MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 APRIL 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 March 2006, the consumer price index rose by 2.3% year on year, down slightly on the outturn for the preceding month. By contrast, core inflation picked up marginally, rising to 0.8%. The reduction in VAT rates in early 2006 had little effect on the month-on-month price indices, and consequently the March data is a much more informative guide to longer-term inflation trends compared with the preceding two months' figures. The month-on-month rate of increase in inflation returned to and even sank below 2%, a level characterising most of last year, with the pattern of price inflation becoming much more balanced. The gap between price inflation of industrial goods and market services continued to narrow in March: the price index of industrial goods kept rising (the change in trend inflation was positive for the first time in more than a year), while the trend rate of services price inflation fell markedly for the third month in a row, in contrast with developments last year. After eliminating the effect of the VAT cut, industrial goods prices passed their turning point in mid-2005, well before this year's exchange rate weakening. In 2006 Q4, the consumer price index exceeded the forecasts in the November and February issues of the *Quarterly Report on Inflation* by 0.6% and 0.3%, respectively. The largest part of this difference was accounted for by the salient increase in unprocessed food prices (for example, vegetables prices surged by some 70% in the last twelve months), which, however, the Bank does not expect to have a lasting impact on future inflation developments.

This year's strong wage growth in the private sector has added to uncertainty regarding the further decline in the market services price index. Private sector earnings grew by 9.1% in January-February 2006 relative to the same period of the previous year, with the 9.6% statutory national minimum wage increase playing a dominant role, as this had the most discernible effect on the market services wage index. Based on the latest available data, the first-round effect of the minimum wage increase is highly likely to exceed the Bank's previous estimate, which, in turn, may raise uncertainty about the extent to which the minimum wage increase will influence pay developments over the medium term.

According to the evidence of industrial output and foreign trade data, robust domestic economic activity continued in February, although the most recent figures suggest some slowdown in growth. Nevertheless, the steady increase in confidence indices and developments in manufacturing orders continue to foreshadow dynamic export growth. The favourable effect of the latter on external equilibrium was partly offset by the persistent rise in crude oil prices in the early months of the year, resulting in a sharp deterioration in Hungary's terms of trade.

According to balance of payments data for 2005 Q4, the seasonally adjusted external financing requirement continued to fall (to 6.1% of GDP), to which the deficits on trade in goods, and the income and transfer account both contributed. It is important to note, however, that considerable methodological uncertainty continues to surround the balance of payments statistics, given the ambiguity of 2004–2005 foreign trade developments with regard to the consistency between the financial accounts and the balance of payments, particularly in respect of the slowdown in import growth. Net non-debt capital inflows were more than sufficient to cover the current account deficit in 2005 Q4; however, part of these came from one-off budget revenues, i.e. from privatisation proceeds.

In 2006 Q1, the government deficit on a cash basis of accounting exceeded half of the forecast of the Ministry of Finance for the whole year, and was HUF 110 billion higher than the central projection in the November *Report*. Based on the first-quarter data, the risk of the annual deficit exceeding the Bank's November forecast has increased, due primarily to the upward effects of the negative interest balance and the social security deficit.

Over the past month, developments in the international financial environment have had offsetting effects on the assessment of forint-denominated investments. Long-term yields have continued to rise in the major markets, with investors earning increasingly higher profits on risk-free US and European government securities. However, emerging market bond spreads have not risen overall. The EMBI spread has remained at very low levels, below 200 basis points. But recently investors have increasingly been distinguishing between countries, based on their own perceptions of risks associated with a given country's economic balance and political developments. Bond spreads of countries perceived to be riskier (e.g. Iceland, Poland, Hungary, Mexico, Turkey) have continued to rise over the past month, with their currencies depreciating against other emerging market currencies.

Developed country long-term yields have risen further over the past month, due to the benign outlook for economic activity and the renewed surge in the price of oil above 70 US dollars per barrel. Interest rate expectations, however, have barely changed. The US 10-year bond yield has risen above 5%, a level not seen since 2002. Markets are confident that the Fed will raise interest rates by 25 basis points in May. By contrast, the discounted probability of a rate hike in June has fallen below 50% recently, in response to the weaker-than-expected economic data released in mid-April. The European 10-year bond yield has climbed above 3.9%, an 18-month high. Futures markets have already priced in a 25 basis point rate hike by the ECB in June, and expect the key policy rate to be 3.25% at year-end.

The forint continued to weaken over the period to Monetary Council's meeting in April, remaining below EUR/HUF 262.00 prevailing at the time of the previous meeting. The exchange rate reached lower successive peaks during temporary rebounds, which suggests the continuation of depreciation in technical analysis terms. According to the latest Reuters survey, the majority of market analysts do not expect the forint to strengthen below 260.00 vis-à-vis the euro over the short term. In their forecast, at end-May the exchange rate fluctuates in a range between EUR/HUF 260.00–270.00, characteristic of the period since the previous survey. However, the exchange rate expected for end-2006 and end-2007 reflects that economists differ over whether the forint's recent weakness will be persistent, and, looking further ahead, they expect the exchange rate to recover slightly but steadily. The weakening of the forint was accompanied by non-residents reducing their exposure to exchange rate risk significantly. By contrast, they reduced their government securities holdings by only HUF 27 billion, as they reinvested the bulk of the maturing portfolio worth a total HUF 158 billion. Investors adopted a wait-and-see approach between the two rounds of the general elections.

Foreign investors have increasingly treated taking exchange rate risk and interest rate risk as separate issues in recent months: they have mainly purchased Hungarian government securities in combination with hedging against exchange rate risk. Consequently, nearly the entire increase in the premium caused by country-specific risks fed through to the exchange rate; and movements in yields only partly followed rises in yields in major markets. Ten-year European and US yields have risen by 60–65 basis points since early 2006. By contrast, the comparable Hungarian forint yield has barely moved up, and the exchange rate has weakened by 6%. The relative stability of government securities yields contributed to the 5-year forward premium 5 years ahead falling to levels close to 200 basis points by mid-April, which, however, is particularly high in a regional comparison.

Expectations of an increase in official interest rates have remained broadly constant over the past month: the yield curve is consistent with an interest rate increase of 75–100 basis points over the period to the end of 2006. According to the latest Reuters survey, market economists and currency traders unanimously expect the Council to keep the base rate on hold in April. However, interest rate expectations for year-end are divided: one group of analysts forecasts a 6% base rate, while another projects a 6.5%–6.75% base rate. There is a broad consensus among investment bank analysts waiting for the announcement of budgetary measures in the wake of the elections – fiscal developments may even influence premia on forint-denominated assets in the short term.

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.

Members agreed that offsetting developments had recently influenced the future prospects for inflation. Risks of higher inflation had increased, which, however, might be counterbalanced by other developments. Consequently, members did not consider it necessary to tighten monetary conditions.

Some members argued during the discussion that developments conducive to meeting the 3% inflation target continued to dominate. Economic agents' lower inflation expectations and the recent fall in the – previously persistently high – market services price index were corroborative evidence of this view. The latter was of particular relevance, as it had also been observed in services prices left broadly unaffected by the VAT cut and, moreover, the drop in early 2006 was likely to strongly influence price developments over the year as a whole, taking into account domestic firms' price-setting behaviour this time around.

Other members were of the view that, while there had been favourable developments, the risks of inflation exceeding the target in 2007 had increased. The most important of these were the continued rise in international crude oil prices and the recent depreciation of the forint, in the event that the two effects were to prove lasting. Wage developments in the private sector posed a risk to the further decline in market services price inflation. While labour market developments had recently been conducive to disinflation, the stronger-than-expected first-round effect of the minimum wage increase this year represented an upward risk looking further ahead, particularly in the services sector. Another negative factor was the increase in industrial goods prices since mid-2005, which was practically unaffected by the reduction in VAT.

Members discussed the possible effects of developments on unprocessed food prices. The high unprocessed food prices of recent months were instrumental in the consumer price index exceeding the Bank's expectations in the first quarter. Council members agreed that this product group – the prices of which tended to be variable – was unlikely to have a major effect on medium-term inflation developments. It could not be ruled out, however, that it might even reduce annual consumer price inflation in 2007, due to the base effect.

Members were divided over the assessment of the smaller-than-expected feed-through of this year's VAT reduction, particularly to industrial goods prices. There were views that this should be treated as a one-off effect, and consequently it would not influence trend inflation. Other members thought that retailers having used the reduction in VAT rates to a greater extent to increase profits than the Bank had expected might suggest that domestic competition was weaker than assumed earlier. This, coupled with the recent pick-up in industrial goods price inflation abroad and the depreciation of the forint, could trigger greater inflationary pressure than previously thought in a wide range of products.

As regards international financial market developments, members of the Council were of the view that, although the external investment climate continued to be favourable and capital inflows to emerging markets had increased recently, the situation continued to be fragile. In the case of the major currencies, central banks' tightening cycle might continue in the near future, which, by way of higher risk-free yields, might reduce investors' appetite for risk around the world, leading to an increase in required risk premia on forint-denominated investments. Under such circumstances, failure to implement early, credible budgetary adjustments might cause a deterioration in assessments of risks associated with the forint's exchange rate. By contrast, if the new Government took credible action even over the short term to improve the fiscal balance, positions built up against the forint in recent months might partly unwind, which could help the forint to strengthen.

Several members thought that, although uncertainty surrounding the future outlook for inflation had increased, the perceived risks were in both directions. Moreover, as inflation in the Bank's latest projection for 2007 was slightly below the target, upward revision of the projection did not in itself translate into expected inflation significantly above the target. Currently, it could not be judged which of the factors affecting inflation at different horizons would prove lasting. Taking all these into account, a monetary policy action could be necessary, were upward risks to inflation to materialise in the future. Other members were of the view that the balance of risks was currently on the upside; however, the precise effect of the individual factors on expected inflation could not be judged. There was agreement among members that the Bank should closely monitor factors affecting inflation and counterbalance developments possibly posing a threat to price stability by tightening monetary conditions.

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 22 May 2006. The minutes of that meeting will be released at 2 p.m. on 9 June 2006.