MAGYAR NEMZETI BANK

ABRIDGED MINUTES

OF THE MONETARY COUNCIL MEETING OF 25 JUNE 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. Each month, the agenda of the second meeting includes the potential modification of the central bank base rate. 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 abridged minutes are available on the MNB's website at:
http://english.mnb.hu/engine.aspx?page=mnben_mt_jegyzokonyv

I. Macroeconomic and financial market developments

In May, inflation decelerated to 8.5%, with core inflation amounting to 5.7%. Based on the data of the last few months it can clearly be established that inflation reached its peak in spring, and a decline in inflation has started. It is not only the base effect that plays a role in the deceleration of inflation. May data indicate that, following high values of previous months, trend inflation (i.e. core inflation which excludes the changes in VAT, medical visit fee and excise taxes) gradually returned to the level of 3%, and compared to the preceding months the methodological uncertainty related to seasonality also became lower. May data have confirmed the turn of the trend observed in April (see Chart 1, Annexes). The decline in trend inflation to a level consistent with the target may indicate that households' expectations which increased last year have not diverted inflation in a lasting manner. Although due to the high rate of increase in wages monetary policy has to continue to pay special attention to the developments in the indicators of inflation expectations, the decline in trend inflation has reduced the risks stemming from a potential permanent growth of inflation expectations.

Examining the changes in the prices of individual components suggests that the appreciation of the exchange rate observed in spring and the weak domestic demand have the most significant impact. Unchanged prices of industrial products could be observed in May, although it is somewhat unexpected that no negative price index of consumer durables can be observed, despite a significant strengthening of the exchange rate. There has been no material change in market services inflation in recent months; it continues to fluctuate in the band of 5%–7% (see Chart 2, Annexes). Marked disinflation of processed foods is a favourable development. For the time being there is still high uncertainty what may underlie disinflation and how permanent it can be in the light of the sharp price increases of raw foods observed in the past quarters.

In terms of items beyond core inflation, the new fares of long-distance public transport have already been reflected in the high price index of regulated prices. Unprocessed food inflation has declined due to the base effect, and this year, so far, there are no signs of a price increase exceeding seasonal in this product group. Oil prices – also due to the base effect – have had a disinflationary effect on the price index, despite the price increase in May.

From the aspect of understanding this year's macroeconomic developments, detailed first-quarter GDP data are of special importance. In the first quarter, the rate of (seasonally adjusted) economic growth reached 2.8%, which is somewhat lower than the preliminary flash estimate of the CSO and is approximately 0.6 percentage points below the dynamics of the previous quarter. However, all this is in conformity with the May forecast.

The main processes which determine economic activity remained broadly unchanged in the first three month of the year, although the difference between the dynamics of external and domestic components became somewhat narrower. Due to the robust external demand, net exports have remained a determining source of growth, although import dynamics have also been raised significantly by strong investment activity. Of the domestic components, consumption has to be highlighted, which continues to show a slight (0.6%) increase, despite a very significant fall in real income in the past quarters.

In the period under review, there has been a definite turn in the volume of investment. Following declines in the previous quarters, the corporate sector has shown salient dynamics due to the manufacturing industry. In the mainly export-oriented sectors, growth was increased by a single large investment as well, but dynamics in these sectors are extremely strong even without this item, thus talking about a turn in trend is well-founded.

However, in the sectors driven by domestic demand, dynamics continue to be negative. Therefore, investment by companies producing for the domestic market and by the household sector indicates a decline. As a result of fiscal consolidation, the fall in investment is the strongest in the public sector. In addition, with regard to investment it is important to mention that the negative gross fixed capital formation dynamics shown in the GDP statistics is consistent with the positive investment; the deviation is explained by methodological differences.

Wage dynamics of the competitive sector have been paid special attention in recent months. Although the indicator measured by the CSO continues to show acceleration, according to our estimate correcting the whitening effect – prepared with the method presented in the May *Quarterly Report on Inflation* – the rate of wage increases has stabilised at a level of around 8.5%–9% (see Chart 3), thus it somewhat exceeds the projected path. In manufacturing, higher wage costs continue to be coupled with adequate improvement in productivity. This does not apply to the services sector, where an increase in unit labour costs can be experienced.

The data of the labour force survey (LFS) carried out by the CSO show a decline in the number of employed in the services sector in the first quarter of the year. In the event that the corporate sector reacts to the deterioration of profit with more lay-offs, the direct cost inflation risk of high increase in wages can be lower (see Chart 4, Annexes). This may also be corroborated by the fact that market services inflation is not accelerating, i.e. companies have not chosen the way of adjustment through prices.

Despite the rising yield environment, global investment sentiment has remained broadly favourable. A further improvement of growth prospects of major markets has increased long-term yields significantly, but the inflation outlook has not deteriorated, thus the increase in the risk-free yield has reduced risk appetite only temporarily. Risk premia stabilising at a low level, rapid correction of equity markets following a fall in prices, depreciation of low-interest foreign currencies and a decline in the price of gold all reflect a high risk appetite.

May and June US economic indicators confirmed the improvement of growth prospects observable in recent months, thus investors' fears of a recession practically ceased to exist. As a result, short- and medium-term expectations of a decline in interest rates became priced out, and long-term yields jumped up. The ten-year dollar yield rose by 60 basis points to a five-year peak in a month. The rapid increase in risk-free yield caused a temporary selling wave and volatility of emerging countries' currencies and bonds as well as developed countries' equities. However, there was no significant rise in the risk premia, as the improvement in growth prospects did not entail an increase in inflation fears; the rise in dollar yields was almost completely attributable to the increase in the expected real interest rate. With the change in market participants' world view, the contradiction between the Fed's and market participants' economic expectations, which had existed for nearly a year, became dissolved.

In June, the cycle of rate increasing continued in the euro area; the ECB increased its policy rate to 4%. The statement following the decision underlined inflation risks and the accommodating character of monetary policy. The ECB staff carried out an upward revision of its growth and inflation forecasts for this year. The 2% inflation expected for next year did not change, while the growth rate declined slightly, close to potential. Market participants expect the rate increases to continue on a quarterly basis as observed now and the tightening cycle to end after the further 50 basis point increase priced for this year.

The increase in yields in major markets had an unfavourable effect on the Central European region as well, causing a temporary weakening of exchange rates and an increase in yields. However, the selling pressure did not last long, which is a significant difference compared to last year. Then, in the first part of the year, due to an increase in inflation fears the region's assets depreciated to a more significant extent and for several months as a result of the US long-term yields increasing to the current level. In the region, it was the exchange rate of the forint that fluctuated to the greatest extent, but the zloty and the Slovak koruna also showed a practically similar performance. Despite a 25 basis point interest rate hike by the Czech central bank, the koruna continued to depreciate, drifting away from the region.

In the middle of May, the forint exchange rate broke out of the trading band of HUF/EUR 245–250 typical since mid-March, and depreciated to HUF/EUR 255 in the first part of June. The depreciation took place amidst a continuing decline in foreign investors' forint risk exposure. Non-residents' significant sales of forint entailed a depreciation which was more moderate than the ones experienced earlier, which is attributable partly to the still dynamic demand for forint of domestic households and partly to domestic corporations' postponed sales of foreign exchange. In the middle of June, the forint exchange rate rapidly appreciated to HUF/EUR 250, non-residents stopped selling forints, and the increase in long-term government securities yields at the beginning of June also became mostly corrected. In June, the long-term forward premium ceased to decline after several months; the level of the premium around 140 basis points is still very high in regional comparison.

Despite the fluctuations in the exchange rate*,* interest rate expectations remained broadly unchanged. Based on the yields, the market expects a 100 basis point rate cut by the end of the year and a further 50 basis point cut next year. For the coming three months, markets have priced a 50 basis point rate cut, although analysts are of different opinions regarding the timing of the first rate cut. According to the Reuters survey, most analysts and currency dealers expect the base rate to be kept at the same level in June and to be cut in July or August.

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

Following a discussion of the latest macroeconomic information and financial market developments, proposals were submitted to maintain the base rate or to reduce it by 25 or 50 basis points.

Members arguing for cutting the base rate mainly called the attention to the fact that – in accordance with the main scenario of the *Report* – trend inflation estimated by the MNB reached a turning point, and declined to a level which is in conformity with price stability. The risk of a permanent increase in inflation expectations decreased considerably. Although the officially disclosed annual increase in wages in the competitive sector remains rapid, several members of the Monetary Council expressed their doubts with regard to the usual interpretation of this indicator, and emphasised that the seasonally adjusted wage level of market services, which can be considered critical in terms of the developments in inflation, is not increasing. Others stressed that although the main indicator of nominal wage developments in the competitive sector may indicate a wage inflation pressure, adjusted for the distortion due to changes in regulations and tax audits a turn of the trend can be observed, which points to limited cost inflation pressure.

Another argument for cutting the interest rate was that the developments in the prices of market services had been in line with the trends observed in earlier years, and there were no visible signs of inflationary pressure. In addition, several members also mentioned that, according to the labour force survey, adjustment through lay-offs in the market services sector was stronger than expected, thus the increase in productivity could be higher, while the increase in unit labour costs could be lower than presumed earlier. This projects a decline in cost-side inflationary pressure. Several members pointed out: as a result of the fiscal adjustment, despite a rise in the global interest rate level, the country's risk assessment had been improving for a longer time. In certain council members' opinion, in the light of the latest GDP indicators, the risk of narrowing of the negative output gap and the weakening of the resulting disinflationary effect became lower. Overall, most Monetary Council members shared the view that the favourable developments in inflation, labour market developments indicating decreasing risks of inflation and the decline in the risk premium allow a cautious interest rate cut. However, they emphasised that developments in the interest rate path are influenced by a number of factors which are external from the aspect of monetary policy, thus the present interest rate step does not mean any commitment with regard to future interest rate decisions.

Those Council members who were in favour of maintaining the base rate argued as follows. Based on the latest wage data it is still not clear that the risk of sticking wage inflation became lower. It cannot be excluded that the high rate of wage increase reflects a further 'whitening' of the labour market, but its estimation is not generally known for the public, and the results are surrounded by significant uncertainty. In the event that the decline in labour market activity becomes permanent, it will hold back the inflation reducing effect of lay-offs. Global interest rate trends are also upward.

Following the discussion, the Chairman invited members to vote on the propositions. Two members voted to maintain the base rate, nine members voted for a 25 basis point reduction and one member voted for a 50 basis point reduction of the base rate. Based on the votes cast, the Monetary Council decided to cut the central bank base rate by 25 basis points to 7.75%.

Votes cast by individual members of the Council:

In favour of maintaining the base rate at 8.00%	2	Péter Adamecz, Béla Kádár
In favour of reducing the base rate to 7.75%	9	Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, György Kopits, Judit Neményi, Gábor Oblath, András Simor
In favour of reducing the base rate to 7.50%	1	Tamás Bánfi

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

András Simor, Chairman
Péter Adamecz
Dr. Tamás Bánfi
Péter Bihari
Vilmos Bihari
Dr. Csaba Csáki
Dr. Ilona Hardy
Dr. Béla Kádár
Ferenc Karvalits
Dr. György Kopits
Judit Neményi
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 July 2007. The minutes of that meeting will be released at 2 p.m. on 17 August 2007.

ANNEX

Chart 1: Developments in trend inflation

(seasonally adjusted, annualised one-month core inflation, excluding VAT, excise tax and medical visit fee)

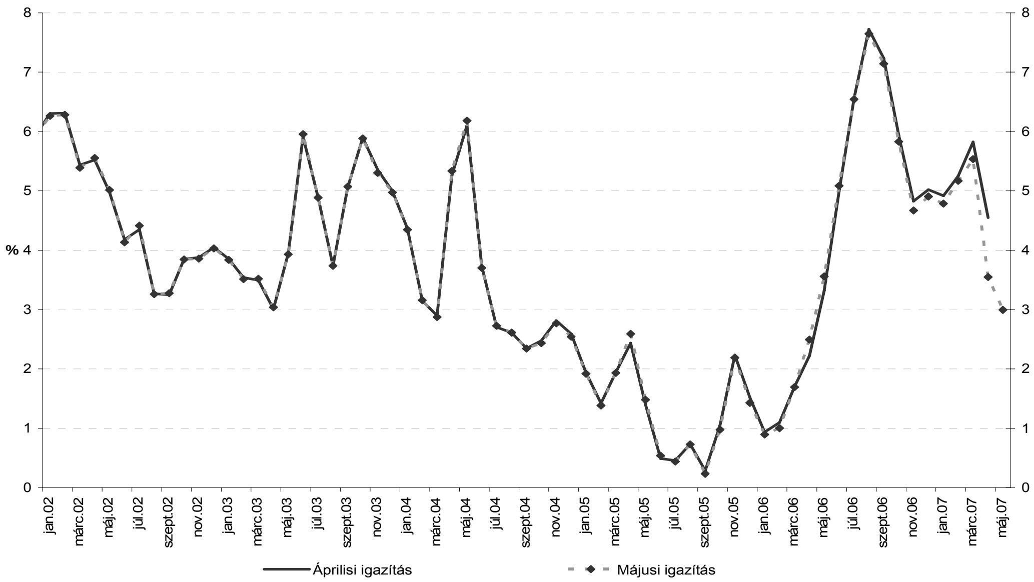
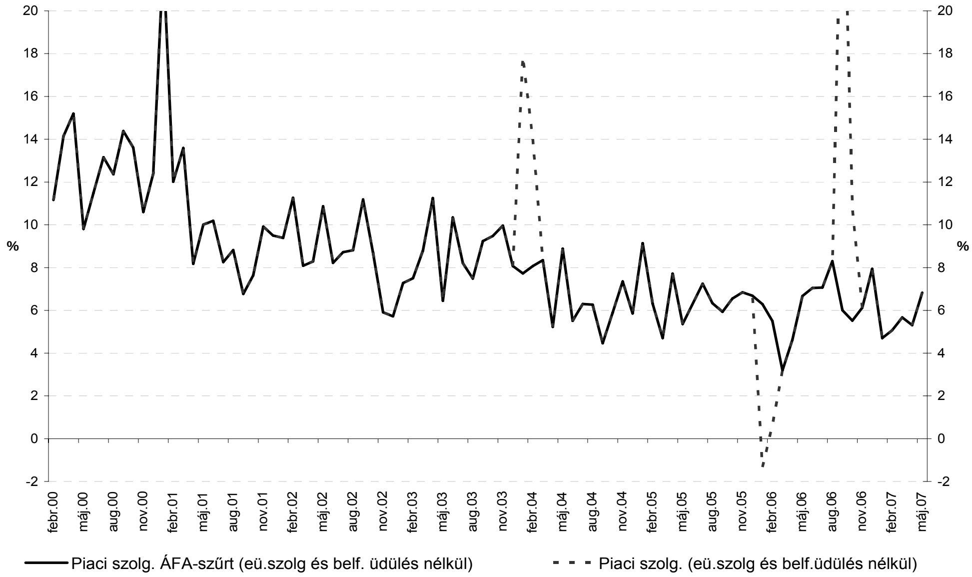


Chart 2: Market services inflation

(annualised month-on-month indices)



ANNEX

Chart 3: Regular wages in the competitive sector

(original and whitening-adjusted time series, seasonally adjusted year-on-year growth, %)

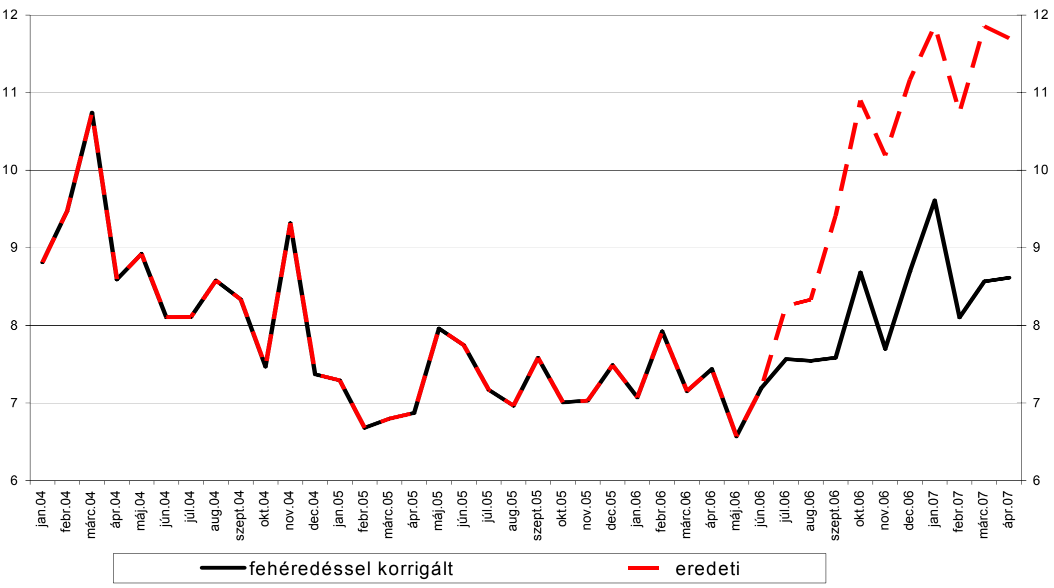
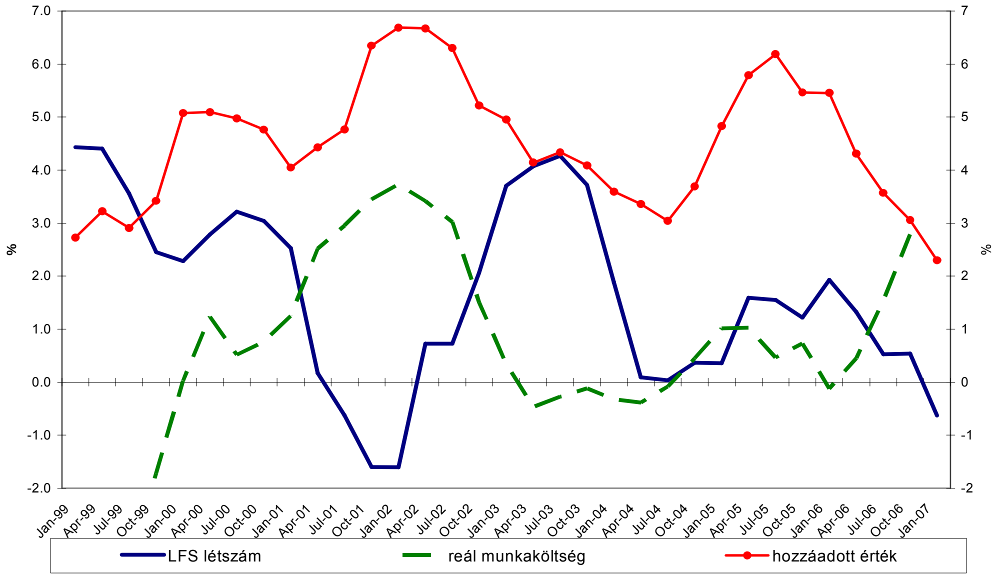


Chart 4: Employment, real labour cost and added value in the market services sector according to labour force survey*

(seasonally adjusted, year-on-year growth, %)



** The real labour cost is adjusted for wage data smoothed by three quarter moving averages and corrected for whitening. The deflator is the consumer price of market services.*