MINUTES

OF THE MONETARY COUNCIL MEETING

OF 20 MARCH 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 February 2006, the consumer price index increased by 2.5% year on year, down 0.2 percentage points on January. Core inflation rose by 0.7% in the year to February and by 0.2 percentage points relative to the preceding month. The year-on-year rise in the constant tax price index amounted to 4.4%.

Although the reduction in indirect taxes early in the year has made it more difficult to evaluate recent inflation developments, the gap between price inflation of industrial goods and market services – which is still wide by international standards – appears to have continued narrowing. The slower-than-expected fall in industrial goods prices and the further decline in market services price inflation in January-February have contributed to the composition of core inflation becoming more evenly balanced. In February, the drop in industrial goods prices turned out much smaller than previously expected, suggesting that producers and retailers probably used the VAT reduction in early 2006 to increase profits. The strong decline in market services prices, which may have been caused mainly by falling inflation expectations and low household demand for the sector's output, in addition to the tax cut, had an offsetting effect.

Private sector gross average earnings grew by 8.1% and government sector gross average earnings by 4.7% in January relative to a year earlier. On balance, whole-economy gross average earnings growth was 6.1% in the twelve months to January. The forecast is for private sector wages to grow by 7.5% in 2006 Q1. If January wages reflect the effect of the national minimum wage increase, the monthly figure is consistent with the picture of expected future developments in wage inflation.

Hungary's gross domestic product grew by 4.3% in 2005 Q4 relative to the same period of 2004, unchanged from the preliminary estimate. Economic growth was 4.1% in 2005 year on year and 4.3% after adjusting for the calendar effect. Although this rate was slightly lower than in 2004, it still remained close to the historic average of Hungarian economic growth. Net exports contributed strongly to growth in 2005. On the output side, the improved performance of the manufacturing, construction and market services sectors was the engine of economic growth.

According to January data, the cyclical upturn in domestic industrial activity continued. Output and foreign trade both picked up, in line with the recovery of external markets. Industrial output growth reached nearly 14% in the first month of the year, with both exports and imports growing by around 20% in euro terms, relative to the same period of the previous year.

The rate of retail sales volume growth rose month by month in the final quarter of 2005, as it did throughout the whole year. The pick-up in volume affected nearly all categories of retail products. The 2–2.5 per cent difference between household consumption growth and rising retail sales values in the national accounts in 2005 is presumably accounted for by a shift in household demand. This, in turn, may have led to a pick-up in demand for industrial goods with a low rate of price increase and a slackening of demand for services with a relatively high rate of price increase.

The government budget deficit was HUF 295 billion in February, broadly comparable with the forecast of the Ministry of Finance. Developments in the previous two months appear to add to the risk of the deficit for the whole year exceeding the projection in the November issue of the *Quarterly Report on Inflation*.

Volatility increased in the major financial markets in March, as an effect of which investors reduced their risk exposure to emerging markets. The forint exchange rate temporarily weakened to levels below EUR/HUF 260.00, last seen two years before; and the yield curve shifted downwards by 30–50 basis points. Movements in prices of forint-denominated assets and in those of assets of other countries in the region were closely aligned in the periods of weakness. The fact that the rise in the forint long-term forward premium ceased to continue, despite exchange rate depreciation and increased market uncertainty, points to the existence of external shocks.

Intensifying expectations of interest rate hikes affecting the major currencies and, consequently, the anticipated decline in ample global liquidity explained the fall in risk exposure. As an effect of favourable economic data and inflation concerns, markets priced in the continuation and further acceleration of the tightening cycles in the US and Europe. Whereas at the beginning of the year the market expected US short-term interest rates to peak at 4.75%, it has priced in a 5% interest rate recently. Statements following the rate increase by the ECB in early March also fuelled expectations of further rate hikes – the market expects another 75–100 basis point increase in interest rates over the period to the end of the year. As an effect of all these factors, long-term yields rose in developed markets: in the US and Europe respectively 10-year yields surged to 18-month and 12-month highs. In Japan, the market also expects interest rates to increase gradually, with the 'quantitative easing' policy of the past five years believed to have come to an end in March.

In contrast with the steady appreciation of currencies in the region, the forint exchange rate has stabilised in a narrow range in recent months. However, the weakening in March affected every market in the region similarly. But while exchange rate depreciation in the case of other currencies may have been a correction to the historic peaks of earlier months, the forint exchange rate fell to levels not seen since early 2004. This weakening of the forint was accompanied by investors selling the Hungarian currency at a slow but steady pace: non-residents' exchange rate risk exposure fell by a total HUF 220 billion in March. Meanwhile, strong buying by foreign investors at government bond auctions continued.

Short-term yields rose, simultaneously with exchange rate weakening, as market expectations shifted towards a faster increase in official interest rates. Whereas at the time of the Monetary Council's meeting in February the yield curve was consistent with a total interest rate increase of 25–50 basis points over the period to the end of 2006 and with another 25-basis point increase next year, the market has recently priced in the entire 75 basis point hike for this year. According to the Reuters survey, market economists and currency dealers unanimously expect the Council to keep the base rate on hold at its meeting on 20 March, and the majority of analysts do not expect interest rates to be changed over the period to end-2006. In the latest poll of short and medium-term exchange rate expectations, the exchange rate is forecast to be weaker than previously, but stronger than currently (EUR/HUF 255–257).

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

Members of the Council unanimously proposed to leave the base rate unchanged at the meeting.

Council members agreed that the recent exchange rate variability, triggered mainly by global forces, had brought the importance of problems with domestic economic balance to the fore. In the current international environment following the interest rate hikes by the Fed and the ECB, investors were expected to be more willing to distinguish between countries, which might affect the forint more adversely in the event of a fall in risk appetite. Any delay in budgetary adjustments therefore represented a continued upward risk to inflation.

Some members were of the opinion that the easing cycle of 2004–05 had now been completed. The earlier favourable prospects for inflation had deteriorated in March, and as there was the near-term possibility of a sustained exchange rate depreciation, meeting the 3% medium-term inflation target could be put at risk. Consequently, launching a tightening cycle might become inevitable.

Other members judged recent inflation outturns to be favourable. They stressed that, while future movements in the exchange rate and the effects of the forint's recent weakness on expectations were difficult to estimate, inflation data released early in the year clearly pointed to an improvement relative to earlier expectations. Although the weaker-than-expected impact of the VAT reduction might result in slightly higher inflation over the short term in 2006, the pick-up in disinflation of market services prices, if it proved lasting, might increase the chance of meeting the inflation target.

Members present at the meeting were in agreement that the effect of exchange rate movements on domestic prices might vary over time. As international evidence had proven, low inflation and the credibility of inflation targets might reduce the strength of exchange rate pass-through. In this regard, Council members considered the recent marked fall in households' inflation expectations as a favourable development.

There was agreement in the Council that, taking account of the timeframe required by exchange rates to pass through to domestic prices, only a lasting currency depreciation could lead to a deterioration in the future prospects for inflation. Some members thought that, in assessing the effects of a potential exchange rate weakening, it should also be taken into account that in the circumstances such a weakening could depress domestic demand, due to the indebtedness of the private sector in foreign currency, which might diminish the inflationary effects of depreciation.

However, opinions differed in respect of the extent to which the forint's weakness could persist. Some members argued that, in retrospect, the current weakness could also prove short-lived, if the Government took the necessary measures to adjust the budget.

By contrast, other members said that, due to the delay in a credible fiscal adjustment effort, the likelihood of further deterioration in risk assessments and a continued fall in the forint exchange rate had increased. As major central banks were now in the upward phase of the interest rate cycle, the forint premium provided some protection and, consequently, the Bank would have to move towards tightening. Such a tightening cycle should be timed so as to smooth the transition period and fend off an overshooting of the exchange rate.

According to some views, although the relationship between the inflation target and the inflation outlook was the single most important determinant of interest rate policy, an adverse turn in the international investment climate, or a sudden deterioration in assessments of emerging markets or Hungary might lead to a situation in which the risk of currency overshooting could arise, due either to excessive volatility or inadequate functioning of financial markets, which then might necessitate an interest rate increase.

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%	**12**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Péter 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
Dr Tamás Bánfi
Dr Csaba Csáki
Dr Béla Kádár
Dr György Kopits
Dr Gábor Oblath

Péter Tabák, Head of Department of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 24 April 2006. The minutes of that meeting will be released at 2 p.m. on 12 May 2006.