MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 29 OCTOBER 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 annual rate of CPI inflation was 6.4% in September, with the core inflation measure at 4.3%. Although the twelve-month rates eased considerably due to last year's increases in VAT and administered energy prices dropping out of the annual comparison, the month-on-month rates reflected a pick-up in the trend inflation rate. The annualised monthly inflation rate – which is a reliable guide to underlying developments – accelerated to 5% in September, after fluctuating between 3%–4% since May.

Most of this recent pick-up in inflation was clearly related to the historically high rate of increase in food prices. Meanwhile, inflation of the other important components of the CPI, e.g. industrial goods and market services, did not increase. According to estimates, around one-third to one-half of the sharp surge in agricultural producer prices has so far fed into consumer prices. These developments suggest that the overall increase in food prices will be higher than the forecast in the August issue of the *Quarterly Report on Inflation*.

Whole-economy gross average wages grew by 7.8% in August relative to the level a year earlier. After stripping out the base effect from the numbers, the clear downward trend in the longer-term rate of private sector wage growth appears to have stalled in the month.

Data on industrial production and foreign trade, currently the main forces of economic activity, reflect buoyant performance in the export-oriented sectors, consistent with the continued upturn in euro-area industrial activity. Industrial production growth picked up once again, rising to around 10% in August, due to the historically high rates of growth in production for exports. In the short term, this increase in industrial production is expected to be sustained. However, the gradual decline in European business confidence indicators since early summer points to a potential slowdown in external demand over the longer term.

Data released on the domestic components of growth since the Monetary Council's latest interest rate decision do not show a clear shift relative to the Bank's earlier expectations. Some signs of the anticipated slowdown in domestic demand are already apparent in retail trade volumes. The downward trend in retail sales in the past 18 months seems to be flattening out. Nevertheless, the growth rate continues to be clearly negative. The double-digit slump in construction output in August relative to a year earlier continued, which can be explained in large part by the absence of orders from the government sector.

The financial market environment remained supportive, despite the problems arising from the US mortgage market showing virtually no sign of easing over recent months. Demand increased for risky assets which were not affected directly by the turmoil. Currencies and stock market indices of several emerging countries rose to historical highs in early October, and risk premia fell. Nonetheless, confidence in the dollar and euro interbank markets remained fragile. Short-term market rates continued to be considerably higher than central bank rates, and liquidity remained low in the market for short-term bank paper. Although investors' mood appeared to be optimistic, the markets reacted to adverse news very nervously. In major markets implied volatility quotes rose again from mid-October, indicating increasing uncertainty.

The extent to which the decline in the US mortgage market and its spillover effects will influence growth in the US and internationally continues to be a key concern. According to the most likely scenario, growth will slow only moderately, and a recession can be avoided. Apart from the real estate market and the closely related industries, there have not yet been significant signs of a decline in other sectors of the US economy, as is evident in the latest economic and confidence data, as well as in the minutes of the FOMC's September policy meeting and the October Beige Book. The markets, however, judge the downside risks to growth to be significant, given that the crisis in the sub-prime mortgage market has not ended yet. Consequently, in October international institutions and a number of market analysts revised down their forecasts for US economic growth. And the markets have priced in further interest rate cuts – a total of 75 basis points – by the Fed over the next six months.

In October, the European Central Bank held interest rates unchanged, and no reference was made to the accommodative stance of monetary policy. Two factors may have played a role in this: (i) credit spreads rose as a consequence of the market turbulence in the summer; and (ii) monetary conditions tightened despite official rates remaining unchanged, due to the significant appreciation of the euro against the US dollar. However, several statements from the ECB stressed the upside risks to inflation, caused mainly by rises in foods prices (these have a high weight in the consumer basket) and, to a lesser extent, by higher energy prices. Euro-area HICP inflation rose above 2% in September; and it is expected to remain above that level over the coming months. The market revised up slightly its longer-term inflation expectations. The yield curve implies one more increase in euro-area interest rates, but the majority of analysts expect rates to remain unchanged in the short term.

Emerging markets performed well overall, with assets of countries of the CEE region appreciating. But while the currencies of the other Visegrád countries strengthened by 1.5%–3% since the Monetary Council's September meeting, the Hungarian forint moved sideways, fluctuating around EUR/HUF 251. The Council's decision in September to lower interest rates by 25 basis points fully met market expectations, and so it did not cause a shift in asset prices. Non-residents' exposure to exchange rate risks remained broadly unchanged, and their government securities holdings rose slightly. Interest rate expectations, priced into the yield curve, were static at their level in the previous month. The market's expectation is for the base rate to be 7.00%–7.25% at the end of 2007 and 6.50% at the end of 2008. Analysts expect rates to be reduced by a little more. However, they are widely divided over the Council's October policy decision. According to the Reuters poll, a slight majority of economists expect the Monetary Council to maintain the base rate, the minority view being that rates will be reduced by 25 basis points. In the survey carried out by portfolio.hu the percentage of respondents who say that interest rates will remain unchanged is slightly higher. However, the Reuters survey of foreign currency dealers indicates that three-quarters of respondents expect the Council to lower rates by 25 basis points.

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

Council members judged that the picture of domestic macroeconomic conditions had not changed materially since the previous policy meeting and that the 3% inflation target could be met in 2009.

Apart from the effects of food prices, additional inflationary pressure could not be identified in core inflation data relative to the previous period. However, based on the latest projections issued by international organisations, high food prices could persist for some time compared to earlier expectations, which, in turn, could have adverse effects on domestic inflation developments. In its decisions, the Council would pay particular attention to ensure that inflation expectations did not rise above the level consistent with price stability, which would put the achievement of monetary policy objectives at risk.

Successful disinflation also required that the wage agreements for 2008 be aligned with the expected decline in inflation. The expansion of domestic demand and companies' efforts to restore profitability were expected to facilitate the future slowdown in the rate of wage growth.

Following discussion of the latest macroeconomic news and financial market developments, the proposals put to the Council were to maintain the key interest rate, or to reduce it by 25 basis points.

Those members who supported a reduction in interest rates argued that inflation would be around the Bank's target on the time horizon relevant for monetary policy. On another view, the recent rise in food prices would act as a drag on demand for other goods, and the resulting disinflationary effect could help to counterbalance inflationary pressure from agricultural prices. The global investment climate had remained broadly supportive recently. And with the crisis in the US sub-prime mortgage market subsiding, risk premia on forint assets had fallen to their levels in May-June, which would enable the Council to narrow the interest rate differential. Based on the shape of the yield curve, market participants expected the Bank to gradually reduce its policy rate. This was closely related to the significant fiscal adjustment measures aiming at rebalancing the economy and reducing its vulnerability to shocks. Several members noted that, given the expected decline in inflation over the period to 2009, the policy rate could be reduced without causing a decline in real interest rates and an easing in monetary conditions. It was also argued that the expected interest rate cut by the US Fed gave the MNB more room to manoeuvre.

Those Council members who voted for maintaining rates warned of the risks associated with wage adjustment and stressed that, due to the rigidities of the Hungarian labour market, next year's wage developments could not be accurately predicted. Several other members were of the view that the pick-up in inflation of food prices internationally, which was now partly reflected in the September outcome for core inflation, posed an upside risk to inflation. Another risk was that one-off shocks, particularly those affecting core inflation, could feed into expectations. Several members noted that the fall in risk premia on forint assets was smaller compared with other emerging market regions. Although investor sentiment about the Hungarian economy was presumably more pessimistic than warranted by fundamentals, the relative interest rate differential reflected in interbank rates had fallen recently, and sentiment should improve in order to enable the Council to ease monetary policy further. On another view, the robust increase in export orders might point to a slight improvement in the macroeconomic outlook and a faster expansion of demand. Several members emphasised that inflationary risks would be identified with much more precision after publication of the November *Report*.

After the discussion, the Chairman invited members to vote on the propositions. Six members voted to maintain the base rate and six members voted to reduce it by 25 basis points. Under the MNB Act, the Chairman has a casting vote in the event of a tie. Accordingly, the Council left the base rate unchanged at 7.50%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.50%	**6**	Ilona Hardy, Béla Kádár, Ferenc Karvalits, Júlia Király, György Kopits, András Simor
In favour of reducing the base rate to 7.25%	**6**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáki, Judit Neményi, Gábor Oblath

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

András Simor, Chairman

Ferenc Karvalits

Tamás Bánfi
Péter Bihari
Vilmos Bihari
Csaba Csáki
Ilona Hardy
Béla Kádár
Júlia Király
György Kopits
Judit Neményi
Gábor Oblath

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

The Council will hold its next policy meeting on 26 November 2007. The minutes of that meeting will be published at 2 p.m. on 7 December 2007.