MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 19 SEPTEMBER 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 3.6% in August, broadly in line with the Bank's short-term projection, but lower than market expectations. The assessment of inflation developments in the price categories relevant for monetary policy has become slightly more uncertain, as the seasonally adjusted monthly core inflation outturn, which provides a better measure of price dynamics, rose in August. Price categories excluded from the core measure of inflation had little impact on the overall level of inflation. Taken together, the future outlook for inflation has not changed materially since the Bank's August projection; however, the risk that inflation outturns may be lower than the central projection appears to be moderating, accompanied by rising uncertainty.

Second-quarter GDP rose at a rate slightly above expectations, reflecting a further pick-up in domestic economic activity. A closer look at the data suggests that this higher growth may have been facilitated by both domestic and external demand factors. On the expenditure side, actual fixed investment spending was significantly higher than the forecast, which, however, was less strongly related to industries which are sensitive to the business cycle (for example, manufacturing investment has been rising steadily since early 2004). Rather, this unexpected pick-up may have been due to the rise in government investment activity (as reflected in the statistics), including motorway construction. Underlying this was the stronger growth in construction output, which also exceeded expectations.

On the output side of GDP, the rise in value added in industry has gathered pace: along with growth in output and goods exports in June, this is another sign of the continued upturn in corporate activity. Meanwhile, however, information on external demand has continued to be mixed. At 0.3% over the previous quarter, euro area GDP growth was largely as expected in Q2. But GDP growth in Germany, Hungary's most important trading partner, stagnated. Despite this, external demand from Germany may have been strong, as the country's weak GDP data reflected the robust increase in German imports. Coupled with strong output data for June and rising manufacturing orders in the period May-June, this suggests slightly stronger German business activity relative to early 2005, which, however, has not yet been reflected in business confidence indices (for example, in the IFO index).

The picture of external balance continues to be surrounded by uncertainties. Although in 2005 H1 Hungary's goods trade deficit was half the level of that registered one year earlier, import growth continued to lag behind the path justified by current macroeconomic conditions. This development may be linked to greater uncertainty involved in the revised accounting treatment of intra-euro area trade statistics and the related possible underreporting of imports. However, import growth has started to pick up, as reflected in July goods trade data, suggesting that the underreporting of imports may have slowed or stopped. This phenomenon will require further examination in forthcoming data, in order to derive a firmer picture of the underlying developments.

Investor sentiment towards emerging markets has remained benign over the past month, and global demand for high-yield assets has continued to be strong. The EMBI Global composite spread index has fallen below its historical low of August.

Hurricane Katrina has caused a 'mini-crisis' in the US, which, however, has been beneficial to emerging markets. The devastation caused by Katrina introduced yet another degree of uncertainty in refined petroleum supplies, triggering a sharp rise in the world market price of crude oil. Higher oil and petrol prices, coupled with weaker-than-expected economic data, have led to a deterioration in growth prospects. Market participants' view that the Fed may put the current tightening cycle on hold has strengthened. Closely related to these developments, US long-term yields fell by some 20 basis points up to the first half of September, and the dollar weakened against the euro, which raised the attractiveness of emerging markets. Emerging country currencies appreciated significantly. The Czech koruna climbed to a five-month peak, the Polish zloty breached the psychologically important 4 EUR/PLN barrier, and the Slovak koruna rose near the level where the National Bank of Slovakia last intervened. Nevertheless, higher-than-expected US unit labour cost data have caused expectations of further interest rate increases to intensify. And a correction has occurred in US long-term yields as well as in exchanges rates of the US dollar and emerging country currencies.

Euro area long-term yields have also experienced some correction over the past few weeks, which is also linked to the higher price of oil and the related risks to growth, although the latest data on growth and business confidence in Germany have been better than expected. Uncertainty about the German elections in mid-September has led to rises in yields.

The forint exchange rate has been fluctuating between EUR/HUF 246.5–243.5 in recent weeks. Residents' forint demand, closely related to their borrowing in foreign currency, has continued to be a dominant factor behind exchange rate stability. Other, less interest sensitive factors, such as privatisation, direct investment inflow, and foreign currency borrowing by both the government and the ÁAK (the state-owned enterprise responsible for motorway management), have also facilitated exchange rate appreciation. This is illustrated by the fact that, whereas following the announcement of the conversion by the central bank of the foreign currency proceeds from ÁAK's bond issue, the forint weakened from 244 to 246.5 against the euro, non-residents then stepped in to sell foreign currencies. Purchases of forints by foreign investors picked up when the international environment changed at the end of August – the forint recovered towards 243.5, with non-resident investors mainly purchasing shares. However, by mid-September a bearish 'double top' pattern, signalling an impending trend reversal, developed in exchange rate charts, which significantly reduced the possibility of further gains from a technical analysis point of view.

The five-year forward spread five years ahead has dropped by 15 basis points to 145 basis points since the Council's last meeting, and has thus also fallen below its fluctuation band observed since December 2003. As forward spreads have been flat in other countries in the CEE region, country-specific factors may have been instrumental in the fall in the Hungarian spread. However, at this juncture it is difficult to judge whether a lasting improvement in the assessment of Hungarian economic fundamentals is behind the fall in the spread.

The size of the Council's interest rate cut in August and the Bank's latest inflation projection both took the market by surprise: short-term yields fell 20 basis points, and longer-term yields dropped 15 basis points. The expected interest rate path shifted lower by 20 basis points relative to its level a month earlier. Market participants priced a 5.5% and a 5.25% base rate for end-2005 and end-2006, respectively, into the yield curve. According to the August Reuters poll of market economists, the overwhelming majority of respondents expect a 25 basis point rate cut at the current meeting of the Council. Analysts' consensus forecast is for the Bank's key interest rate to be around 5.5% at both end-2005 and end-2006.

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

After discussing 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.

Several members argued that, based on the prospects for meeting the inflation targets and the recent financial market developments, the conditions for a 50 basis point cut were now in place; however, some caution was warranted due to the existing uncertainties at home and abroad.

Members took similar views regarding the assessment of international economic and financial developments. Global appetite for risk continued to be strong, even taking account of the increased uncertainty regarding the Fed's future interest rate policy in the wake of Hurricane Katrina. However, several members raised doubts about how long the current favourable conditions would last, particularly in the light of global imbalances. After reviewing the latest fiscal developments, members were unanimous that the basically unfavourable trends had not changed. Eurostat's decision had only cast light on the fact – well-known to the Council and explored in previous issues of the *Quarterly Report* – that fiscal processes had shown little sign of improvement in 2005. Closely related to this development, uncertainty about next year's budget deficit and the possible date of adoption of the euro in Hungary had increased.

Several members stressed that the required fiscal consolidation was jeopardised by the competing proposals for tax reductions set forth by the main domestic political groups. One of the greatest risks facing the Hungarian financial sector was the rapid build-up of foreign currency debt. According to some views, the convergence of domestic and foreign interest rates may lead to a reduction in demand for foreign currency loans. Other members took the view that the increased focus on foreign currency lending was not solely due to demand-related issues, but that other factors were at play as well. Borrowing in foreign currency had also been boosted by commercial banks' preference for foreign currency lending over forint loans, in order to minimise their exchange rate risks. Accordingly, this was the reason why the decline in forint interest rates had not automatically led to a contraction in foreign currency lending.

Another argument in favour of a 50 basis point rate cut was that the effects of factors conducive to holding core inflation at a low level could persist, as a result of which inflation might fall below the medium-term target by 2007. Although the general government borrowing requirement was extremely high, its direct inflationary effects were negligible.

The Chairman invited members to vote on the propositions that the base rate be reduced by 25 basis points or reduced by 50 basis points. Twelve members voted in favour of a 25 basis point reduction and one voted in favour of a 50 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. György Szapáry
Dr. Ilona Hardy
Judit Neményi
Tamás Bánfi
Dr. Péter Bihari
Vilmos Bihari
Dr. Csaba Csáki
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 24 October 2005. The minutes of that meeting will be released at 2 p.m. on 18 November 2005