MINUTES
OF THE MONETARY COUNCIL MEETING
OF 19 JUNE 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 determining 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 developments

Macroeconomic data on the previous month

In May 2006 the annual rate of the consumer price index rose to 2.8 per cent, exceeding the value for April by a half per cent and surpassing market expectations. In parallel, core inflation also rose by 0.3 of a percentage point, reaching the current rate of 1 per cent. The annual monthly index of trend inflation, filtering the effect of the VAT decrease, jumped to 4 per cent from the roughly 2 per cent stable level measured a year ago. Analysing the causes, it may be established that the rise in core inflation is primarily linked to the shock inflation of processed food prices and the unexpected increase in the price of market services. In May the monthly change in the price of processed food on a yearly basis exceeded 9 per cent, and was more than 6 per cent in relation to market services. The latter development is all the more surprising because in the first months of the year the pace of monthly price changes in this area seemed to stabilise at a level lower (at approximately 4 per cent) than witnessed in the course of 2005. Moreover, the disinflation of industrial goods did not continue, presumably linked to the joint effect of a weaker exchange rate, the rise in import prices and the possible weakening of market competition. In addition to the increase in core inflation, the continuing high inflation of vehicle fuel and unprocessed food prices (annual rate of 13.3 per cent and 18.5 per cent, respectively) considerably contributed to the rise in the consumer price index.

In 2006 Q1, the economy grew by 4.6 per cent year on year, moderately exceeding the rate of growth indicated by preliminary data and the 4.5 per cent forecast in the report on inflation for the month of May. According to the detailed data, the growth in household and government consumption was on a more moderate level, while the rise in net exports (primarily as a result of growing exports) and investment was higher than anticipated earlier. The above data in itself would warrant a moderately downward move in comparison to the most recent 4.5 per cent forecast for GDP growth in 2006.

The most recent economic data, however, provide a more varied picture. Increasingly certain signs of slowing industrial output surfaced already in recent months, and preliminary data for April confirmed a turning point in terms of industrial growth. In April the volume of industrial output was only 1.8 per cent higher than the figure for April 2005. This reversing trend is in line with the stall of the business confidence index in the euro zone, implying slower external economic growth, as reflected also by slackening growth in the volume of foreign trade. Net exports, however, grew at a dynamic pace because imports basically did not rise. In light of the above trend, the contribution of net exports to economic growth is therefore linked to some uncertainty, because the slowing rate of imports, reflected by data for April, may partly result from the noise in the time series.

Since the report on inflation for May, data collected from the labour market generally forecast the probability of moderate inflationary pressure. The rise in the unemployment rate stalled at the beginning of the year, followed by a gradual fall, in consequence of the growing number of employed. In January-April 2006, whole-economy gross average earnings rose by 7.5% in comparison to the rate measured a year earlier. Within the above figure, wages increased by 8.6% in the private sector and by 6.1% in the public sector. Data for April confirms that wage inflation in the private sector slackened further following the single wage shock caused by the raise of the minimum wage.

The reported fiscal measures and their effect on the expected development of the government budget

Important news was published recently in relation to budgetary developments. Firstly, on 8 June the Government modified the 2006 deficit target upward, and secondly, on 10 June

the prime minister announced adjustment measures. Since then, numerous statements and news reports have been issued which bear an impact on this year's deficit and the extent and structure of the adjustment; thus, the expected budget path may undergo further change. Uncertainty remains because the reasons for the modification of the 2006 deficit target have not been clearly defined to this day, thereby limiting the accurate distinction of single and long-term effects.

Considering the above uncertainty factors, on the basis of the reports and announcements, the following observations may be made in relation to fiscal developments in 2006.

1. The deficit target has increased, despite taking into account the effect of the announced adjustment measures. Therefore, the upward modification of the deficit target firstly implies the existence of the risks already indicated in the report on inflation, and secondly, the subsequent rise in expenditures.
2. The insufficient information available suggests that modification of the deficit target is primarily motivated by demand enhancing factors, and only to a lesser extent by single consolidation factors. Among the deficit reducing measures, the 2006 demand enhancing effect would have corresponded to roughly 2.5 per cent of GDP, while the general government borrowing requirement would have reached 11.5-12 per cent of GDP.
3. The introduced deficit reducing measures offset much of the acknowledged exceeded deficit. On the whole, the deficit reducing measures decrease 2006 demand by 1-1.5 per cent. The tax increases generate nearly HUF 200 billion in surplus revenue; the combined amount of medication expenditures and gas compensation may decrease by approximately HUF 50-60 billion, and the freezing of reserves may reduce the deficit by a maximum of HUF 112 billion. Past experience suggests, however, that the effect of the last mentioned measure is quite uncertain.
4. On the whole, the rate of growth in demand this year resulting from budgetary policy is expected to reach 1-1.5 per cent of GDP, while the general government borrowing requirement could reach roughly 10.5 per cent of GDP.
5. There is major uncertainty surrounding the rate of the ESA deficit because it greatly depends on single factors, such as debt assumption and the settlement of the costs of motorway construction. The reaching of the announced 9.4 per cent deficit target also allows the undertaking of single deficit increasing amounts; with the omission of these, the deficit could decrease by 0.4 per cent of GDP.

In addition to the announced measures, the five-year tax decrease programme has been suspended, the effect of which corresponds to nearly 1 per cent of GDP, that is, the continued application of the itemised health contribution and the cancellation of the planned decrease of the social security contribution in 2007 and 2008 adds with such a rate to the improvement of the social security funds' balance. In consideration of these effects, the measures announced so far decrease demand by roughly 4.5 per cent, and the general government borrowing requirement may be reduced to approximately 6-6.5 per cent of GDP. Uncertainty, of course, remains at a high level. Firstly, the amount of VAT and excise tax revenues may change by several tenths of a per cent of GDP, depending on the effect of the falling deficit on consumption, and secondly, a somewhat higher deficit may arise if the wage increase in the public sector in 2007 exceeds the 5.4 per cent rate presumed in the report on inflation. The possible assumption of the debts of MÁV and BKV, and the necessary capital injection for MÁV, constitute an additional major uncertainty factor, arising throughout the whole forecast period. These factors, however,

rather produce an effect on the deficit and debt, and less on inflation and economic growth.

On the basis of currently available information, the 2007 ESA deficit is expected to approximate 4.5-5 per cent of GDP, if the costs of motorway construction are not settled in the ESA deficit.

Table 1 Forecasts related to various deficit categories
(as a percentage of GDP)

	2006	2007	2008
Eredményszemléletű hiány (ESA)	9,0-9,7	4,2-5,4	3,5-4,8
Széles értelemben vett államháztartás finanszírozási igénye	10,1-10,9	5,8-7,0	5,1-6,4
Keresleti hatás	1,1-1,9	(-4,8)-(-3,6)	(-1,1)-0,2

The recently announced measures and determinations drawn from previous measures will cause an additional narrowing of demand in 2008 by over 0.5 per cent. As a result, the general government borrowing requirement could fall below 6 per cent, while the ESA deficit could approximate 4 per cent of GDP. It should again be emphasised that this may only be possible if neither the consolidation of unprofitable state companies, nor the costs of motorway construction are added to the ESA deficit. Only the minimum value of the 2008 deficit forecast is below the likely 3.6 per cent rate of the Maastricht criterion. Thus it is very likely that the announced measures are insufficient for the introduction of the euro in 2010.

With regard to the structure of fiscal adjustment, firstly, it basically ensures the reduction of the deficit on the revenue side, since approximately three-quarters of the announced measures serve the reduction of the deficit through tax and contribution increases, while one-quarter involve cuts in government subsidies and the reform of public administration. Secondly, roughly 70 per cent of the measures reduce household disposable income, while 30 per cent reduce disposable income in the corporate sector.

Effect of the announced fiscal measures on the expected development of the macroeconomic path

Numerous uncertainties arise concerning the assessment of the macroeconomic and inflationary impact of the announced measures. The updating of the detailed and complete macroeconomic forecast will be fully explained in the August report on inflation.

The demand enhancing effect of fiscal policy in this year – without adjustment – would be greater than presumed in the May report. This is predominantly due to certain government investments and other instances of overspending (e.g. in connection with the floods). Thus, this would have improved the picture for growth in 2006. The development of inflation, however, was worse than expected, partly as a result of shocks (e.g. food and oil prices) attributed to exogenous factors by monetary policy, and partly in consequence of core inflation developments. On the whole, the above factors increase the 2006 inflation forecast of the MNB, while their impact on 2007 may be limited.

The announced series of fiscal measures is added to the above assessment of the situation. In economic terms, the measures basically produce an impact through five different channels:

- the direct price increasing effect of regulated prices and indirect tax increases,

- the effect of tax, social security increases and other higher burdens (including the reduced gas price compensation) decreasing the disposable income of households,
- measures directly affecting the commodity market (e.g. freezing of expenditures),
- items affecting the labour market (layoff of approximately 14 thousand workers, deferral of planned reduction of employer's social security contribution) and
- increased taxation of capital.

The largest of the above measures are linked to the first two channels. A number of measures (e.g. tax and employer's social security contribution increase) decrease inflation and GDP through the reduction of aggregate demand, while the cost and price shocks, and the postponement of the reduction of the employer's social security contribution increase inflation and barely affect or reduce (e.g. VAT increase) growth. The increase in corporate taxes also essentially raises inflation and curbs growth. Thus, the full inflationary and real effect predominantly depends on the rate of demand and cost (price) shocks, as well as the structure of adjustment.

Depending on the further gas price increase in 2007, regulated prices significantly increase inflation in 2006 and 2007 (by 2-3.5 per cent in 2007). The VAT increase clearly constitutes an inflationary shock. Presuming that, upon weakening demand caused by fiscal adjustment, producers are able to only partly effect the VAT increase, inflation may rise by roughly 1 percentage point as a result. Although the layoffs in the public sector contribute to a looser labour market, their rate (as far as we know) would lead to lower wage inflation only to a limited degree.

According to our estimates, in 2007 household disposable income will fall as a result of the adjustment by over 5 per cent when compared with our earlier forecast (a 3 per cent fall in real income is expected in comparison to 2006). This will result in reduced household consumption; according to our estimates, the growth rate of consumption will fall by 2-3 percentage points in both 2007 and 2008, in comparison to the previous report. The most important uncertainty factor in the assessment of the development of consumption is determining whether households consider the measures to be of a lasting nature and whether these produce a varying effect on different consumer groups. If they expect the measures to remain in the long term, the consumption smoothing behaviour is less prominent (with a greater fall in consumption). If, however, the measures affect consumers with smaller liquidity constraints (and higher income), there is a greater likelihood of consumption smoothing. The growth rate of consumption will most probably equal 1-2 per cent in 2007 and 0-1 per cent in 2008. Even lower consumption is possible, however, if the income shock is firmly believed to be of a long-term nature. The increase of corporate taxes produces a negative impact on investments, although it is possible that to a limited degree companies will attempt to compensate losses in profit with price increases or lower wages.

The development of inflationary expectations and wage bargaining may significantly modify the above inflationary and macroeconomic effects. Currently there is major uncertainty with regard to the assessment of the above developments, although these factors will determine the level at which inflation will resettle in 2008 (when the direct effects of the single price and VAT shocks will have ceased). A risk arises in relation to the impact of a major fiscal adjustment of a predominantly cost inflationary nature on inflationary expectations. Furthermore, the negative household income shock may also increase nominal wage demands in 2007 and 2008. Two per cent higher nominal wage demands could raise inflation in 2008 to even 4.5 per cent. In this case, the increase in GDP and household consumption would not slow down so much, either.

In relation to effects produced on GDP, our above estimates do not contain so-called non-Keynesian effects reducing the growth sacrifice. In the course of our analyses, we found that the most likely non-Keynesian effects in Hungary may predominantly originate from the investment enhancing effect of a lower interest premium and the expansion of the labour market. We are of the view that the currently known measures may produce investment enhancing effects only to a limited degree, since the increase of corporate taxes attenuates the impact of a possible decrease in the interest premium. Investment prospects are further aggravated by the fact that the measures point in the direction of rising work costs and worsening competitiveness. Considering that the announcements suggest that the downsizing in the public sector will not constitute a major event in relation to labour market trends, the non-Keynesian effects of this should also be limited, due to the expansion of the labour market.

Table 2 Expected macroeconomic and inflationary effects
(annual average rates of growth)

	May Report on Inflation	**"Update"**		**May Report on Inflation**	**"Update"**
Inflation			**Household purchased consumption**		
2005 actual	*3.6*		2005 actual	*1.7**	
2006**	2.1	3.2 – 3.4	2006	3.7	approx. 3
2007**	3.3	6.0 – 7.0	2007	3.4	1.0 – 2.0
2008**	3.2	3.5 – 4.5	2008	3	0.0 – 1.0
GDP growth			**Gross fixed capital formation**		
2005 actual	*4.1**		2005 actual	*6.6**	
2006	4.5	approx. 4.5	2006	6.3	7.3
2007	4.2	2.0 – 3.0	2007	2.8	2.0 – 2.5
2008	3.8	2.5	2008	4.4	approx. 4

** Calculated with a 272 forint/euro rate.

In 2006 the demand effect of general government may exceed the forecast of the recent report on inflation by 0.5-0.8 per cent of GDP, despite the deficit reducing measures, and the general government borrowing requirement may reach 10.8 per cent. Thus, the external borrowing requirement of the country could reach 7-8 per cent of GDP. In 2007 the GDP-proportionate external borrowing requirement of the country will significantly fall as a result of the adjustment; its rate, however, is expected to fall short of the effect of the stringency measure of the government exceeding 4 percentage points. The reduced financing capability of the private sector may in part offset the external balance improving effect of a decreased deficit. Household disposable income will fall by a rate of over 3 per cent of GDP as a result of the announced government measures, while the disposable income of the private sector will decrease by nearly 2 per cent of GDP. As a result of the above effect, the financial savings of the household sector are expected to fall by 1-1.5 per cent, while the borrowing requirement of the private sector will rise by 1 percentage point. The external borrowing requirement of the country may thus decrease by a rate falling short of the effect of the government stringency measures, and may reach 5-6 per cent of GDP in 2007.

Money market developments

In recent weeks the development of the international financial markets was also sharply determined by the rise in inflationary risks and the related central bank reactions. In line with market expectations, the ECB increased the euro base rate by 25 basis points, although communications linked to the measure dampened fears associated with the acceleration of interest rate increases. Thus, the markets returned to a previously assumed path, with a 25 basis point quarterly pricing of the rate until next March. In reaction to the publication of data implying inflationary pressure and the statements of several Fed executives, market participants also priced the American interest rate increase for the end of June and expressed a high probability of further stringency steps. Expectations relating to the peak of the stringency cycle rose to approximate 5.5 per cent, the highest level of the current cycle.

The steps of the emerging markets' central banks also reflected growing inflationary and market risks. The Turkish and South African central banks, strongly affected by the turbulence witnessed on the money markets in the past one and a half months, also implemented interest rate increases at a higher than expected level. Additional stringency measures of numerous central banks were in conformity with the global interest rate increase cycle. The risks continue to point in the direction of a prolonged stringency of monetary conditions.

Equity risk exposure continued to fall on a global level in reaction to rising central bank interest rates and moderately worsening growth prospects. Selling caused major drops in prices on the stock markets of both developed and emerging countries. The fall in exposure did not expand to foreign currencies on emerging markets and bond markets, although capital withdrawal by non-resident participants continued in certain countries linked to greater risks. Investors shifted interest from the equity markets to government securities with lower risks which, combined with growth fears, resulted in a decrease of the long-term euro and dollar yields, marking a reversal of growth witnessed for several months.

Following the May meeting of the Monetary Council, the forint rate fluctuated between 261 and 265 HUF/euro, and the government securities market also remained cautious. Following the budgetary measures and the announcement of the increased deficit target, the exchange rate was devalued to 271 HUF/euro – unprecedented since 2003. Long-term government securities yields increased by 20-30 basis points. After S&P worsened the rating of the Hungarian foreign currency debt, the forint weakened to a 273 HUF/euro rate, followed by a further major 40-50 basis point increase in long-term yields. The long-term forward spread increased to 225 basis points, following its temporary fall below 200 basis points in May. The negative market reactions may be attributed to S&P considering a further downgrading. On the basis of technical factors, there is a greater likelihood of a further devaluation. According to the Reuters survey, however, the longer-term exchange rate expectations of analysts – measured prior to the downward rating – basically remained unchanged, anticipating approximately a 260 HUF/euro average rate up to the end of 2007. The general wave of equity selling also caused a major drop in prices on the Hungarian capital market. Since the end of May, non-residents have reduced their equity stocks by HUF 150 billion. In parallel to the sale of equities, non-residents have also significantly reduced their forint exposure.

In contrast with the uniform short-term interest rate expectations of recent months, in the middle of June some analysts and foreign currency market brokers were forecasting an interest rate increase by the June meeting of the Monetary Council. The majority of analysts predict a rising base rate of an average of 6.5 per cent until the end of the year, followed by

a falling base rate reaching the current level by the end of next year. In contrast with the above, on the basis of the yield curve the market priced a 6.75 per cent two-week interest rate by the end of this year and a 7.25 per cent rate by the end of next year.

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

Following the review of macroeconomic information and the position of the financial market, proposals were made for maintaining the base rate at the current level and for increasing it by 25 and by 50 basis points.

The members agreed that the announced fiscal package of measures bears a significant impact on the general government balance and thereby the external balance. Considering that in recent years the volatility of the Hungarian economy has been associated with the double deficit problem, the expected decrease in the external and internal balance deficit may in itself contribute to a fall in the rate of expected premium and greater room for manoeuvre on the part of monetary policy.

It was also noted that the announced package of measures was unfavourably received by the market, in contrast to its expected impact on balance developments. Long-term government securities yields rose and the forint was devalued. Some argue that the negative market reaction is not essentially attributable to the announced measures but the major adjustment of the 2006 deficit, announced simultaneously, as well as other factors, such as the downward rating of Hungarian government securities. Others believe that the disappointment of investors is linked to the structure of the adjustment package in that the reduction of the deficit primarily relies on tax increases and the increase in other government revenues, and currently contains few elements which point in the direction of transforming the expenditure side of general government. The above development raises doubts as to the long-term sustainability of balance. The tax increases further give rise to a large rate of government income absorption and an increased cost of human labour, worsening the competitiveness of the country and its potential for growth.

The members agreed that the announced adjustment programme produces an effect on inflation through several channels. Monetary policy is faced with a complex situation. The expected fall in demand promotes decreasing inflation, and the increase in the VAT rate and the rise in regulated prices accelerates the above process. Opinions varied as to whether inflation, significantly rising as a result of single factors in 2007, will fall again to approximate the 3 per cent target of the central bank in 2008.

Council members who were in favour of maintaining the level of the interest rate argued that the considerable fall in domestic demand could prevent the spiralling effects of the single cost shocks, therefore inflation will not necessarily rise in 2007 to the high level forecast by the team. The decrease in the number employed in the public sector and the moderated wage policy of the government would offset rising wage inflation, ensuring the avoidance of inflationary effects and promoting the implementation of the 2008 inflation target. We maintain the view that the external and internal balance position of the Hungarian economy is shifting in the direction of sustainability as a result of the already announced measures and planned reforms. This will likely reduce the interest premium expected by investors and establish a favourable environment for reducing inflation. Some members expressed the view that a maintained interest rate level is also warranted by the fact that an interest rate increase would question the credibility of the measures and worsen the assessment of budgetary prospects on the market. In the current volatile position of the

money market it is not clear whether a maintained interest rate level or an increase would be more effective in reassuring investors. An increase in interest rates could even accelerate bond sales and position closing of investors.

In contrast, those arguing in favour of increasing the interest rate emphasised that there is the risk of inflationary expectations freezing at a higher level without the active intervention of monetary policy. Moreover, there is no guarantee that the government measures will reduce risk premium. On the basis of measures announced so far, investors have concluded that the method chosen by the government primarily focuses on revenues and relies heavily on the inflationary effect of the measures. Consequently, for the time being, risk premium expectations have not slumped, and a shift in this regard remains uncertain. If in this position the central bank demonstrates a cautious approach for too long it may lose credibility in the eyes of the market, which it could only regain by a subsequent higher interest rate increase. With a view to anchoring inflationary expectations, monetary policy must, as soon as possible, indicate to economic participants that the Monetary Council continues to make all due efforts in maintaining a predictable, low inflationary environment. An increased interest rate is also warranted by the fact that the reversal of the trend has become quite apparent in the international investor environment. The era of ample global liquidity and high investor risk assumption has most likely come to an end. In reaction to further rising European and American interest rates caused by inflationary risks, investors are reducing their exposure on the more volatile markets, which adversely affects forint investments. An increase of the forint interest rates is also justified by the interest rate increase cycle of countries playing a relevant role in relation to Hungarian markets.

Among those in support of increasing the interest rate, some argued that presently it is sufficient to implement a moderate, 25 basis point increase, allowing the bank to indicate that it is keeping its eye on inflationary risks. Others argued that due to rising yield expectations, the bank could send a clear signal to economic participants by effecting at least a 50 basis point increase of the interest rate.

The Governor then put the three proposals to the vote. Five members voted in favour of maintaining the current interest rate level, 4 members voted for a 25 basis point increase and 4 members for a 50 basis point increase. Since the decision of the Monetary Council requires a corresponding vote of the majority of members in attendance (7 members in this case), a second round of voting was held. In the first round, members voting for a 50 basis point increase (Governor Zsigmond Járai, Deputy Governors Péter Adamecz, Henrik Auth and György Szapáry) supported the 25 basis point increase for the purpose of passing the decision, recording their separate opinions in the minutes. Thus, the Monetary Council decided to increase the central bank base rate to 6.25 per cent.

Votes:

In favour of maintaining the base rate at 6.00%	**5**	Tamás Bánfi, Péter Bihari, Csaba Csáki, Judit Neményi, Gábor Oblath
In favour of increasing the base rate to 6.25%	**8**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Vilmos Bihari, Ilona Hardy, Béla Kádár, György Kopits, György Szapáry

<u>In attendance:</u>

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

The Government was represented by Álmos Kovács, deputy state secretary of the Ministry of Finance.

The Council will hold its next rate-setting meeting on 24 July 2006. The minutes of that meeting will be released at 2 p.m. on 11 August 2006.