MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 20 NOVEMBER 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 policy 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 October 2006, the consumer price index rose at an annual rate of 6.3%. Core inflation was up 4% on a year earlier. Consumer prices increased by 0.4 percentage points and core inflation by 0.5 percentage points relative to September. The October data suggest that underlying inflation remained very high: excluding tax effects, the annualised month-on-month rates of core inflation have been in a range between 6%–7% recently. Looking ahead, however, there is no sign of inflation rising further, in contrast with recent months.

In analysing the latest inflation numbers, due consideration must be given to the fact that the VAT increase in September may cause distortions in the price index. First, based on tax changes over the past few years it can be assumed that one month is unlikely to represent a sufficiently long period for a tax increase to feed through to consumer prices in full and that repricing may take several months to be completed. Therefore, the official data may overestimate actual inflation developments for a few months. Secondly, however, the tax increase may have provided a good opportunity for retailers to bring forward price rises planned for the months following September, which had an offsetting effect. As a result of these two factors, the outturn in October may slightly underestimate underlying price developments, i.e. there is a greater likelihood of actual inflation being somewhat higher than suggested by the headline figure.

Looking at the individual components of inflation, the outturns for tradable and processed food prices showed improvements. In both product groups, the monthly rates of price increases slowed to levels last seen in the early summer months, albeit the pace of inflation remained high relative to previous years. By contrast, the annualised month-on-month rates of services price inflation rose further. As for the components excluded from the core measure of inflation, gas prices – a category within administered prices – began to reflect the VAT increase; and annual inflation of vehicle fuel prices did not continue slowing, despite the fall in October, due to the base effect.

The pick-up in consumer price inflation in recent months has probably reflected the feed-through from earlier cost shocks, in addition to administrative factors, but it also appears to have been the consequence of an increase in inflation expectations. In the former case, a one-off inflation shock can be expected, whereas in the latter case, persistent inflationary pressure may be building up. The central inflation projection in the November issue of the *Quarterly Report on Inflation* is based on the assumption of a cost shock; a sustained rise in inflation expectations is only one of several upward risks to inflation. Accordingly, the unfavourable inflation developments of recent months are mainly reflected in the forecast for 2007, and consequently, the central projection has not changed materially relative to August, due to the assumption of a stronger exchange rate and a drop in oil prices. However, the forecast is for core inflation to be higher in 2007 and lower in 2008, compared with the August update, which reflects the temporary nature of the recent acceleration in inflation.

In the central projection, inflation rises further until the end of 2007 Q2. It then starts to edge down; however, it is forecast to remain above the medium-term target over the entire forecast period. Annual average inflation may be around 7% in 2007 and 4% in 2008. Simultaneously with this, core inflation is likely to drift downwards from mid-2007 to the end of the forecast horizon, before falling below 4% in 2008 H2. The balance of risks to inflation in the central projection is broadly symmetrical.

Private sector wages grew by 7.6% in September relative to a year previously. Compared with August data, there was a sharp fall in irregular pay. This reinforces the view that employers brought forward bonus payments in part because of the increases in taxes and contributions in September. However, the bad news was that regular pay growth in the private sector accelerated further, rising to above 9.2% in September. This high figure was closely related to pay rises in services.

According to the provisional estimate, Hungary's GDP grew by 3.7% in Q3 year on year, reflecting a fall in the annual rate of economic growth. Due to methodological reasons, substantial revisions were made to actual data for the previous quarters. This renders evaluation of fresh data more difficult. But despite the uncertainties, the major trend indicators, e.g. seasonally adjusted quarter-on-quarter percentage changes, do not seem to point to a slowdown. Rather, they signal a slight pick-up in growth.

September output data, showing a year-on-year increase of 9.2%, also provide little evidence of a significant slackening in the pace of economic activity. Export growth was down slightly on the month, in line with the expected slowdown in international business activity; however, the growth rate of domestic sales has not yet shown signs of a trend change. Further ahead, the fall in the growth rate of domestic orders is consistent with the expected significant slowdown in demand.

Foreign trade data for September also reflect buoyant economic activity, in line with robust external demand. The trade deficit amounted to EUR 1.6 billion in the first nine months of the year, down 25% on the same period of 2005. It is important to note, however, that this fall in the deficit was mainly attributable to good performance in H1; and data for recent months do not point to a further improvement. According to data for the period up to August, Hungary's terms of trade deteriorated by nearly 2% in the first eight months of 2006, mainly due to higher energy prices.

In the forecast in the November issue of the *Report*, Hungarian economic growth slows down sharply from 4%–5% in previous years, consistent with the August update. The economy is likely to be growing well below its potential level over the next two years: after a period of more than a decade, a negative output gap is expected to arise. In the forecast, economic growth is around 2.5% in 2007 and 2008, and it may be close to potential this year, due to strong performance in H1. The slowdown is expected to start in 2006 H2, with the current business cycle reaching its low point in the middle of next year. However, a vigorous recovery is unlikely in 2008, and consequently, the negative output gap will remain over the longer term.

In international financial markets, investors have maintained their positive mood since the improvement in October. Despite news of weaker-than-expected growth in the United States, markets remain confident that the economy will slow only gradually and that a 'soft landing' will be achieved. Expectations for the future path of dollar interest rates remained unchanged relative to the preceding month: market participants continue to price in a 25 basis point increase by the Fed for mid-2007. Long-term dollar yields fell, and the Dow Jones stock market index surged to an all-time high. The fall in consumer prices was faster than expected, but core inflation remained above the Fed's comfort zone.

The ECB's decision in early November to leave interest rates on hold and the strong statement accompanying it broadly met expectations. The market is confident that the ECB will increase interest rates again in December. Further tightening is expected in the first half of 2007; however, uncertainty remains about its size and timing. The most likely scenario is that the ECB will raise rates by 25 basis points in H1. Although the forecast by the European Commission reflects an upbeat outlook, several investment banks expect European business activity to slow, due in part to a moderation in US economic growth.

Emerging country currencies continued to appreciate. Risk premia barely changed. The political stalemate in the Czech Republic continues to drag on, and could probably be resolved by calling early elections. However, a poll can only be held after three failed attempts at forming a new government. In Poland, the political situation remains uncertain: the government is in constant need of support from non-coalition MPs. Inflation is above target on the forecast horizon, and consequently, interest rates may be raised in coming months. In Slovakia, investor sentiment has improved much over recent months, due to the government taking care to keep the fiscal deficit within the 3% Maastricht reference value. So far, only a fraction of the measures to boost expenditure, promised during the election campaign, have been implemented, which has reassured the markets. The koruna has appreciated to a historical peak recently. Despite the strong exchange rate, however, inflation continues to be above target, and therefore, the National Bank of Slovakia may decide to tighten policy in coming months.

Market sentiment remained firm in Hungary. The central bank, market analysts and the rating agency Fitch alike judged the Government's fiscal consolidation package for next year as realistic, although they maintained the opinion that its structure was unfavourable. This, coupled with the benign international environment, helped to maintain investors' positive mood. However, little improvement is seen in the assessment of Hungary's long-term convergence, which is indicated by the five-year forward premium five years ahead stabilising at a high level recently. After appreciating rapidly in October, the strengthening of the forint slowed. Nevertheless, the currency gained nearly 2% over the period, similarly to the Polish zloty and the Slovak koruna. After short forint positions were closed out in October, non-residents' forint exposure continued to increase, though much more modestly, which was related in part to purchases of forint-denominated assets, and government securities and equities in particular.

The 25 basis point interest rate increase by the MNB in October was not a surprise. However, as an effect of the Bank slowing the current interest rate cycle and the sustained strength of the exchange rate, the market priced out the probability of further rises following the decision. Investors expect the Bank to lower interest rates by 25 basis points next year. The majority of analysts polled by portfolio.hu nevertheless anticipate yet another 25 basis point increase at the Monetary Council's November policy meeting, and moreover, many expect further tightening not only in November, but also at the subsequent meetings. Over the past two months, analysts' expectations for official interest rates at year-end have been slightly above those priced into the yield curve. This is in contrast with previous experience, when their forecasts remained constantly below the interest rate level implied by the yield curve. According to the latest Reuters poll, 14 out of the 23 respondents expect a 25 basis point increase, and 9 expect that policy will remain on hold. The majority of analysts expect the Bank to revise down its inflation projection relative to August: the 9 respondents expect the forecast for 2008 to be lowered to 3.8% on average.

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

Following the discussion of the November issue of the *Report*, propositions to maintain interest rates, as well as to raise them by 25 basis points were put to the Council.

As uncertainty surrounding information currently available was greater than usual, the Council was widely divided over the assessment of future prospects.

Members arguing for maintaining interest rates at their current level thought that inflation in 2008 could be below the central projection, and therefore, it could be close to the 3% target. The arguments they advanced in support of this view were as follows: (i) The disinflationary impact of slower economic growth caused by a contraction in demand could prove stronger than assumed in the central projection. (ii) The estimates in the forecasting models had used a sample period over which real wages had not fallen. In view of the fact that currently real wages were likely to fall significantly, the forecast could underestimate the disinflationary impact. (iii) Policy had been tightened significantly over the recent period, which had not yet had its full effect. Therefore, there was no need of further tightening. (iv) Simultaneously with an improvement in macroeconomic indicators, investor sentiment could strengthen further, and the risk premium could fall in the period ahead. Nor did the global financial environment point to a decline in investors' willingness to bear risk. For this reason, it was more appropriate for the Council to adopt a 'wait-and-see' approach. (v) Less benign wage and inflation data for recent months could be explained mainly by one-off factors. No strong evidence of an increase in inflation expectations was found. Consequently, there might be a case for further tightening, if signs were to become manifest. (vi) Taking this into account, some members thought it was justified to interpret the medium-term target in a way that it also took account of underlying trends in inflation. (vii) Although the projection for average inflation in 2008 was clearly above target, general inflation, and particularly its core measure, was set to fall spectacularly. Inflation expected for end-2008 was close to the 3% target. (viii) Policy tightening might do harm beyond certain limits. High interest rates could encourage borrowing in foreign currency. But a strong exchange rate would reduce borrowers' debt-servicing burdens and, ultimately, policy tightening could weaken the contractionary effect of fiscal measures.

Those members favouring a 25 basis point rate increase all pointed to the risks inherent in inflation expectations. They were of the view that, even if there was no clear-cut evidence that the inflation target could not anchor economic agents' inflation expectations to the extent necessary, there were signs of this happening, particularly as regards the rates of wage growth and inflation for recent months. For them, raising interest rates further was inevitable in order to coordinate expectations and prevent them from rising. One member noted that the path for wages assumed in the inflation projection might even turn out to be overly optimistic, given the likelihood that wage inflation would be higher, driven by expectations.

Members arguing for a rate increase pointed out that financial markets did not yet clearly expect the current tightening cycle to have come to an end. Past interest rate rises had strengthened the Council's commitment to disinflation. In the circumstances, the Council would take material risks with its credibility if it failed to tighten in line with expectations. It was noted that market sentiment for monetary policy was of key importance, because inflation in 2007 would approach the level where it had been at the time of the adoption of the inflation targeting system. If the Bank did not take every effort to ensure that the inflation shock proved temporary, it would cast a shadow over past achievements of policy in bringing down inflation.

After the discussion, the Chairman invited members to vote on the two propositions. Seven members voted to maintain the base rate, and five members voted for a 25 basis point increase. Based on the votes cast, the Council left the base rate unchanged at 8.00%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.00%	**7**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáky, Ilona Hardy, Judit Neményi, Gábor Oblath
In favour of raising the base rate to 8.25%	**5**	Péter Adamecz, Henrik Auth, Zsigmond Járai, Béla Kádár, György Kopits,

The following members of the Council were present at the meeting:

Zsigmond Járai, Chairman	Dr Csaba Csáky
Henrik Auth	Dr Ilona Hardy
Péter Adamecz	Dr Béla Kádár
Dr Tamás Bánfi	Dr György Kopits
Vilmos Bihari	Judit Neményi
Dr Péter Bihari	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 18 December 2006. The minutes of that meeting will be released at 2 p.m. on 12 January 2007.