MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 28 NOVEMBER 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

According to the most important Hungarian economic data released over the past month, the fall in inflation has generally continued, with domestic business conditions remaining broadly stable.

In October 2005, the consumer price index rose by 3.2% and core inflation by 1.4% year on year, falling by 0.5 percentage points and 0.1 percentage point, respectively, relative to the preceding month. The decline in inflation in the month under review affected both the core and non-core measures of inflation. Within the core measure, the monthly rate of industrial goods inflation rose slightly (i.e. the momentum of deflation eased). By contrast, market services inflation continued to be high, although it has been slowing gradually for a period now. Indicators of the overall trend of inflation have been fluctuating between 1%–1.5% since March, providing evidence that core inflation has stabilised at a sustained low level. However, the differential between the overall consumer price index and core inflation has recently been widening, particularly on account of high oil and unprocessed food prices. In addition to the favourable international business climate, the strong exchange rate and import competition have helped to bring down tradables inflation. Meanwhile, the gap between inflation rates in the services and tradables sectors has failed to narrow materially.

According to Ecostat's flash estimate, Hungary's gross domestic product grew by 4.6% in 2005 Q3 relative to the same period of the previous year. However, the new accounting method adopted by the CSO in October, in compliance with a 2002 Commission Regulation, has made it somewhat more difficult to evaluate economic performance. Under the new approach, the CSO allocates financial intermediation services indirectly measured among user sectors, in contrast with earlier practice. Economic growth according to the previous accounting method was 0.4% lower, suggesting that growth rates have stabilised over the past few quarters. This pace of growth can be explained by lively investment activity, closely linked to motorway construction, and by the continued strong expansion of household consumption.

A picture of recent developments in consumption demand can be derived from retail trade data for September 2005. Seasonally adjusted total retail sales growth, including vehicle fuel sales, was 5.2% relative to a year earlier, with narrowly defined retail sales volume (i.e. which excludes vehicle fuels) rising by 6.5%. However, the data are insufficient to determine whether consumption demand gathered momentum or continued to grow at its earlier rate. This is suggested by the fact that, while the month-on-month growth rates of narrowly defined retail sales volume picked up in August-September, the rate of total retail sales growth stopped accelerating further.

Whole-economy gross average earnings growth was 7.7% in September year on year. Here, private sector earnings grew by 7.5% and government sector earnings by 7.9%. The September outturns suggest that seasonally adjusted wage inflation in the private sector has stagnated around 7% for some time now, and that the slowdown in wage inflation has stalled temporarily over the past 1–2 quarters.

The November issue of the Bank's *Quarterly Report on Inflation* provides an overall assessment of future prospects. Over the period to the end of 2007, inflation is expected to be low and economic growth stable. Inflation is likely to fall to around 1% on average in 2006, due mainly to the reduction in VAT rates and increases in certain administered prices postponed earlier. The rate of inflation is forecast to rise gradually towards the 3% inflation target in 2007.

Labour market conditions have been easing in 2005: ULC growth in the private sector has approached to the level consistent with low inflation. There has been little cost-push inflationary pressure from the labour market – wage growth is expected to be broadly in line with the inflation target on the forecast horizon. Inflation expectations stabilising at low levels and consumption demand expanding more slowly than in earlier years have also been conducive to the development of a low inflation environment.

In the *Report*, the forecast is for core inflation to rise following the reduction in VAT rates in early 2006. One reason for this is that, whereas up to now nearly every macroeconomic indicator has pointed to continued disinflation, they now offer somewhat mixed signals about future prospects. The expected gradual rise in imported inflationary pressure over the period ahead provides an explanation for a likely reversal in the longer-term trend of inflation. In addition, the high world market price of oil, and the feed-through of oil and administered prices to production costs also deserve special mention. The expected future pick-up in domestic demand is an upside risk to inflation.

The Monetary Council's decision in October to leave interest rates unchanged largely met market expectations. However, the fact that the case of an interest rate increase was raised at the meeting took some analysts by surprise. Following the decision, selling of forints in large volumes by non-residents since mid-September reversed temporarily. A smaller portion of short forint positions was closed out. Simultaneously with this, the exchange rate strengthened to EUR/HUS 248 by early November. But volatility, a gauge of investor uncertainty, remained in the government securities market. A correction, similar to that in the foreign exchange market, did not take place, with the premium stabilising at a high level. Exchange rate strengthening and the increase in non-residents' exposure to exchange rate risk, however, proved only temporary: the forint weakened again to EUR/HUF 254 by mid-November, after reports by European and other international institutions reinforced market participants' concerns about the size of government deficit. The recent political situation in Poland, i.e. the formulation of a minority government, public statements hinting at fiscal easing and a delay in euro adoption, had adverse effects on investor sentiment in the region. These developments in the Polish political scene represent a contagion risk for a protracted period.

Forint premia increased in a benign global environment, associated with very low emerging-country risk premia and exchange rate appreciation in the countries of the CEE region. US long-term yields stopped rising further in early November. This, coupled with news related to a fall in oil prices, surprisingly robust purchases of securities by non-residents and a slowdown in the property market, overshadowed evidence of higher-than-anticipated inflationary pressure and stronger-than-expected business activity, and increased investors' appetite for risk around the world. From a technical point of view, the earlier build-up of large short positions in the bond market slowed down the rise in yields. Due to the upside risks to inflation, the market priced in a further 75 basis point increase in US official interest rates for the coming six months. This may have contributed to the appreciation of the dollar. The exchange rate broke through 1.2000 against the euro in early November, strengthening to a two-year high; however, this did not have a material influence on emerging markets, as longer-term expectations continued to foreshadow a structural weakening of the dollar.

Forint yields have risen along the length of the curve in the past month. The rise in short-term yields may be explained by higher short-term euro yields. As an effect of (i) the risk of higher inflation associated with slightly stronger-than-expected growth in the euro area; (ii) the weaker euro exchange rate; and (iii) the related statements by senior ECB officials, the market priced in an interest rate increase in early December by the ECB, previously expected only for 2006 Q1. Based on the shape of the forint yield curve, the market priced in a 6.5%–6.75% base rate for end-2006, in contrast with the earlier 6.25%. This slightly contrasts with the fact that, according to the November Reuters poll, the majority of respondents do not expect an interest rate increase in 2006. Market economists and currency traders' forecasts are for the base rate to remain unchanged in November, with the majority of analysts expecting a 6% official interest rate for end-January.

However, an increase in the long-term premium also contributed to the rise in long-term yields. This suggests that the deterioration in assessments of Hungary's economic fundamentals which started in mid-September continued in November. The five-year forward premium fives years ahead rose near to 250 basis points, its peak to date, and long-term government securities yields, at around 7%, hit the highest level in several months. As a consequence, the majority of investors purchasing forint-denominated bonds this year had unrealised mark-to-market losses on their holdings, which threatened to cause a scaling-back of positions and a further rise in yields.

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

The exchange rate had been relatively stable and inflation had fallen in the past 18 months. This had created an opportunity for a gradual, but significant reduction in official interest rates from their high levels at end-2003.

In assessing recent economic and monetary developments, Council members agreed that, in view of the current trends in the domestic economy, the inflation targets for end-2006 and end-2007 could be met. They concluded that the consumer price index was likely to be near the bottom of the target range at end-2005 (3.2%), despite strong inflationary pressure from exogenous factors materially influencing inflation (i.e. oil prices and imported inflation) over the past 12 months. Some members noted that the decline in core inflation – a key indicator for monetary policy – to historical lows had played a dominant role. Core inflation had fallen to 1.4% in H2 both in Hungary and the euro area. The favourable change in the pattern of domestic demand and the curtailment of consumption growth had also played a part in this, in addition to intensifying market competition and the strong forint exchange rate.

International investors' risk appetite continued to be high. Consequently, the country's external financing conditions were currently favourable. The economy had been hit especially hard by high oil prices, but other factors, particularly international competition, had broadly offset this.

However, the favourable inflation projection contained a greater degree of uncertainty. Currently, the Council could not be sure about the way in which the global and domestic imbalances would be corrected. This represented an upside risk, particularly as regards the inflation projection for the second year of the forecast period.

Members agreed that caution was needed in the conduct of monetary policy. A potential worsening in the global investment climate and expected interest rate hikes by leading central banks might entail a rise in risk premia on forint-denominated assets and a reduction in the interest rate differential. In such circumstances, Council members did not see an opportunity to reduce the base rate further and, consequently, they regarded leaving the base rate on hold as an appropriate and cautious policy approach.

The Chairman invited members to vote on the proposition that the base rate should be left unchanged at 6.00%. The Council voted unanimously in favour of the proposition.

Votes cast by individual members of the Council

In favour of leaving the base rate unchanged at 6.00%	**13**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Péter Bihari, Vilmos Bihari, Tamás Bánfi, Csaba Csáki, Ilona Hardy, Béla Kádár, György Kopits, Judit Neményi, Gábor Oblath, György Szapáry

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

Zsigmond Járai, Chairman
Henrik Auth
Péter Adamecz
Dr. György Szapáry
Dr. Ilona Hardy
Judit Neményi
Dr. Péter Bihari
Vilmos Bihari
Dr. Tamás Bánfi
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 19 December 2005. The minutes of that meeting will be released at 2 p.m. on 13 January 2006.