MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 25 FEBRUARY 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

Annual consumer price inflation was 7.1% in January 2008. Core inflation rose by 5.2% in the year to January. Inflation was down on the CPI measure and up on the core measure, compared with the previous month. The latter continued to reflect higher processed food price inflation, with the effects of primary shocks, caused in large part by higher agricultural producer prices, wearing off more slowly than previously expected.

From a macroeconomic perspective, the most important news is that the expected sharp increase in market services prices has not yet occurred – firms have so far chosen not to adjust their prices to take account of rising energy and vehicle fuel prices. And it remains uncertain whether the price increase, which was widely anticipated for January, will take place in the coming months.

Hungary's gross domestic product grew by 0.8% in 2007 Q4 compared with the same period of the previous year and by 0.7% after adjusting for calendar effects. That was down sharply from projected calendar-adjusted growth of 1.2%. GDP growth amounted to 1.3% in 2007 as a whole, also weaker compared with 1.6% envisaged in the November *Report* forecast. Overall, the prospects for economic growth deteriorated somewhat last year.

The latest data on retail sales, industrial production and foreign trade point to a protracted period of economic stagnation. The volume of retail sales fell more sharply in November than in October (by 4.2%; and by 3.3% including motor vehicle, components and fuel sales). There has also recently been a slowdown in industrial production: output in December 2007 was up 5.3% on a year earlier, compared with a growth rate of 8.1% over 2007 as a whole. The pace of foreign trade growth also moderated, with growth in both exports and imports of goods continuing to fall in the final month of 2007.

According to data released by the CSO, gross average earnings in the private sector stood 3.2% higher in December 2007 than a year earlier. After removing the effects of the reduction in the informal sector and the changed seasonal behaviour of bonuses, the outturn for December was slightly lower than assumed in the short-term projections. And the latest available data appear to be consistent with the assumption that firms have been striving to restore profitability by cutting back on bonuses over the short term, the reason being that regular pay growth, at 8.2%, was much higher according to the CSO. Subdued wage growth also supports the view that the inflationary shocks in the recent past have not yet translated into second-round effects.

International conditions continue to be difficult for forint-denominated assets. In addition to losses from the recent turmoil in the US sub-prime mortgage market and its spillover to the global financial system, concerns about a potential slowdown in the world economy have increased recently, and consequently, asset prices have continued to move abruptly. Despite the temporary improvement in sentiment, credit spreads have not fallen materially – in fact they have risen further since the beginning of the year. This is an indication of heightened uncertainty in credit markets.

The majority of data released on the US economy suggested that growth was slowing. Preliminary fourth-quarter GDP growth fell and forward-looking confidence indicators weakened, and there was a further tightening in credit availability. Faced with the risk of recession and market concerns about the possibility of a prolonged decline in equity prices, the Fed reduced interest rates aggressively. It lowered the target for the federal funds rate by 75 basis points at its special meeting in mid-January and by a further 50 basis points at its regular policy meeting at the end of the month. As a result, official interest rates have been cut by a total of 225 basis points since the mortgage market crisis broke out in August 2007. Markets expect the Fed to focus primarily on mitigating the risk of recession in the coming months, and that it will reduce rates by 50 basis points in March and by another 50 basis points over the period to end of the summer. The Fed Chairman has suggested that, as an effect of the interest rate cuts and a fiscal package, growth may start to pick up in the second half of the year. The downward correction in share prices reflects that fears of a recession have receded only temporarily. Among other factors, this picture is corroborated by the price of oil rising to almost USD 100 per barrel.

In the euro area, the latest economic data releases turned out better than expected, but there continued to be a wide gap between the ECB and market participants' assessment of current economic conditions. Although the ECB's earlier strong communication has become more balanced over the recent past due to downside risks to growth, it has nevertheless given little indication of an imminent cut in interest rates. By contrast, financial markets remain concerned about the downside risks and have priced in a cumulative reduction of 75 basis points to the end of the year.

In Central Europe, the central banks of the Czech Republic and Poland have raised policy rates by 25 basis points in recent weeks, in reaction to rising inflationary pressure. This may have contributed to the appreciation of currencies in the region: the Czech koruna and the Slovak koruna both rose to historical highs against the euro in mid-February. By contrast, forint assets weakened considerably. The exchange rate has fallen to EUR/HUF 267, i.e. by nearly 3%, since the Monetary Council's January meeting. Medium and long-term government securities yields have risen by 70–90 basis points. The CDS spread, reflecting the default risk on the Hungarian ten-year dollar-denominated bond, has widened by 40 basis points. These divergent movements compared with other countries in the region show that investors assign forint assets to a higher risk category.

The depreciation of the forint was associated with a continued fall in foreign investors' exposure to exchange rate risk; sales of government paper were strong and those of shares a little more modest in February. Despite the sell-off, foreign investors' holdings of government securities are now HUF 150 billion higher than at the beginning of the year. Foreign institutional investors' falling demand, which is closely related to portfolio restructuring by pension funds, may also have dampened demand for government bonds at the auctions and contributed to a significant rise in yields.

There has been a considerable change in interest rate expectations since the Council's January meeting. Whereas in mid-January the market expected rates to be reduced by 25–50 basis points this year, interest rate increases of a total of 50 basis points have now been priced into yields, simultaneously with the exchange rate weakening. This is consistent with the continued increase in inflation expectations: in the latest Reuters poll, respondents raised their expectation for 2009 annual average inflation to 3.7%. According to the survey, as many analysts expect a 25 basis point interest rate cut in February as the number of those expecting rates to be maintained. Nearly half of respondents, however, expect rates to fall from their current level towards the end of the year, with the other half expecting them to remain unchanged or edge up slightly. Five of the currency dealers polled expect a 25 basis point cut, three expect a 50 basis point increase, and six expect rates to be left unchanged at the February meeting.

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

Before the immediate policy decision, the Monetary Council took a decision on the abandonment of the peg of the forint to the euro and the fluctuation band of the domestic currency. The overwhelming majority of Council members thought that over the long term abandoning the band could help to meet the Bank's policy objectives within the framework of the inflation targeting system. However, several members noted that the task of judging the importance of the decision should be left to economic agents. Consequently, it was perhaps useful to gain experience of how the new regime worked in practice before making an assessment of the effects of abandonment, as the transition to the floating rate regime could cause uncertainties over the short term.

Eleven members supported the abandonment of the peg and one member voted against.

Votes

In favour of abandoning the fluctuation band	**11**	Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Béla Kádár, Ferenc Karvalits, Júlia Király, György Kopits, Judit Neményi, Gábor Oblath, András Simor
In favour of maintaining the fluctuation band	**1**	Tamás Bánfi

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.

Members agreed that the upside risks to inflation had increased significantly in recent months. Due to the rapid rise in imported inflation, driven by increases in food and energy prices, the inflation projection for 2009 could rise above the Bank's 3% target. Members judged that the increase in projected inflation had clearly been caused by reasons outside the sphere of monetary policy. Nevertheless, the Monetary Council stood ready to tighten policy, in order to prevent the recent inflationary shocks from having potential second-round effects which could jeopardise the medium-term outlook for inflation.

Council members agreed that there had been a significant deterioration in the prospects for domestic growth recently. The decline in demand, coupled with the more persistent effect of fiscal adjustment measures than earlier thought, could contribute to the disinflation process continuing. However, there was a division of views about how international financial market trends would influence future developments in Hungarian inflation. Some members emphasised that the majority of international institutions had revised down their growth forecasts for both the United States and Europe, and that the deterioration in economic conditions abroad could amplify the downward effects on inflation of the decline in domestic demand. Other members, however, warned that, due to the slowdown in global growth, central banks' anti-inflation policy might come under more intense pressure, which in turn could lead to higher imported inflation, particularly in the light of the rapid rise in energy and food prices worldwide.

For members it was encouraging that, despite the shocks, second-round effects had not yet been identified. According to the latest wage and employment data, corporate adjustment was stronger than earlier expected. In addition, there had been a fall in services price inflation. But several other members noted that the series of adverse shocks to consumer prices could reinforce each other, and currently the size of second-round effects could not be measured accurately. For this reason, it was possible that at a later date the Bank would have to react to shocks of external origin which by themselves would not require a monetary policy response.

Several members pointed out that, as an effect of the financial market disruption, there had been a sustained fall in international investors' willingness to take risks. Some other members noted that the risk premium for holding forint-denominated assets had risen further at a time when the overwhelming majority of emerging country central banks had raised interest rates, which had led to a narrowing of the relative spread on forint assets.

After the discussion, the Chairman invited members to vote on the propositions. Eight members voted to maintain the base rate and four members voted for a 25 basis point increase.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.5%	**8**	Tamás Bánfi, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Júlia Király, Judit Neményi, Gábor Oblath, András Simor
In favour of raising the base rate to 7.75%	**4**	Péter Bihari, Béla Kádár, Ferenc Karvalits, 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
Júlia Király
Béla Kádár
Ferenc Karvalits
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 31 March 2008. The minutes of that meeting will be published at 2 p.m. on 18 April 2008.