MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 22 MAY 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 April 2006, the consumer price index rose by 2.3% year on year, unchanged from the preceding month. Core inflation was up 0.8%, falling by 0.1% relative to March. According to the price indicators which also incorporate the latest monthly data, inflation developments were little changed over the period to April: trend inflation remained close to 2%, as seen last year.

April's data provided corroborative evidence on the persistence of disinflation in market services, which began in early 2006. Importantly for policy purposes, there is no sign yet of the weaker exchange rate affecting industrial goods prices, given the reversion in the monthly change in industrial goods prices to negative territory in April. But recently the overall consumer price index has been very strongly influenced by sharply rising unprocessed food prices – increases in the latter account for more than half of the 1.6% gap between the CPI and core inflation.

According to the preliminary estimates which do not contain the main components of GDP, economic growth amounted to 4.5% in 2006 Q1 relative to the same period of the previous year. This rate proved lower than the pace of growth recorded in 2005 H2 and diverged slightly from the Bank's earlier projection, which had been for growth to pick up further in the first half of 2006.

Data on both industrial output and foreign trade reflected strong economic activity, despite the recent deterioration in Hungary's terms of trade, and cast a somewhat different light on the picture painted by provisional and aggregate GDP figures. The March outturns for industrial output and goods exports, showing rises of 14% and 20% respectively, suggest that robust external business activity continues to play a dominant role in domestic growth. Nevertheless, the economic cycle in Hungary's export markets is perhaps nearing its peak and therefore the recovery of external demand is unlikely to gather pace in the period ahead. Based on these developments, net exports are expected to continue contributing positively to economic growth this year, although less strongly than the brisk rate of 2005.

Whole-economy gross average earnings growth was 7.3% in 2006 Q1 year on year. Earnings grew by 9.1% and 5% respectively in the private and public sectors. With March's data available, uncertainty surrounding the assessment of labour market developments in the wake of the statutory minimum wage increase in January seems to have abated. Accordingly, wage inflation fell in March, after rising strongly in January-February. Although the latest numbers do not significantly alter the picture of longer-term pay developments, they point to a higher path of wages over the short term. However, in the May issue of the *Quarterly Report on Inflation* the forecasts are for (i) labour market conditions to loose, (ii) labour supply to rise in excess of labour demand growth and (iii) businesses to continue substituting between capital and labour.

The rises in US dollar and euro yields have been the most important developments in international financial markets recently. Markets increasingly switched their focus to inflationary risks and consequently to the possibility of faster-than-expected monetary policy tightening, in addition to favourable growth prospects and steadily rising materials prices. In its press release accompanying the 25 basis point rate rise in May, the US Fed emphasised the increased role incoming economic information played. Forward markets priced in another 25 basis point interest rate increase in the United States for this year; however, they attached a low probability to such a move by the Fed at end-June.

The US dollar has lost much of its value since March: it has fallen to a twelve-month low vis-à-vis the euro, in which the majority of fresh European economic data reflecting a recovery of growth must have played a role. As a consequence, expectations of interest rate rises increased slightly. Markets priced in a 75–100 basis point tightening of policy by the ECB over the period to end-2006. Whereas earlier the dollar's weakness had benefited emerging market assets, now it encouraged investors to realise profits on positions in high-yielding assets financed from dollars and to reduce their exposure to risk.

A wave of emerging country asset sales sprang from the Turkish market in mid-May. As was the case during the March episode, this adverse blow to global risk appetite mainly affected countries which investors believed were exposed to higher equilibrium or political risks. The external shock also broke the forint's appreciation which began in mid-April: the exchange rate temporarily weakened again from EUR/HUF 259.00 near to 269.00, the low point prevailing in early April. This, however, was followed by a swift correction, simultaneously with an improvement in the external environment.

According to the latest Reuters survey, longer-term exchange rate expectations barely changed, with analysts expecting a slight appreciation. The assessment of the outlook for the government budget by investors is of key importance for future exchange rate movements. It is clear from investment bankers' analyses that the markets are anticipating fiscal adjustments. However, in the absence of such efforts, the increased vulnerability of forint-denominated assets to external shocks may remain or even increase.

Although the shock in May mainly translated into exchange rate depreciation, as happened in earlier months, the yield curve shifted upwards slightly and the long-term forward premium against the euro stopped falling. Even so, the rise in long-term forint yields over the past several months was significantly more modest as compared with those in yields in major markets. Based on the shape of the yield curve, the market priced in a nearly 75 basis point interest rate increase over the period to the end of the year. By contrast, there is broad consensus among analysts polled by Reuters that the Monetary Council will keep interest rates on hold in May; and the average of longer-term expectations does not deviate substantially from the current 6% level.

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

After discussing the latest macroeconomic news, financial market developments as well as the main points of the *Quarterly Report on Inflation*, the Council unanimously voted to leave the base rate unchanged.

There was a diverse range of views among members about the latest inflation developments. Some argued that inflationary pressures had increased in the Hungarian economy. The recent fast rises in oil and materials prices had led to greater inflation risks around the world. The effect of the minimum wage increase on general pay levels could prove stronger, the associated inflationary pressures of which being aggravated by robust activity in the industrial sector. All these had been coupled with a weaker-than-earlier exchange rate for several months. Both the European Central Bank and the Fed being in the tightening phase of monetary policy was cited as another source of risk. That implied the likelihood of a fall in international investors' willingness to take risks. For these members, therefore, these factors pointed to the need for an increase in interest rates, and a delay in taking action was detrimental to the credibility of monetary policy.

In contrast, several members stressed that, for the time being, no conclusive proof of inflationary pressure building up could be identified and that the underlying inflation developments were practically consistent with price stability, an environment that had not been experienced for decades. Market services price inflation had moderated significantly this year and households' inflation expectations had fallen to a historical low, which they thought was particularly good news for inflation prospects. Although in the current forecast inflation was above the medium-term target for 2007, there could nevertheless be a range around the 3% target which would not warrant any monetary policy action and, in these members' view, the current inflation projection was within that range.

There was agreement among Council members that the new Government's measures to adjust the budget, which were not available at the time of the meeting, could fundamentally alter the picture painted in the *Report* and significantly influence the assessment of risks associated with forint investments. They were of the view that the inflation projection produced by Bank staff was based on technical assumptions which were highly likely to become invalid in the wake of the new Government's moves. For this reason, members thought it was useful to wait until the announcement of the new government programme and its reception, in order to better assess the medium-term risks to inflation.

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, Tamás Bánfi Péter Bihari, Vilmos Bihari, 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 Tamás Bánfi
Dr Péter Bihari
Vilmos Bihari
Dr Csaba Csáki
Dr Ilona Hardy
Dr Béla Kádár
Dr György Kopits
Judit Neményi
Dr Gábor Oblath
Dr György Szapáry

Tibor Erhart, Head of Division of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 19 June 2006. The minutes of that meeting will be released at 2 p.m. on 7 July 2006.