to point to falling wage inflation. All this is consistent with the recent easing of labour market tightness and suggests ongoing adjustment by the corporate sector to the low inflation environment.

Annual growth in total retail trade turnover was 4.3% in June 2005 (3.7% after adjusting for the calendar effect). According to the seasonally adjusted month-on-month indices, retail sales have been rising at a slightly accelerating, albeit fairly steady, rate since end-2004, and actual data foreshadow a faster-than-anticipated increase in household consumption in the period ahead. However, developments in household financial savings suggest that the sector's consumption expenditure has recently been rising at a cautious pace, even with the better-than-earlier prospects for income growth.

Manufacturing activity continues to be robust. Although the rate of output growth fell slightly in June, growth in Q2 was strong relative to the previous period. This was outstanding in comparison with other countries in Central Eastern Europe. According to preliminary data, Hungary's trade deficit amounted to EUR 114 million in June, considerably lower than analysts' average forecast of EUR 280 million. Exports of goods have been rising at a stable rate since early 2005. Machinery and equipment has been the driving force behind this increase, although the consumer electronics and telecommunications industries, which recently saw massive capacity improvements, and manufacture of transport equipment, have also played a major role. Imports of goods gathered momentum in Q2 after stagnating earlier in the year. Despite this, growth in imports of goods has remained at a relative low level and, consequently, the balance of goods turned out significantly more favourable in H1 than a year previously. Nevertheless, the conflicting news about external balance and GDP over the recent period has introduced a degree of uncertainty in the evaluation of trade statistics, as they point to higher imports than evidenced by the data.

GDP growth was 2.9% in 2005 Q1 year on year. However, after adjusting for the calendar effect, GDP growth was higher, coming in at 3.5%. The pick-up in performance of the production sector on the output side, and rising consumption and improving net exports on the expenditure side, suggest accelerating GDP growth over the period ahead. In its flash estimate released on 15 August, Ecostat expects GDP growth to be very strong, at around 4% in Q2 year on year. However, uncertainty about imports and inventory investment also renders evaluation of these data difficult.

The economic outlook for 2006–2007 is surrounded by greater-than-usual uncertainty. One of the most important sources of this stems from the Government's announcement of certain measures which may considerably influence future growth, the external balance, inflation and, indirectly, investors' assessment of risks. However, a comprehensive picture of the impact of fiscal policy can only be provided when the details of the coming years' draft budgets become available.

In the general government sector, the impact of fiscal policy on demand would remain expansionary in 2006, even assuming moderate wage growth, constant operating costs and investment over the next two years, due to the transient nature of this year's Government measures aimed at improving the fiscal balance and other measures announced so far. The fiscal demand impact would only be slightly contractionary in 2007. The Bank's forecasts for inflation and growth are conditional on a stable exchange rate and unchanged interest rates, and as such contain the implicit assumption that the financial markets will judge the fiscal adjustment to be sufficient, so that investors maintain their current benign risk assessment. If all these conditions are met, the economy may gradually return to a path of balanced growth and nominal stability, after a temporary detour. Although as an effect of fiscal easing demand is likely to expand more strongly than previously earlier, its inflationary consequences are likely to be offset by measures affecting the supply side. Consequently, inflation may stabilise around 3% in 2007, i.e. on the new forecast horizon, following a brief decline in 2006.

Faster consumption growth, expected as an effect of government measures, is likely to fuel the future pick-up in economic growth to 3.9% in 2006 and to 3.8% 2007. The fall in consumer prices, caused by the reduction in VAT rates, the cut in personal income taxes and the extension of the family benefit scheme, are likely to contribute to household real income. The external markets relevant for the Hungarian economy are expected to grow at a stable rate and, consistent with this, exports and corporate investment are likely to continue rising steadily. In sum, the higher consumption path and slightly above-trend economic growth are expected to generate increased demand-pull inflationary pressure.

The future effects of the significant, differentiated minimum wage increase, announced for 2006, are difficult to account for. However, the moderation in wage inflation, observed in the past few years, is likely to stall only briefly. In the second half of the forecast period, factors exercising downward pressure on inflation may regain predominance, due to the planned tax measures with the effect of reducing labour costs, already announced (abolition of the health contribution and the reduction in social contribution). Coupled with the expected rise in productivity, this may have a disinflationary impact on unit labour costs over the longer term.

The risks to the conditional inflation projection are roughly evenly balanced. Faster consumption growth, and the fact that the minimum wage increase may have longer-term spillover effects and lead to wage compression, in addition to an immediate increase in labour costs, are likely to exert upward pressure on inflation. However, if the temporary drop in inflation in 2006 helps to reduce inflation expectations, this may add to the likelihood of lower inflation in the period ahead. Another factor causing uncertainty is future developments in the trade balance, which may directly affect the current account balance, with a further potential impact on economic growth as well as indirectly on the assessment of the risks facing the Hungarian economy. Due to Hungary's EU accession last year, the method of recording statistical data was overhauled: the previous customs-based recording was replaced by self-declaration of turnover. Broadly since this shift, i.e. from 2004 H2, imports as reflected in the official statistics have been lower than would be justified by current economic activity. Information currently available is insufficient to understand the underlying causes of this change; however, the probability of import demand in Hungary falling to such an extent is low. For this reason, it cannot be ruled out that part of the observed improvement in net exports has resulted from the methodological changes discussed earlier, which is presumably

a short-run effect. Similar uncertainties have also been observed in other new EU Member States.

The international investment climate has remained benign in recent weeks: global demand for emerging market and high-yield assets has remained strong, and risk premia have fallen slightly over the past month. The forint has appreciated by 1% against the euro since the latest rate-setting meeting, and it has recovered by a total 4.5% from its trough at end-May. This strengthening of the exchange rate has been bolstered by favourable investor sentiment in the region as well as by less interest sensitive forint demand of domestic and foreign market participants. On the one hand, domestic participants' foreign currency indebtedness generates continuous demand for the forint. Foreign currency borrowing by households, the higher share of foreign currency debt within government borrowing, as well as news about issues of foreign currency-denominated bonds by the State Motorway Management Company and the inflow of privatisation proceeds have also been supportive. On the other hand, equity purchases have recently been behind the increase in non-residents' holdings of forint-denominated assets, as their government bond holdings fell over the past one month, due to the maturity of a large pool of bonds. Technical factors (e.g. exotic currency options and the related hedging activity) may have also temporarily buttressed the recent strength of the exchange rate.

With the US dollar appreciation in the past several months coming to a halt, the euro has been strengthening rapidly since end-July. Earlier, in periods of rapid, trend depreciation of the dollar, CEE currencies occasionally appreciated against the euro, as investors, anticipating further dollar weakness, were more willing to take short positions against the dollar in currencies that offered higher yield. The currencies of the region have strengthened by 1%–2.5% in the recent period.

US short and long-term yields continued to rise, explained by better-than-expected economic data and the resulting improvement in prospects for economic activity. The tenth consecutive 25 basis point increase in the target for the federal funds rate by the Fed in early August met market expectations. However, in the statement accompanying its latest decision, which was nearly identical to the June press release, the FOMC dampened the market's concern over a potential speed-up in the current tightening cycle. In consequence, yields stopped rising further in mid-August. The potential downturn in US bond markets continues to be the most significant risk. However, as long as the rise in costs of dollar-based financing continues to be modest, it will probably not have a perceptible influence on willingness to take risks.

The interest rate cut by the MNB's Monetary Council in July did not come as a surprise to the market and therefore the decision, as well as the minutes of the July meeting, published three weeks after, had an only modest impact. However, due to the continued strengthening of the exchange rate and the lower-than-expected (core) inflation data for July, expectations of further rate cuts intensified. The path of expected interest rates shifted lower by some 45 basis points relative to its level one month before. Market participants priced a 5.75%–6% base rate for end-2005 and a 25 basis point official rate cut for next year into yields. According to the Reuters poll, the majority of forecasters and currency traders expect the Council to reduce interest rates by 25 basis points at its meeting on 22 August. Short-term government securities yields are consistent with expectations of a larger cut.

As a result of the downward shift in the path of expected interest rates, yields fell along the length of the term structure: yields below 6% at maturities over one year were last seen in May 2003. However, the long-term forward differential vis-à-vis the euro stopped narrowing. The five-year spread five years ahead could not break through the 150–200 basis point range where it had been oscillating since early 2004, but it stabilised close to the bottom. The spread also mirrors longer-term, fundamental risks. Its decline relative to earlier months may have reflected the effects of the improving inflation environment and lower-than-expected trade deficit data.

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

After discussing the Bank's current *Quarterly Report on Inflation* and considering the latest macroeconomic news and financial market developments, Council members explored the cases of reducing the base rate by 25 basis points or 50 basis points.

Members noted that the 3% medium-term inflation target set jointly with the Government, in effect from 2007, could be met over a 5–8 quarter time horizon based on the assumptions underlying the latest inflation projection.

At the time of announcing a medium-term inflation target consistent with price stability, they had deemed it important to emphasise that monetary policy should examine the future outlook for inflation after eliminating the direct price-reducing effect of the tax measures. Thus, relevant information for the decision was that, in the Bank's latest projection, inflation at end-2005 was lower by some 0.5 percentage points than the previously-set target, and, after eliminating the direct effects of the proposed reduction in VAT rates, the CPI projection for 2006 was also in the lower half of the target range.

There was unanimous agreement that the external environment continued to be favourable. Despite the risks originating from Turkey and Latin America, emerging-country spreads had remained at low levels and a potential contagious crisis spreading to Hungary and the CEE region seemed less likely than earlier. For the moment, the US interest rate cycle did not appear to have an impact on financial market developments in emerging countries and the CEE region, as the market had priced the gradual rise in US interest rates into yields. Investors' willingness to take risks appeared to be robust. The favourable external environment was also reflected in assessments of the CEE region, and of forint-denominated investments in particular.

Core inflation, consistently below expectations, was also supportive of the favourable medium-term outlook for inflation and provided a foundation for a sustained fall in inflation expectations. Members viewed the prospects for wage inflation as encouraging for the inflation process, according to which the slowdown in the rate of wage growth was likely to stall only briefly as an effect of the minimum wage increase; and the trend was expected to continue downwards over the longer term. Even with the current better-than-earlier prospects for income growth, household consumption expenditure was expected to rise only modestly; and the rise in the sector's savings had proved stronger than the rate of consumption growth. These developments could help sustain low inflation.

Despite the existing problems relating to economic balance, members judged the market's current mood to be favourable and more responsive to good news (e.g. the higher-than-expected July government surplus, encouraging import data, etc.). In their view, this was reflected by (i) the yield curve, which had shifted lower, (ii) the longer-term interest rate spread, which had stabilised at a low level, and (iii) the strong exchange rate.

The majority of Council members held the opinion that the prospects for meeting the inflation targets and, based on external circumstances, the conditions for a 50 basis point rate cut were now in place, and there was an opportunity of a larger interest rate cut, while remaining within the range of market expectations.

Some members noted that for the market it was now clear that the MNB would not react to the temporary fall in inflation in 2006 caused by tax measures, and so a larger-than-earlier interest rate cut would not send a false signal about the future stance of monetary policy. It was also argued that, although the Bank looked beyond the decline in inflation in 2006, the forward-looking real interest rate would rise significantly in 2006.

On another view, it was an important factor from the perspective of external balance that the external financing requirement could be expected to fall, due to the rise in household savings, despite the uncertainty about trade data. An improvement in the external position was likely even if the assumption in Bank's projection, i.e. that the general government borrowing requirement would increase by 1%, was met, opposite to the case of a contraction as outlined in the convergence programme. There appeared to be a favourable shift in the pattern of financing: dependence on portfolio inflows was lower, which reduced the required risk premium.

Arguments in favour of a 25 basis point rate cut placed greater emphasis on the fact that, despite the recent encouraging developments which had been pointed out, the Hungarian economy continued to face significant risks, particularly in respect of the fiscal outlook. For the time being, actions to offset the effects of fiscal easing resulting from the announced tax measures and one-off revenue shortfalls did not appear to take specific form. This was identified as a key issue from the perspective of its potential impact on the required risk premium, rather than as threatening to cause inflationary pressure through the demand effect or increase financing risks. In the members' view, such risks had not diminished: indeed, they had increased since the last rate-setting meeting and, therefore, based on the principle of cautiousness and coherence, they argued that an interest rate cut larger than 25 basis points was not appropriate.

Based on the uncertainty about the fiscal outlook, some members pointed to the greater-than-usual uncertainty surrounding the entire macroeconomic path on the medium-term horizon, relevant for monetary policy.

The Chairman invited members to vote on the propositions that the base rate should be reduced by 25 basis points or reduced by 50 basis points. Eight members of the Council voted in favour of a 50 basis point reduction and four voted in favour of a 25 basis point reduction.

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

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

Dr. György Szapáry was not present at the meeting.

Péter Tabák, Head of Department of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 19 September 2005. The minutes of that meeting will be released at 2 p.m. on 14 October 2005