MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 21 JANUARY 2008

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 domestic economy

Annual consumer price inflation was 7.5% in December 2007. Core inflation rose by 4.8% in the year to December. Inflation was up on both measures compared with the previous month. Higher inflation towards the end of the year, driven primarily by the recent rises in processed food and vehicle fuel prices, continued to reflect external causes. Annual average consumer price inflation was 8% in 2007. Inflation fell in the period to the middle of 2007, before resuming an upward trend in the final months of the year.

Rising processed food prices continue to be the underlying reason behind the recent increase in the rate of core inflation. However, the December data may mark a turning point in this respect, given the drop in unprocessed food prices in the month; and producer prices in the food industry also fell according to November data. The good news is that the high prices of processed foods and crude oil have not yet fed through to domestic industrial and market services prices.

Retail sales fell by 3.4% in October, and the overall volume of retail sales (i.e. including motor vehicle, components and fuel sales) was down by 1.6% on the same month a year earlier. The most recent available data appear to reinforce the view that retail sales growth may have passed its trough in 2007 Q3 and a tentative recovery is likely to have started around the end of the year. Nevertheless, there has been little or no improvement in household confidence since early 2007.

The annual increase in the volume of industrial production was 5.5% in November. Consequently, measured on the basis of both short and long-run dynamics, the trend indicators point to a further slowdown in the rate of industrial production growth. This loss of momentum in industry is consistent with the easing in the rate of export growth. There was a moderation in November in the growth rates of both goods exports and imports: the trend estimate, produced on the basis of current price and volume data (the October data being the latest available), points to a slowdown in the rate of export growth.

According to the CSO's Labour Force Survey for September–November, the whole-economy unemployment rate was 7.5% (7.7% seasonally adjusted) in the review period. The decline in the number of employees translated into an increase in the number of people unemployed. On the other hand, due to the revision of seasonally adjusted data, activity has now been falling rather than stagnating, the major reason being the decline in the number of people in employment, already noted.

According to data released by the CSO, whole-economy gross average earnings rose by 9.3% in November compared with a year earlier. Within this figure, the rate of private sector earnings growth moderated to 7.6% from 9.0% in the previous month. Similarly to October, in November regular pay growth continued to be higher than total earnings growth. This was closely related to cutbacks in bonuses, which in turn supported the hypothesis of a short-term labour market adjustment through bonus payments.

The recommendations for next year's wages, determined with the participation of the nationwide associations of employers and employees under the auspices of the National Interest Reconciliation Council, envisage a 5.0%–7.5% increase in private sector wages in 2008. Although since the early 2000s none of the actual wage settlements has fallen within the agreed range, there has been a moderation in recent years in the deviation from the mean of the negotiated wage. Based on November data, annual wage growth is expected to slow to 7.7% in 2008 from 8.3% a year earlier. This forecast seems to be sustainable in the light of the Council's recommendation. The introduction of the guaranteed minimum wage for skilled workers and this year's increase in the national minimum wage may pose the risk of higher wage growth. If that were the case, wage growth in 2008 could be even above the 5.0%–7.5% range specified in the agreement. This would affect 27.4% of employees, and require an average 9.7% increase. However, taking into account that the average wages of those affected would rise even if the measures had not been taken, the effect of the minimum wage increase is likely to be much smaller than that.

Financial markets

Conditions in international financial markets remained highly volatile. The repricing of credit risks is expected to continue in the coming months. Flash reports for the final quarter of the year again revealed huge losses incurred by financial institutions affected by the crisis in the US mortgage market. In addition, the latest data suggest that the risk of the US economy moving into recession increased. As an effect, risk appetite fell, with investors reallocating their portfolios from equities and high-yield corporate bonds into lower-risk government securities and commodities. In mid-January, the decline in risk exposure spilled over to emerging markets.

In the United States, worse-than-expected economic data were released, including figures on employment, confidence, retail sales and the housing market. There is still a probability that high oil prices, as well as the decline in stock and housing prices, will hold back growth in household consumption. The Federal Reserve Chairman admitted that downside risks to growth had increased and hinted at further monetary policy easing. Expectations of an interest rate cut have intensified more recently: based on futures quotes, the market is confident that the Fed will reduce rates by 50 basis points at the end of January and has priced in another 75 basis point easing of monetary policy for the period to the middle of the year. The provision of liquidity assistance in a concerted effort by the major central banks, continuing in January, as well as the absence of liquidity problems expected by the end of last year, both acted to reduce pressure in interbank markets, and short-term dollar and euro interest rates fell significantly. However, lending by large US banks to the corporate and household sectors continues to be very subdued, and business in certain securities market segments has not yet returned to normal.

In the euro area, economic activity slowed somewhat towards the end of 2007 compared with the third quarter, and the January confidence indicators deteriorated. The Governing Council of the ECB left key European interest rates unchanged in January; however, the language of its communication accompanying the decision was strong. The statement referred to (i) continued strong short-term upward pressure on inflation and (ii) upside risks to price stability over the medium term. For this reason, the ECB should take pre-emptive actions in order to control second-round inflationary effects. Economic growth may be around the long-term trend, but risks point to slower growth. Despite the strong wording of the statement, the euro market priced out the probability of an interest rate increase; and the yield curve implies a slight reduction in rates over the medium term.

Inflation expected for 2007 as a whole continued to rise in Central Europe. In addition to the food and energy price shock affecting all the countries in the region, higher administered prices in Hungary and the Czech Republic from this year, compounded by the increase in certain taxes in the latter, contributed significantly to inflation rising. Despite the 9% depreciation of the Czech koruna in the past six months and mild statements by the Czech National Bank, markets still expect official interest rates to be raised by 25 basis points on two occasions. As for the National Bank of Poland, which has maintained a tighter policy stance, markets priced in rate increases of 75 basis points in total. Slovakia may have been the least hit by the shock – the market expects the policy rate to remain unchanged over the medium term.

Despite the significant rise in expected inflation, interest rate expectations in Hungary have barely changed in the past two months. The market has priced in official rate increases in a total of 50 basis points for this year. In the latest Reuters poll, respondents' average expectation for the base rate is 6.68%. Their forecast is for the base rate to remain unchanged in January and to fall in March–April.

There was a significant increase in credit risk premia in Central European countries, reflecting continued uncertainty about credit markets. In mid-January, as an effect of the dramatic fall in risk appetite accompanying recent adverse news from the US, Central European currencies weakened. For example, the forint fell to EUR/HUF 255. In contrast, long-term forward premia barely rose, suggesting that asset prices in the region were influenced by external market factors rather than domestic economic fundamentals. In the current uncertain market environment, this may add to the volatility of forint asset prices in the short term.

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

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

Council members agreed that upside risks to inflation had picked up further recently, driven by the acceleration of imported inflation on the back of rises in food and energy prices, as well as the expected increase in administered prices. Several members noted that the effects of the various adverse shocks to consumer prices could reinforce each other. Therefore, a precondition for meeting the 2009 inflation target was that the Bank should stand ready to tighten policy in order to prevent a rise in expectations, if circumstances warranted it.

Members pointed out that the latest data showed inflation rising at a higher-than-expected rate, due to increases in processed food prices. The goods news, however, was that the food price shock had not yet fed through to other product and market services prices. That pointed to the absence of second-round effects. Council members were in agreement that food price inflation could start to fall from 2008 H2; however, the pace of decline would depend strongly on supply-side responses, as well as on whether processed food prices would respond to the expected fall in unprocessed food prices as fast as they had during the time when prices were rising. Members agreed that the increase in administered prices could have an adverse effect on consumer prices, particularly in the current inflation environment. Some members warned that the liberalisation of the energy market would also pose upside risks to the outlook for inflation.

Several members noted that in recent months market analysts had gradually revised up their inflation forecasts for 2009, which could suggest a deterioration in inflation expectations. In contrast, other members emphasised that, ultimately, what mattered for inflation was real economic agents' expectations; and neither the agreement on private sector wages nor actual developments in wages suggested a reduction in the role the central bank target played in guiding expectations.

Members of the Council agreed that news concerning the labour market in the past few weeks had generally been positive for inflation. Based on employment data, labour market conditions had eased. In addition, the corporate sector had adjusted to the adverse domestic economic conditions by cutting back on bonuses. However, there was a division of views on the expected rate of wage growth in 2008. Several members thought that the 5.0%–7.5% range in the agreement reached at the bargaining rounds foreshadowed subdued wage inflation, which in turn could help to meet the inflation target. Others warned that future wage developments were currently surrounded by considerable uncertainty. In this regard, the increase in the skilled workers' minimum wage posed upside risks to inflation. The key question remained whether firms would abide by the agreement and whether the adjustment through bonuses within the year would guide employers in setting regular pay for 2008.

Members judged that domestic economic developments were worse than thought previously, and that the most important components of domestic demand had not yet shown clear signs of a turnaround. In addition, the slowdown in US economic growth could have a negative impact on growth in both Europe and Hungary. This could help to achieve a faster reduction in inflation from the demand side. However, it was also argued that if the contribution of the output gap to disinflation proved weaker than estimated, it could have a partly offsetting effect. Some members noted that international demand for raw materials might fall, due to the slowdown in the global economy, which could help to contain inflationary pressures.

Several members noted that the advanced economies were tested by the most severe capital market turbulence of the past decade, the effects of which had spilled over to emerging markets as well. International investors' willingness to take risks had fallen, as suggested by the depreciation of emerging market currencies and the massive falls in stock prices, in addition to rises in risk premia on sovereign bond issues. Several other members warned that the sustained rise in the risk premium on forint-denominated assets had occurred despite the reduction in the country's vulnerability as an effect of the fiscal adjustment measures. Looking forward, market uncertainty was likely to remain for some time.

After the discussion, the Chairman invited members to vote on the propositions. Ten members voted to maintain the base rate and one member voted for a 25 basis point increase. Accordingly, the Council left the base rate unchanged at 7.5%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.5%	**10**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Béla Kádár, Ferenc Karvalits, Judit Neményi, Gábor Oblath, András Simor
In favour of raising the base rate to 7.75%	**1**	György Kopits

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

András Simor, Chairman
Tamás Bánfi
Péter Bihari
Vilmos Bihari
Csaba Csáki
Ilona Hardy
Béla Kádár
Ferenc Karvalits
György Kopits
Judit Neményi
Gábor Oblath

Dr Katalin Haraszti, Acting Head of Department at the Ministry of Finance, was present as the Government's representative.

The Council will hold its next policy meeting on 25 February 2008. The minutes of that meeting will be published at 2 p.m. on 21 March 2008.