MINUTES

OF THE MONETARY COUNCIL MEETING

OF 28 AUGUST 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 July 2006, the consumer price index rose by 0.2 percentage points to 3.0% year on year. Core inflation was 1.9%, increasing by 0.6 percentage points relative to the preceding month. The trend inflation indicators and developments in certain components of the consumption basket both are evidence of the pick-up in inflation. During recent months, there have been strong increases in core inflation, measured on the basis of month-on-month percentage changes, from the stable 2% level in the previous period. This rise in inflation continued in July: the annualised month-on-month rate of core inflation rose near to 7%, which was significantly higher than the price indices observed over a longer period in the past, even taking account of the variability of monthly data.

Looking at the components of core inflation, processed food prices rose the most strongly in July, similarly to the period May-June. Jumps in the prices of unprocessed foods and energy as well as in transport costs in recent months, coupled with a weaker forint exchange rate, explain the rise in processed food prices. Inflation of industrial goods prices also continued to increase, mainly affecting non-durable goods the prices of which tend to be less volatile. So far, the weakening of the exchange rate in June has been only very modestly reflected in prices; however, it may exercise a dominant influence on price changes in the months ahead. The latest price data for market services reinforce the view that the decline in inflation early in the year was only temporary, with the month-on-month indices returning to the 6%–7% level characteristic of 2005.

In the forecast in the August issue of the *Quarterly Report on Inflation*, inflation rises steeply to 8.2% over the period to mid-2007, before falling gradually, although it remains above 4% on average annually in 2008. This higher path relative to the projection in the May *Report* is mainly attributable to the stabilisation measures and trend inflation developments.

The expected rapid rise in consumer prices in the coming months may be linked in part to increases in indirect taxes and administered prices, and in part to recent developments foreshadowing higher inflation. Increases in taxes, affecting mainly the corporate sector, are putting upward pressure on inflation through higher production costs. Over the medium term, the fall in aggregate demand, and particularly in consumption, points to lower inflation. Expectations have remained stuck at higher levels recently, due to the inflation shock, which is seen as an upward risk to inflation further on.

Wage data for H1 suggest that robust earnings growth in the first quarter was followed by a downward correction of wage inflation. The reduction in the rate of wage growth in June continued in July, which is good news for inflation prospects. Irregular pay in the financial sector, which accounts for a relatively low share, was a major factor behind the volatility of wage inflation in recent months; and the contribution to this from increases in nominal wages in other sectors was lower than had been thought.

According to the flash estimate for second-quarter GDP growth, economic activity slowed in the period. After adjusting for the calendar effect, the rate of economic growth, at 3.9%, fell short of expectations and was lower than the corresponding figure for Q1. Available information on the output side suggests that sharply declining construction output and decelerating industrial production growth explained the decline in the rate of growth. On the expenditure side, slowing growth was mainly the result of weak investment activity, and household investment in particular. However, output growth was very lively in June, rendering evaluation of the underlying developments in business activity difficult. In addition to the continued strong rise in exports, domestic sales growth also picked up somewhat in June, thus interrupting the slowdown observed in earlier months. Based on the recent profile of output growth, i.e. a further slowdown in domestic manufacturing sales (manufacturing accounts for the largest share of the domestic market), the high outturn for June appears to be a temporary correction.

The latest retail sales data also increase the likelihood of a slowdown in domestic demand: the volume of retail sales rose by just 3.9% in June relative to the same period of the previous year, after eliminating the calendar effect. The trend data suggest that the deceleration in retail sales growth, which started in 2004, continued in 2006 Q2; and the strong pick-up in Q1 was mainly fuelled by transient factors, such as the VAT cuts and the high rate of wage growth.

According to the preliminary data, the goods deficit was EUR 1,099 million in 2006 H1 and was thus nearly EUR 100 million lower than in 2005 H1. External demand, stimulated by strong international business activity over a prolonged period, and import growth lagging significantly behind export growth in certain months of the year contributed to the rise in net exports.

In the projection in the August *Report*, dwindling domestic demand is the most important contributory factor to the slowdown in economic growth. As an effect of the fiscal measures, household real income is expected to fall in 2007 relative to the stable growth rates of earlier years, which will be reflected in both consumption and capital expenditure. Net exports are likely to contribute significantly to economic growth as a result of exports led by favourable European business activity looking ahead and lower import growth due to subdued domestic demand. Higher net exports and the Government's austerity measures are expected to reduce the current account deficit.

Investors in international financial markets stepped up their exposure to risks. At its rate-setting meeting in August, the FOMC discontinued its tightening cycle of the past two years. Market participants had expected yet another rate increase in July. However, based on data suggesting a gradual slowdown in economic activity and the Fed's communication, they are increasingly confident that the US tightening cycle has now ended. Closely aligned with the cycle coming to an end, long-term dollar yields fell, which had a favourable effect on emerging market assets. After weakening significantly in May-June, currencies of emerging countries were in particularly strong demand, and retraced some of their losses.

On 3 August, the Governing Council of the ECB raised key European interest rates to 3%, which was interpreted by market participants as a sign of faster rate increases in the current tightening cycle. According to expectations – also underpinned by the Council's communication – interest rates may be raised by 25–25 basis points in October and again in December, with the cycle possibly continuing into 2007. Although long-term euro yields fell, similarly to their US counterparts, the differential between ten-year dollar and euro yields sank to a twelve-month low. This may be explained by (i) the narrowing of interest rate differentials, (ii) the re-balancing of global economic activity, as well as by (iii) slowing growth in the US and rising growth in Europe.

In Hungary, the appreciation of the forint continued after the increase in official interest rates in July: associated with a benign external environment, the exchange rate recouped 5% of its losses by mid-August. Virtually every currency of the region appreciated in the period. Despite increased political risks, the Polish zloty and the Slovak koruna strengthened to a three-month high vis-à-vis the euro, with the Czech koruna surging to a historical peak. Although the rate increase by the Hungarian authorities came as a surprise to some participants, the markets' response to the move was favourable. In addition to the appreciation of the forint, long-term government securities yields edged down and the forward premium to the euro fell to 200 basis points. However, long-term expectations regarding interest rate increases barely changed as a consequence of the interest rate move – only the pace of expected rate increases picked up. Non-residents purchased forints in the amount of nearly HUF 130 billion during the three weeks following the MNB's interest rate move, breaking the wave of continuous sales which began in May.

Nonetheless, the strengthening of the exchange rate proved short-lived and once again the forint started to weaken, triggered by rumours (which were later denied) of a downgrade of Hungary's debt and statements by Government officials referring to the abandonment of the target date for adopting the euro. Underlying the country-specific nature of depreciation, movements in the exchange rate broke away from those in other currencies of the region, and the forint dropped to a five-year low against the zloty. It then fell temporarily to EUR/HUF 280.00 in the wake of the release of the draft Convergence Programme. Yields rose. According to the path of forward rates and survey evidence, market participants had long thought that adopting the euro would not be feasible in 2010. Nevertheless, the abandonment of the target date, the absence of a new target date as well as the higher paths for deficit and debt in the Programme came as a negative surprise. According to the Reuters poll of analysts, the expected date of euro adoption was delayed further. The long-term forward margin, also reflecting the credibility of the Convergence Programme, rose to 250 basis points, the highest level in several months. Non-residents' exposure to exchange rate risk quickly fell by HUF 230 billion.

Simultaneously with the weakening of the exchange rate, expectations of interest rate increases intensified. Based on the shape of the current yield curve, the market expects a 7.75% and an 8% base rate at end-2006 and end-2007, respectively. According to the latest surveys of market economists, currency dealers and fund managers, the overwhelming majority of respondents expect the Monetary Council to raise interest rates in August. However, expectations vary between 25 basis points and 50 basis points.

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

The Council discussed the latest issue of the *Quarterly Report on Inflation.* All members present at the meeting agreed that the inflation projection warranted an immediate increase in rates. The only proposition offered to the Council was to raise the base rate by 50 basis points. One argument in favour of a rate increase was that the annual rate of consumer price inflation was now clearly likely to be above target by a significant margin for a protracted period, and therefore it was justified to signal the Council's commitment to price stability through a distinct move. For some members, the recent inflation developments which might also reflect increases in inflation expectations would themselves call for an interest rate increase. The upward effects on inflation of the Government's price and tax measures would prove temporary; however, the Council would strive to rein in second-round inflationary effects.

On one view, the forecast was surrounded by significant risks. Wage inflation put upward pressure on inflation, i.e. wage growth might turn out markedly higher than in the central projection. However, the disinflationary effect of falling demand might prove stronger than expected, as the current measures were not associated with a monetary easing, in contrast with the stabilisation package of 1995. For another member, the risk of a higher wage path outweighed that of the demand effect.

Some members were of the view that conditions had not improved since the 50 basis point rate increase in July. Consequently, there was no room for reducing the speed of tightening. The market's perception of exchange rate risk had deteriorated in August. Foreign investors' reaction to news that the Government no longer committed itself to any target date for adopting the euro was unfavourable. In relation to the size of the interest rate increase, one member argued that the 50 basis point increase did not necessarily mean that monetary conditions were now as tight as they had been at the beginning of the year, as it could well prove insufficient to offset the exchange rate depreciation seen in the recent past.

There was a debate among members over whether the stabilisation measures, recently implemented or planned by the Government, could be expected to reduce perceptions of country risk. Some were of the view that risk perception was likely to improve even over the short term. Others noted that such an improvement had not yet occurred and that Hungary's risk perception was unlikely to improve materially in the absence of further measures. On another view, perceptions of risk would decline, if the budget and current account deficits were to fall in 2007–08 as projected.

Some members pointed out that, in view of the current inflation projection, further interest rate moves would be required in order to deliver price stability over the medium term. Others, while not disputing the need for further tightening, were of the view that it was not useful to undertake a commitment to a tightening cycle, due to the openness of the Hungarian economy and its sensitivity to changes in perceptions of risk. At its policy meetings, the Council must take its decisions by taking account of current developments and with the necessary flexibility.

The Chairman invited members to vote on the proposition that the base rate should be raised to 7.25%. The Council voted unanimously in favour of the proposition.

Votes cast by individual members of the Council

In favour of raising the base rate to 7.25%	**12**	Zsigmond Járai, Péter Adamecz, Henrik Auth, Tamás Bánfi, Vilmos Bihari, Péter Bihari, 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
Vilmos Bihari
Dr Péter Bihari
Dr Ilona Hardy
Dr Béla Kádár
Dr György Kopits
Judit Neményi
Dr Gábor Oblath
Dr György Szapáry

Álmos Kovács, State Secretary of the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 25 September 2006. The minutes of that meeting will be released at 2 p.m. on 13 October 2006.