MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 23 JANUARY 2006

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

In December 2005, the consumer price index increased by 3.3% year on year. Core inflation rose by 1.3% in the year to December. On average, consumer prices were 3.6% higher in 2005 than a year earlier. Although this figure was broadly in line with inflation developments in 2005, its composition has made the assessment of longer-term inflation developments somewhat more difficult. One source of this uncertainty is that the inflation differential between the traded sector – particularly industrial goods and processed food items – and market services, known as the internal real exchange rate, continued to rise in December, mainly due to the persistence of high price inflation in market services.

The inflation differential continues to be high, fluctuating around 6–7 percentage points. This implies that intensifying import competition, which puts downward pressure on inflation of traded goods, is still playing a role in domestic inflation developments. However, another feature of import competition may have been important in December, namely that a number of retailers cut their prices earlier, in anticipation of the official reduction in VAT rates effective from January.

In the labour market, private sector wage inflation continued to adjust gradually to the low inflation environment. Gross average nominal wages grew by 7.2% in the first 11 months of 2005, which was in line with the Bank's November wage inflation projection for 2005. The unemployment rate remained at the relatively high levels characterising 2005, amounting to 7.2% in the period September-November.

Based on available fourth-quarter data, dynamic economic growth continued, consistent with the Bank's November forecast. The recovery of business activity in external markets was an important contributory factor to this growth, which was also reflected by the rise in confidence indices towards the end of the year. However, the domestic components of growth also played an increasing role, in addition to the robust rise in Hungarian exports: growth in retail sales volume picked up in October, and domestic industrial sales continued to expand in November.

In 2005, the government deficit on a cash basis was lower than the forecast presented in the November issue of the *Quarterly Report on Inflation*, at 4.6% of GDP. This may be explained by the Government's one-off revenues at the end of the year. Excluding these, the deficit was higher by 2% of GDP, exceeding even the Bank's forecast. The 2005 general government deficit on an ESA 95 basis is not yet available; the expert estimate of 7.5%–8.1% as a per cent of GDP, provided in the November *Report*, may be regarded as a benchmark until the first official release by Eurostat.

International investor sentiment developed very favourably in the first few weeks of 2006, with the majority of emerging markets picking up. The continued low level of long-term U.S. dollar yields caused the global surplus of liquidity to persist, which resulted in emerging-country risk premia continuing to decline. The weakening of the dollar, which may have been related to uninspiring economic data on the major markets and the reversal of interest rate expectations, also benefited emerging markets. Investors interpreted the minutes released on the latest FOMC meeting as signalling that the U.S. tightening cycle was now nearing an end. By contrast, the statement by the President of the European Central Bank left some room for rises in the key European interest rate. A potential international crisis or a massive portfolio shift continue to pose the greatest risk for Hungarian financial markets; however, in the market's evaluation such risks have fallen recently.

Regional investor sentiment was also strong, in line with global developments. While in December the focus of the markets was concentrated on the upgrade of Slovakia's debt, in January Poland shifted to the centre of attention. The Government reshuffle, the conversion of the government's foreign currency debt in the market and public statements in support of the zloty put strong upward pressure on the Polish currency.

Non-resident investors resumed buying the forint in early January: they took long positions in the currency to the tune of HUF 210 billion. Initially, non-residents' demand for forints mainly financed their purchases of government paper, a phenomenon which had not been seen for months. In mid-January, however, the closing of synthetic positions against the forint which were taken earlier also triggered significant demand for the currency.

The forint exchange rate has been fluctuating in a relatively narrow band between 253.00–249.50 vis-à-vis the euro since the previous meeting of the Monetary Council. Whereas in the second half of December the forint weakened and long-term forward rates rose, accompanied by a fall in non-residents' asset holdings, in January foreign investors generated considerable forint demand in the improving international and regional climate. Strong forint buying by non-residents was not accompanied by significant currency appreciation, reflecting the stability of exchange rate expectations; however, the current account deficit is seasonally high and foreign currency borrowing by households is seasonally low in the early months of the year, which may also have played a role.

Purchases of government securities by non-residents were accompanied by a drop in forint yields. Currently, the yield curve is consistent with a total 25 basis point interest rate increase over the period to the end of 2007. The FRA market has priced virtually unchanged official interest rates into forward rates for this year. Market participants do not expect official interest rates to change in the period to the general elections, but they are divided over the outlook following the elections. According to the various market surveys (e.g. the Reuters poll, portfolio.hu, etc.), market economists do not agree on the outcome of the next interest rate decision: the majority of forecasters expect a rate cut, with some expecting interest rates to be raised.

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 at 6%.

Members agreed that the outlook for inflation continued to be favourable and that the 3% target set for 2007 could be met. The reduction in VAT rates effective from early 2006 might push inflation well below the target level temporarily. There was general agreement in the Council that the tax effect would be transient and would not call for monetary easing.

Council members held the view that the international investment climate was currently very favourable and that investors' appetite for risk was strong. Consequently, there continued to be robust demand for high-yield forint-denominated assets. Some members of the Council thought that the possibility of global imbalances being corrected by a 'hard landing' should not be ignored, which – if it materialised – could bring about erratic movements in financial markets.

Others drew the Council's attention to the fact that – although global imbalances were indeed unsustainable over the longer term – the anticipated correction would not necessarily take place in the near term.

Members agreed that changes in the international environment were unpredictable and that a potential shift in investor sentiment might increase the risk of the Hungarian economy's equilibrium problems being remedied by the market.

Adding to this risk, the timing of the budgetary adjustment was still uncertain. The latest version of the convergence programme did not provide appropriate point of reference to make an informed judgement.

Several Council members were of the view that the recent favourable inflation developments could themselves allow a further interest rate cut; however, the market's unfavourable assessment of Hungary's economic balance and the unpredictability of shifts in global financial markets currently did not allow the Council to act accordingly. Nevertheless, if these factors changed favourably, there could be a case for reducing interest rates cautiously.

Other members thought that the outlook for future inflation currently gave reason to leave interest rates on hold, but given that the unfavourable budgetary position had yet to improve, the resulting financial market risks would persist and might even accumulate. In the latter case, an interest rate increase might be warranted.

Members did not attempt to match the two types of view within the Council, as they agreed that changes in financial markets' appetite for risks might affect future interest rate developments significantly and, therefore, it was justified to maintain a cautious approach to interest rate setting.

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