MINUTES

OF THE MONETARY COUNCIL MEETING

OF 19 DECEMBER 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

Inflation remained low in November. The consumer price index and core inflation, up 3.3% and 1.4% year on year respectively, rose only marginally relative to October. The underlying developments indicated some slight upward pressure on inflation, and were consistent with the Bank's latest projection. The modest increase in core inflation in the preceding month was closely linked to the pick-up in inflation of goods competing with imports, particularly industrial goods and certain food items, which, in turn, may have been related to a decline in the previous downward pressure on prices stemming from market competition. Meanwhile, inflation in the market services sector, which considerably exceeds the general inflation level, remained high around 7%, reflecting strong cost pressures from wages and inflation expectations which have ceased falling recently. Looking at the price categories excluded from the core measure of inflation, the picture is somewhat more mixed: the effect on inflation of movements in vehicle fuel prices was upwards, while that of administered prices and unprocessed foods prices was downwards. Lower vehicle fuel prices reflected the direct effect of the recent near-term downturn in the world market price of crude oil. However, despite these developments in prices in November, the longer-term effects on costs of the sharp rise in global oil prices over the past two years continue to pose an upward risk to inflation.

Turning to wage inflation developments, adjustment to the low inflation environment continued in October. Private sector wages rose by 6.9% relative to October 2004, continuing the earlier slight downward trend. The recommendation for a 3.5%–4% increase in gross wages in 2006, agreed by the Interest Reconciliation Council, is a sign of adjustment to the low inflation environment. Nevertheless, it remains unclear whether such a rise in pay takes account of the estimated average 1 per cent upward effect on wage levels generated by the increase in the national minimum wage. In respect of future developments in wage growth, however, the possibility of wages rising in excess of the IRC's recommendation, as has been the case in recent years, coupled with the potential feed-through of the minimum wage increase, represents a significant risk.

Hungary's gross domestic product grew by 4.5% in 2005 Q3 relative to the same period of the previous year. Net exports and government investment in the road infrastructure were the major sources of this growth. Industrial output and foreign trade data for October suggest that the benign cyclical developments, characterising Q3, may continue in the final quarter of the year. Rising external demand has recently been the driving force behind growth, consistent with the pick-up in activity in Hungary's main export markets. Growth in both euro area GDP and imports in the quarter was the strongest in several years; and the effect of the European business cycle was also reflected in industrial output data for countries of the CEE region.

Assessments of Hungarian economic fundamentals have continued to deteriorate in recent weeks, after the ratings agency Fitch again turned investors' attention to the risks stemming from the persistently high budget and current account deficits, and rising government debt. However, favourable investor sentiment around the world, and particularly the recovery of regional markets, were once more effective in reversing exchange rate depreciation and the rise in yields, although the long-term forward premium continued to move up.

Accompanied by high trading volumes, the forint weakened by more than 1.5% in early December, after Fitch downgraded Hungary's forint and foreign currency-denominated debt rating by one notch. The exchange rate broke through the technically important EUR/HUF 254–255 level and weakened to an 18-month low. However, this fall failed to induce a perceptible change in exchange rate expectations and heighten expectations of official interest rate hikes.

Although investment bankers continued to recommend selling forints, referring to the unfavourable economic fundamentals, near-term sell recommendations did not contain an exchange rate objective weaker than EUR/HUF 260.00. The five-year forward premium five years ahead, reflecting fundamental risks, rose to around 250 basis points, a peak level in several years, and long-term government securities yields once again climbed above 7%. Foreign investors resumed selling forints and taking synthetic forward positions against the currency. They broadly maintained their government securities holdings and sold some HUF 20 billion of shares held.

The appreciation of Central and Eastern European currencies has continued in recent weeks, which has also contributed to the relatively swift correction of the decline in prices following the downgrade of forint-denominated assets. With the easing of political uncertainty following the general elections, the Polish zloty has strengthened to a three-and-a-half year high against the euro. The Slovak koruna has appreciated to its strongest level to date after the announcement of Slovakia's entry into ERM II, expected by the markets to occur at a much later date. And the Czech koruna has also risen to historical highs. Although the forint strengthened near to 252.00 vis-à-vis the euro and yields declined, this clearly lagged behind the performance of other markets in the region.

Global investor sentiment has been very favourable in recent weeks: emerging-market premia have remained low, despite rising modestly. Expectations, later proving self-fulfilling, that the FOMC would signal its interest rate cycle nearing an end as early as December fuelled investors' demand for high-yield assets. Although the ECB's 25 basis point rate hike on 1 December met market expectations, official statements accompanying the decision temporarily dampened concerns over the development of a tightening cycle. As an effect of an improvement in the economic outlook and fresh public statements, however, short-term forward rates resumed rising: the market priced in a 25 basis point increase in European interest rates for the coming three months and another 25 basis point increase for the period to the end of 2006.

Despite the significant fluctuations in the forint exchange rate, the short end of the yield curve was stable throughout December. If the forward curve reflected only short-term interest rate expectations, it would be consistent with a total 25 basis point interest rate increase over the coming three months and with a further 75 basis point increase over the period to the end of 2006, which implies an only slightly higher path than in the preceding month. However, the rising curve presumably contains the risk premium of a larger interest rate hike priced in with a lower weight as well as a greater degree of uncertainty surrounding expectations. This is also reinforced by the latest Reuters poll. Market economists and currency traders' forecasts are for the base rate to remain unchanged at the end of 2005. Analysts expect an around 6% official interest rate for end-2006; however, expectations are widely dispersed, with some of them even holding out the possibility of a larger interest rate cut.

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

After discussing the latest macroeconomic news and financial market developments, the only proposition offered to the Council was to leave the base rate unchanged, which all members supported.

Members stressed that information which had become available since the latest rate-setting meeting, such as news of interest rate increases by the European Central Bank and the Fed, had not materially altered the conditions for monetary policy conduct. However, the ratings downgrade by Fitch had contributed to a further deterioration in assessments of risks associated with forint-denominated investments. The Council interpreted the significant rise, particularly at longer maturities, in the risk premium on forint-denominated assets since the downgrade as an unfavourable development.

Several members of the Council noted that the recent favourable developments in domestic wages and unit labour costs had greatly contributed to the fall in inflation expectations and had been conducive to the consolidation of the low inflation environment. In respect of domestic economic performance, several members noted that there were no signs of the pick-up in activity triggering inflationary pressure and that next year's wage agreements reflected economic agents' adjustment to the low inflation environment.

Members agreed that, with the current level of interest rates, the prospects for meeting the 3% inflation target in 2007 were good. However, views were divided on the issue of interest rate decisions in the period ahead. Some members argued that, according to the logic of the inflation targeting regime, it was justified to keep monetary policy on hold at a time when the inflation projection was at the 3% medium-term target. Others were of the view that developments in, and the trend of, the components of inflation would allow further interest rate cuts, which, however, was constrained by the rise in the required risk premium due to the uncertainty about future developments. They did not consider the temporary increase in prices in 2006, caused by the reduction in VAT rates, to be relevant for monetary policy.

The interest rate hikes by the Fed and the ECB had barely affected the currencies of emerging countries and the CEE region. This general investor optimism had also benefited the forint: the effect of the government debt downgrade on the stability of the currency had proved short-lived. Despite higher exchange rate volatility over the near term, market participants' exchange rate expectations had remained basically unchanged. Several members of the Council also pointed to increased risks arising from exogenous factors. The downgrade since the latest interest rate decision had had a temporary, though negative, influence on the Hungarian money market. In the short term, the Hungarian money and foreign exchange markets continued to be sensitive to unfavourable developments in the international climate, due to the existing risks to economic balance.

While fundamentally in agreement that interest rates should be left unchanged, a debate developed among the members regarding the room for monetary policy manoeuvre. The Council was divided over whether the credible easing cycle of the past two years had ended.

Members of the Council described the position of general government and the increasing indebtedness of the state as alarming and unsustainable over the longer term. They agreed that fiscal adjustment was unavoidable and that its effect on inflation depended on both the timing and method of implementing policy actions, which, however, could not be judged currently. Consequently, forecasting the required future interest rate decisions was much more difficult compared with the past.

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 23 January 2006. The minutes of that meeting will be released at 2 p.m. on 10 February 2006.