MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 26 MARCH 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 most relevant macroeconomic data released in recent weeks were February inflation and January wage growth. In February, the consumer price index rose by 8.8% and core inflation by 5.8% year on year. The overall CPI was up 1 percentage point on the previous month, mainly due to further rises in administered prices (i.e. for natural gas and pharmaceuticals). The month-on-month rate of core inflation, indicative of underlying inflation developments, remained at around 3% in February, which was lower than last year's level, similarly to the January figure. Probably the most important explanation for movements in core inflation is disinflation of industrial goods prices, reflecting the exchange rate appreciation seen in recent months. The month-on-month rate of services price inflation in February was supportive of the notion that the decline in inflation seen in January could continue: price indices for this group returned to the 6%–7% range characteristic of 2004–2005, following the high outturns in the autumn months of 2006. However, in evaluating the inflation numbers it should be kept in mind that the VAT increase in September may have altered the timing of pricing decisions, and thus the price indices for the past few months may underestimate underlying inflation developments.

Private sector wages rose by 10.4% in January 2007. Although the annual growth rate of wages fell relative to the final month of 2006, there was a sharp rise in regular pay, with growth picking up to 14.7% from 10.4% in December. This rise in regular pay growth was at odds with developments in productivity, particularly as regards market services. The data did little to remove uncertainty about the extent to which distorting factors, arising from the reduced scope for the underground economy, may have been reflected in rising wage inflation.

The second release of GDP data for 2006 Q4 was comparable with the provisional estimate in terms of the rate of economic growth: after adjusting for the calendar effect, Hungary's GDP grew by 3.4% in the final quarter of 2006, taking the annual average growth rate to 4%. The quarterly data for Hungary show a gradual decline, which is in contrast with the robust economic growth registered in the neighbouring countries and across the EU. Based on the latest numbers, the wedge between the rates of domestic demand growth and export growth widened even further within the overall pattern of economic growth.

With regard to domestic growth components, the decline in fixed investment recorded in the previous quarters was not followed by an upward correction towards the end of the year. Accordingly, on the whole, gross fixed capital formation fell in 2006, a development which has not been seen in the past decade. According to the GDP figures, household consumption growth was slow in 2006. Complemented with retail sales and confidence indicators, these data show that, for the most part, the slowdown in consumption can be linked to the second half of last year.

The strong contribution of net exports to growth was, however, good news from the perspective of economic activity. Led by buoyant external business activity, exports rose dynamically in 2006, while imports grew at a slower rate than exports, due to weak domestic demand.

The January data on trade in goods cannot be viewed as an indicator of likely developments for the remainder of this year, due to the seasonal effects arising around the turn of the year. Nevertheless, the trend indicators which also incorporate the January data show little change relative to 2006 H2. According to revised 2006 data, the deficit on goods fell by EUR 1.2 billion relative to 2005, and amounted to EUR 1.7 billion in 2006, excluding the settlement of one-off purchases of military fighter aircraft.

Although investor risk appetite has remained high for a prolonged period now, international financial markets experienced some minor volatility shocks in February and March. Investors briefly reduced their exposures to risks in response to the temporary strengthening of the Japanese yen and then in the face of adverse news on US mortgages with lower-grade credit risk. Withdrawals mainly affected the equity markets, though they also weakened emerging market currencies. Nonetheless, assessments of economic prospects in the major markets were little changed, and consequently, the rise in volatility raised risk premia only marginally. The temporary fall in prices which affected a wide range of investment assets is, however, a sign of increased market uncertainty.

In the Unites States, the Fed maintained its target for the federal funds rate. The tone of the accompanying statement shifted somewhat towards less favourable economic prospects, implying that the Federal Reserve's views, which were more focused on inflation risks, and the market's views, which were more focused on risks to growth, became more aligned. The Fed no longer hinted that US official interest rates would be raised further, which analysts interpreted as a bias towards policy easing. Based on futures prices, the markets see a two-thirds probability of a reduction of rates in August.

In Europe, the tightening cycle continued. The interest rate increase by the ECB in March met market expectations. In its communications, the ECB continues to place greater emphasis on inflation risks. Accordingly, the markets have partly priced in another interest rate hike in June, but views are divided as to how the ECB will act thereafter. The latest set of economic data has reinforced the earlier benign outlook for business activity. The ECB's staff revised up slightly their growth projection for this year and next year, as well as their inflation forecast for next year.

Forint-denominated assets became somewhat less attractive relative to the euro and other currencies of the region, due to the increased market volatility at the end of February. However, in March the exchange rate rose above its trading range from the more recent period: in part, this can be attributed to market rumours that Hungary would soon be abandoning the official intervention band. Some market participants took positions in options, in anticipation of a forint appreciation. Hedging activity by option writers added to the volatility of the exchange rate. Forint appreciation was also fuelled by a shift in the official intervention band of the Slovak koruna announced in mid-March. The koruna's central parity, which has appreciated significantly in recent years and since joining ERM II in November 2005, was shifted upwards by 8.5%. That, in turn, helped other currencies of the region to strengthen. After the announcement, the forint appreciated to levels stronger than EUR/HUF 245.00.

Simultaneously with the exchange rate appreciation, expectations of an interest rate reduction intensified. Based on the shape of the yield curve, the market expects the base rate to be 7.25% at the end of this year and 7% at the end of 2008, which implies a 25 basis point lower level relative to the previous month. Analysts even expect interest rates to fall more rapidly. In the Reuters poll of economists, the consensus forecast is for the base rate to be 7% at end-2007 and 6% in December 2008. According to survey results, both analysts and currency dealers expect the base rate to remain on hold in March; however, forward prices imply that the market has priced in a reduction even over the short term. Government securities yields declined along the entire yield curve, and the long-term forint premium fell. The five-year ahead five-year forward premium eased to levels around 165 basis points, a level where it has not been since September 2005, prior to the Government raising the deficit target and abandoning the 2010 target date for adopting the euro.

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

Following discussion of the latest macroeconomic news and financial market developments, the only proposition offered to the Council was to maintain interest rates.

Several members thought that the risks to inflation had not increased in recent months, and therefore further policy tightening was not needed at the current meeting. Various arguments were advanced to support this view, as follows: (i) According to information currently available, the inflation target could be met in 2008. The higher-than-expected rise in private sector gross wages in January could not be clearly attributed to a pick-up in wage inflation. The sharp rise in wages may have also been caused by declarations of wages becoming more accurate, due to the tightening of tax audits. (ii) Net wage growth was significantly slower than gross wage growth, which, in turn, was expected to dampen domestic demand. Falling demand was likely to prevent an increase in inflation expectations. (iii) On one argument, the current monetary conditions acted to slow output growth over the short term, which might have a stronger-than-expected disinflationary impact.

Several members noted that the yield spread on forint-denominated government bonds had fallen significantly recently. In addition to global and regional influences, this development could also be explained by the fact that investors' perception of the fiscal adjustments had improved. If the fall in spread proved to be sustained, there could be more room for monetary policy manoeuvre.

By contrast, others were of the view that the latest data pointed to an increase in inflation risks. In all probability, higher-than-expected gross wages in the private sector reflected an increase in inflation expectations and contributed to cost-push inflation pressures. The downward effect on inflation of the slowdown in demand was limited, and it could only be felt over a period of time. And consequently, this factor could not offset in full the effects of rising inflation expectations. For this reason, it was warranted to maintain the current tight monetary conditions. To a large extent, the size of the risk premium depended on global willingness to take risk, which was expected to remain volatile in the period ahead, and therefore the recent fall in the risk premium on the forint might not necessarily signal a lasting improvement.

After the discussion, the Chairman invited members to vote on the proposition. With twelve votes in favour of the proposition, the Council voted unanimously to maintain the base rate at 8.00%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.00%	**12**	Péter Adamecz, Henrik Auth, Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáky, Ilona Hardy, Béla Kádár, György Kopits, Judit Neményi, Gábor Oblath, András Simor

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

András Simor, Chairman
Henrik Auth
Péter Adamecz
Dr Tamás Bánfi

Dr Csaba Csáky
Dr Ilona Hardy
Dr Béla Kádár
Dr György Kopits

Péter Bihari	Judit Neményi
Vilmos Bihari	Dr Gábor Oblath

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 23 April 2007. The minutes of that meeting will be released at 2 p.m. on 11 May 2007.