MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 OCTOBER 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 rose by 3.7% in September 2005 in year-on-year terms, with the annual growth rate of core inflation falling below 2%. The rise in prices of industrial goods in August proved to be short-lived, and the decline in tradables prices, which has characterised the whole year, continued. This, in combination with other developments, has resulted in stable quarter-on-quarter core inflation rates of around 1% since early 2005, although the price index of market services has continued to exceed core inflation by a large margin. Overall inflation remains significantly higher than the core measure: the direct effect of the oil price shock was a strong contributory factor in this regard, as seen in the euro area and the US. Looking ahead, forecasts point to a higher inflation environment in developed countries, despite the current low levels of core inflation. To summarise, although no news has arisen which could influence the domestic outlook for inflation in either direction in 2007, the continued high price of oil and rising inflationary pressure from external markets, coupled with slightly higher-than-expected consumer demand, have increased the upside risks to the central projection.

In line with the Bank's August projection, wage inflation in the private sector moderated gradually to reach 6.9% in August, following the salient outturn in June. In the services sector, which is less exposed to competition from abroad, adjustment to the lower inflation environment continues to be slower. This is also reflected by the higher-than-average rates at which the sector's wages and prices have been rising recently.

GDP growth may slow in the second half of the year, after rising robustly in H1. However, the high level of government investment due to motorway construction and stronger growth in consumption expenditure relative to the previous year continue to fuel domestic demand. The 2006 Budget Bill contains proposals which could boost real income and demand significantly. This may provide further fiscal stimulus to domestic demand growth in the near future. On the output side, the strong rate of growth observed in H1 stalled in mid-summer, and may turn out much slower in H2. Exports have been rising rapidly since the start of the year, but the rate of growth of goods exports is expected to slow, due to the deceleration of industrial output growth.

Import growth, which has been lagging far behind export growth since 2004 Q2, appears to be picking up. This may be linked to the moderation in the statistical distortion to trade data observed earlier. Hungary's external financing requirement, i.e. its combined current and capital account deficit, fell further in 2005 Q2 to reach 6.6% of GDP. However, the financing requirement, derived on a national accounts basis, has continued to fluctuate around 8%–10% as a proportion of GDP in recent years.

Market assessment of the risks of holding forint-denominated assets has deteriorated over the past month, to which the raising of deficit targets by the Government, the lack of political commitment to implement fiscal consolidation and the potential delay in the adoption of the euro all have contributed. The forint weakened, albeit briefly, to a low of EUR/HUF 254, the weakest level for several months, before fluctuating around 252–254. Exchange rate depreciation was associated with foreign investors selling the currency at a brisk pace, which, however, did not entail a decline in their holdings of government securities and equities. Presumably, uninterrupted purchases of forints by households, related to their borrowing in foreign currency, only partially offset forint sales by foreigners – forward purchases by domestic firms were needed to restore equilibrium in the foreign exchange market. In line with earlier experience, however, the corporate sector was only willing to take over the risk of holding forints from foreign participants at a lower exchange rate.

The earlier very favourable climate in international financial markets deteriorated in October. In the United States, concerns about growth in the aftermath of Hurricane Katrina lessened, and market participants turned their attention towards the perceived upside risks to the inflation outlook, despite core inflation remaining low. Statements by several senior Fed officials and publication of the Minutes of the Federal Reserve Board's September meeting contributed to this. US ten-year yields rose near to 4.5%, a six-month peak, and expectations of interest rate increases intensified. In the euro area, slightly better data on economic activity and high inflation also stoked expectations that the European Central Bank might raise rates, and market participants interpreted the statements following the Governing Council's meeting as implying that upward pressure on inflation was building. In early October, emerging countries and markets of high-yield assets alike experienced concerted selling by investors. Although profit realisation following the rally over a longer period was not preceded by any significant news, the expected tightening of monetary conditions in developed countries must have contributed to this phenomenon. Following a decline for several months, the EMBI index of emerging-country spreads rose above 250 basis points from 230 basis points in early October. Despite the rise, that level is considered very low historically. Although the selling wave hit the entire CEE region, it affected the Hungarian market most significantly, suggesting that country-specific factors were also at play.

Yields at the far end of the Hungarian government securities market rose by more than 100 basis points. After falling to a two-year low in early September, the five-year forward spread five years ahead rose significantly, breaking through its 150–200 basis point fluctuation band observed since early 2004. The gap between Hungarian and Polish forward premia rose to its highest level to date. This strong increase in the premium occurred despite indications by S&P and Fitch that the adoption of the euro at a later stage alone would not cause a downgrade in Hungary's rating. While market participants initially interpreted the rise in yields as a good opportunity to buy, market expectations and recommendations by investment bankers both shifted towards selling forints. However, the majority of market participants do not expect significant exchange rate depreciation as a baseline scenario.

Expectations of further interest rate cuts by the MNB were priced out of the market. Following the 25 basis point reduction in September which was broadly in line with market expectations, participants priced in a further 50 basis point cut for the period to the end of the year. But the path of expected interest rates flattened out as an effect of unfavourable news on the Budget and exchange rate weakening. Disregarding the potential distorting effect of the liquidity premium, the near end of the yield curve reflects a 25 basis point and a 50 basis point interest rate increase for end-2006 and end-2007 respectively. According to the October Reuters poll, the consensus forecast of market economists and currency traders is for the Council to leave interest rates unchanged. However, longer-term expectations, on balance, show the probability of a small reduction.

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 leaving the base rate unchanged or increasing it by 25 basis points.

Members agreed that inflation developments were consistent with the inflation target. However, investor uncertainty about Hungary's economic balance and convergence path had increased significantly in recent weeks. By restating the target date for euro adoption, the latter issue had been resolved only on the surface, as there had not been any specific accompanying measures, in the absence of which markets did not give credit to the figures contained in the Convergence Programme. The higher 2005 deficit target, on the one hand, and the deficit envisaged in the 2006 Budget Bill, significantly exceeding the target in the

Convergence Programme, on the other, had greatly contributed to the perceptible rise in the required risk premium on forint investments in a slightly more unfavourable international climate.

In arguing that the central bank base rate should be left unchanged, some members stressed that, according to the logic of the inflation targeting regime, there was no need to raise interest rates, as the inflation target could be met under the monetary conditions anticipated for the period ahead. Leaving interest rates on hold did not represent monetary easing, given the anticipated fall in inflation. Several members noted that developments over the past period did not imply any change for the Council in assessing the country's equilibrium position.

Several members emphasised that, following a sustained period of interest rate cuts, leaving the central bank base rate unchanged was sufficient in its own right to signal that the Bank would pay particular attention to increased market risks in the future. Overall, the rise in the risk premium had occurred against the background of a continued benign international environment, as a consequence of country-specific factors. For this reason, the Bank should be prepared for further unfavourable shifts in market developments. While increasing political risks in the region might prompt investors to 'wait and see', there continued to be significant upside risks in domestic fiscal processes.

Nonetheless, several members of the Council stressed that, although expectations of higher interest rate premia had increased, reflecting the worsening assessment of Hungarian economic fundamentals and the convergence process, this mainly influenced the prospects of further interest rate cuts.

Some members were of the view that, due to continued inflationary pressure from the world market and the accompanying interest rate increases, the historically favourable global financial environment was expected to deteriorate, while market assessment of developments in domestic economic balance was unlikely to change favourably. They argued that a small increase in interest rates at the current meeting would reduce vulnerability and strengthen the Bank's credibility. Despite the conducive inflation environment, they judged indirect inflationary risks to be of a magnitude which would require proactive monetary policy in the current situation.

The Chairman invited members to vote on the propositions that the base rate should be left unchanged at 6.00% or it should be increased by 25 basis points. Ten members voted in favour of leaving interest rates unchanged and two voted in favour of a 25 basis point increase.

Votes cast by individual members of the Council

In favour of leaving the base rate unchanged at 6.00%	**10**	Zsigmond Járai, Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Béla Kádár, György Kopits, Judit Neményi, Gábor Oblath, György Szapáry
In favour of a 25 basis point increase	**2**	Péter Adamecz, Henrik Auth

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
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 28 November 2005. The minutes of that meeting will be released at 2 p.m. on 16 December 2005.