MINUTES

OF THE MONETARY COUNCIL MEETING

OF 22 JANUARY 2007

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

The outturn for inflation in December 2006 is probably the most important piece of macroeconomic data which has become available since the Monetary Council's latest policy meeting, according to which consumer prices were 6.5% higher than a year earlier. On a seasonally adjusted basis, the annualised month-on-month rate of core inflation, providing a better description of the interaction between supply and demand, rose by 5.7%.

The interpretation of inflation data over the next few months will be made more difficult by uncertainties surrounding methodology, as the accounting treatment adopted by the CSO for rises in administered prices and gas price subsidies may produce noisy data and annual CPI inflation above 9%.

Whole-economy average earnings growth was 6.5% in November 2006 year on year. Private sector wages grew by 8.6% and government sector wages by 3%. Actual data for October-November do not yet provide a clear steer as to whether wage inflation will pick up further in the near future or it will begin to slow, as projected in the November 2006 issue of the *Quarterly Report on Inflation*. The recent high rates of wage growth were posted with conditions on the labour market gradually loosening. This may also suggest that the upward pressure on inflation of the Government's measures aimed at rebalancing the economy may have partly contributed to an increase in inflation expectations.

The latest news on domestic business activity reinforced the view given in the November Report of the widening gap between growth in external and domestic demand. The rise in the volume of output in November continues to suggest that industrial activity has remained firm recently, while export growth has so far been unrelenting, largely due to robust external demand. It seems that the long-awaited decline in domestic industrial production will not occur until later, which may be closely related to the persistence of the current recovery in international economic activity, even surprising other forecasting institutions.

Turning to domestic demand, there has been some news on retail trade where the volume of sales slowed significantly in October relative to the first half of 2006, affecting turnover in both durable and non-durable goods. This moderation in retail sales may be due to the early negative effects on the purchasing power and consumption expenditure of households exerted by the Government's current and prospective measures to redress the balance of the economy, although there is currently some uncertainty as to the size of these effects.

In 2006 Q4, Hungary's external financing requirement calculated from the bottom up was 4.5% of GDP, and around 8% of GDP under the top-down approach. Although this constituted a sharp drop compared with the previous quarter, the improvement was largely attributable to the volatility of transfers between Hungary and the EU. There appears to have been a shift in the pattern of financing towards net inflows of direct investment capital, which may help bolster investor sentiment.

Global risk appetite has stabilised at a high level recently, and the search for higher returns has kept risk premia relatively low. Under these circumstances, future prospects for risk premia are asymmetrical, with very little scope left for a further decline in premia on a broad range of market assets, while investors are taking on more and more risks, thereby adding to the vulnerability of markets. The outlook for the US economy continues to be the most significant source of risk – growing concerns about inflation may again lead to a sudden fall in risk appetite, as happened in May and June last year.

Such risks have increased somewhat over the past month, in response to the release of benign economic data in the United States, further reducing the likelihood of a recession. Consequently, expectations of a reduction in interest rates in the US receded, dollar yields rose and the dollar exchange rate strengthened. The markets revised down their expectations of a reduction in US interest rates priced into yields for this year, from 50 basis points at the end of December to 25 basis points. Though temporarily, the rise in dollar yields dampened demand for higher-risk assets in January.

Investor demand for forint-denominated assets remains strong. This is indicated by the steady rise in non-residents' holdings of Hungarian government securities and by the fact that the forint exchange rate reversed its temporary fall in January more rapidly than other emerging market currencies. Strong global appetite for risk, coupled with high interest rates compared with those in other countries in the region, may buttress demand in the near future. Another factor which may also play a role is the expectations of market participants for an improvement in Hungary's macroeconomic indicators (e.g. the current account balance and the fiscal deficit), which has probably been priced only partially into the long-term premium. But Hungary's favourable regional position does not necessarily mean protection against a swift and sharp reduction in global risk appetite. Currently, the likelihood that an upsurge in volatility will trigger a sell-off in emerging markets in the short term is low; however, it is still a risk for the future.

The expected decline in the forint's short-term interest rate differential to the euro seems to be taking longer, after market participants interpreted President Jean-Claude Trichet's statement in January as suggesting that the ECB's key policy rate would only be raised again in March. Based on the yield curve of the euro, the interest rate increase in March should be the last step in the current tightening cycle, although some analysts have not ruled out yet another rate increase. Expectations of a reduction in interest rates in Hungary also fell as an effect of the temporary exchange rate weakening in January. Market participants have priced in a 7.50% interest rate for the end of the year, which is 25 basis points higher than in the preceding month. Economists polled by Reuters expect the Bank's base rate to be 7.00%–7.25% at year-end; and they expect that rates will be lowered by another 100 basis points in 2008. They and currency dealers alike expect the Council to maintain rates at their January level.

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

Following the discussion of the latest macroeconomic news and financial market developments, the proposals offered to the Council were to maintain interest rates or raise them by 25 basis points.

Members arguing for maintaining rates were of the view that as long as there was no clear-cut evidence of the perceived inflationary risks materialising, the Council should not alter its current 'wait-and-see' approach. Firstly, the latest wage and inflation data did not deviate too much from earlier expectations. Secondly, other factors which suggested some upward pressure on inflation mainly reflected one-off price shocks and, particularly as regards wage data, changes in the regulatory environment. The rise in contribution rates in September and the planned introduction of the solidarity tax in 2007 may have contributed to rapid increases in irregular pay in certain months of the year. And the new regulations on the minimum contribution base may have led to a rise in regular pay in areas with the lowest wage levels. It was also argued that although there was a risk of a sustained rise in inflation expectations, the downward effects of fiscal consolidation on demand might turn out stronger than projected, which, in turn, could keep expectations in check. The fall in oil prices, coupled with exchange rate appreciation partly in response to earlier policy tightening, could help meet the inflation target.

Members preferring a 25 basis point increase in rates judged that the latest macroeconomic data pointed to rising inflation expectations. They saw a few signs of this already happening: (i) the continued rapid increase in services prices within the headline figure for December was highly likely to have been a consequence of increased expectations; (ii) wage inflation was not yet showing signs of slowing, particularly in the services sector, which was of particular importance for future developments in inflation; (iii) there was little sign yet of demand falling back more than anticipated and there was no reason to assume that such a fall in demand would have a greater downward effect on inflation than currently thought. Some members emphasised that it would be appropriate to prevent a further rise in inflation expectations with a well-timed tightening and that the Council should not wait until such an increase in expectations was reflected in a sustained rise in inflation. These members argued that a small increase in rates now would help avoid the need for a potentially larger step later on.

After the discussion, the Chairman invited members to vote on the two propositions. Nine members voted to maintain the base rate and four 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%	**9**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáky, Ilona Hardy, Béla Kádár, György Kopits, Judit Neményi, Gábor Oblath
In favour of raising the base rate to 8.25%	**4**	Péter Adamecz, Henrik Auth, Zsigmond Járai, 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 Csaba Csáky
Dr Ilona Hardy
Dr Béla Kádár
Dr György Kopits
Judit Neményi
Dr Gábor Oblath
Dr György Szapáry

Péter Tabák, Head of Department at the Ministry of Finance, was present as the Government's representative.

The Council will hold its next rate-setting meeting on 26 February 2007. The minutes of that meeting will be released at 2 p.m. on 14 March 2007.