MINUTES

OF THE MONETARY COUNCIL MEETING

OF 31 MARCH 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

The February data did not materially alter the Council's assessment of inflation. Inflation increased by 6.9% on the CPI measure and by 5.3% on the core measure in the year to February. Services price inflation slowed slightly, but remained within the 5%–7% range seen in the past few years. By contrast, inflation of industrial goods prices picked up, explained in part by the recent sharp rise in energy prices, which, in turn, should be reflected in services price inflation in the months ahead. The rate of processed food price inflation fell, but rises in commodity market prices of agricultural products, coupled with higher inflation of industrial goods and unchanged inflation of market services prices, add to the uncertainty surrounding the further reduction in inflation.

The outlook for Hungarian growth has not changed significantly. The volume of retail sales fell by 3.0% in January 2008 compared with a year earlier, and by 2.5% including motor vehicle, components and fuel sales. The January data provide little evidence of a trend reversal. Industrial production was up 6.6% on a year earlier. The slowdown in the rate of industrial production growth continued, with growth remaining below the average of the past five years. The pace of foreign trade growth did not moderate further in the month.

The January outturn for wage growth was higher than expected, but there is still uncertainty about the interpretation of data, due to a number of factors. According to data released by the CSO, gross average earnings were down 1.5% in January 2008 from a year earlier. Private sector earnings grew by 9.7% and government sector earnings fell by 14.6% compared with the same period of 2007. The increases in the guaranteed minimum wage and the national minimum wage may have played a role in the 9.7% annual increase in private sector wages. And the sharp fall in the number of manual workers over the past year has caused an upward distortion in statistics. Significant employment adjustment has been taking place in areas affected by the increase in the minimum wage. Consequently, employment risks may be more pronounced than inflationary risks.

Financial markets

Global risk appetite has fallen further and the prices of risky assets have declined since the Monetary Council's last rate-setting meeting. International banks' liquidity and solvency problems have come to the fore again. For example, the US investment bank Bear Stearns found itself in a difficult financial situation. JPMorgan Chase announced a takeover bid for the ailing bank at a fraction of its share price of a few weeks earlier. The Fed provided active support to the takeover in the form of lending to the bidder. The spread between interbank market US dollar rates and risk-free interest rates once again rose to the peak reached in December, and credit default swap (CDS) spreads on investment banks widened sharply.

The Fed attempted to offset banks' liquidity problems by taking further actions. It launched a set of new facilities, allowing a wider range of participants to access credit at less stringent collateral requirements and at longer maturities. These measures led to a reduction in the probability of bank failures, and, coupled with another rate cut of 75 basis points, helped consolidate market sentiment. In March, a number of large banking institutions released their results for the first quarter, which were better than expected.

There is an increasing consensus that the US economy has already moved into recession. According to the Case-Shiller index, house prices were 12% lower in January than a year earlier – and the Fed expects the house price correction to continue. Meanwhile, banks are tightening their credit standards. The Fed also expects inflationary pressures to ease, due to

the output gap; inflation expectations, however, are rising according to various measures. Many believe that downside risks to the economy are so high that the Fed has set aside its inflation concerns, at least temporarily. Including the decision taken in March, the Fed has eased monetary policy by a cumulative 300 basis points since the financial disruption started. The market has priced in a further 50 basis point reduction over the period to the middle of the year. Meanwhile, the dollar has fallen to a historical low vis-à-vis the euro.

The price of crude oil continued to rise, moving to almost USD 110 per barrel, which was then followed by a downward correction. Based on futures quotes, oil prices are expected to ease further.

In March, the ECB left key European interest rates unchanged. Market participants had expected a shift of emphasis in the bank's communication towards downside risks to growth. But those expectations were not met, with President Trichet continuing to give more weight to inflation risks. The ECB staff revised upwards their inflation projection, while revising downwards their forecast of economic growth. Euro-area economic indicators have since provided a mixed picture, and no new information has been released which would cause a change in the ECB's current stance. The market has priced two interest rate cuts into the government yield curve in the period to the end of the year; however, such a move is expected to occur in the second half according to market commentators.

In Central Europe, currencies proved resilient to the swings in risk appetite. Only the Czech koruna ended the period in negative territory, after the Czech National Bank intervened verbally against the currency on several occasions. The National Bank of Poland raised its key interest rate by 25 basis points to 5.5% at end-February, and then to 5.75% at its meeting a month later, to counter rising inflation pressure caused by increases in administered prices. Fitch upgraded the Czech Republic, explaining its decision by improved fiscal discipline. S&P improved its outlook on Slovakia to positive, saying that Slovakia's EMU entry was increasingly likely.

High-yielding currencies weakened. At 20%, the Icelandic krona depreciated the most. In Iceland, long-term yields rose by more than 140 basis points, simultaneously with the fall in the krona exchange rate, but short-term yields rose only moderately. Consequently, the 125 basis point increase in official interest rates came as a surprise to the market.

Liquidity fell sharply and yields rose in the Hungarian government securities market. In the beginning, primary dealers only refused to quote prices to each other, then they did not meet their commitment to quote bid-offer prices either. Although during that period domestic participants complained that the market dried up, exceptionally large turnover was registered in the Central Clearing House and Depository database. This suggest that there was a significant reallocation among foreign participants. Activity slowly returned to normal, owing to the measures taken by the Government Debt Management Agency and an improvement in international market sentiment, with the spread on government securities falling to 50–100 basis points compared with its level on 27 February. Non-residents were net sellers of government paper during the first days of March. Since then, however, they have reduced the value of their holdings gradually by HUF 90 billion.

In early March, the non-German euro-area government securities market experienced a sell-off and a drying-up similar to those affecting the Hungarian market. The situation was especially difficult in Italy, where a government securities auction was cancelled. Later, liquidity conditions began to improve, but the yield differential between German and non-German government securities remained at a historically high level. In a couple of emerging and regional securities markets, for example in Poland, there were also signs of illiquidity, but conditions were far less turbulent than in the Hungarian market.

The observed rise in government securities yields cannot be linked solely to the increase in

the risk premium. Rather, it resulted from market illiquidity. This view is also supported by the widening in swap spreads. The markets of interest rate swaps and other interest rate derivatives (e.g. FRAs) were not affected by liquidity problems, and therefore, in the current circumstances the yields on these instruments are presumably much closer to the market's expectations than government securities yields.

Term premia have also risen, due to increased interest rate volatility, i.e. market participants have chosen to invest in short-term instruments, lest they incur huge losses on account of potential sharp movements in yields. This may cause an upward bias in both interest rate swap and FRA rates relative to expectations.

The rise in the risk premium also points to a considerable increase in CDS spreads on Hungarian foreign currency-denominated bonds. This spread widened by 90 basis points (the strongest increase compared with other sovereign issuers' CDSs) during the securities market crisis. The Hungarian CDS has risen by a total of 200 basis points since last summer. Currently, the price of default risk of the Hungarian state is at the same level as those of the Baltic states and Bulgaria. Nor has there been any improvement in performance in recent weeks, despite the fact that the government securities market has consolidated somewhat since then. The rise in the Hungarian CDS reflects the deterioration in investor sentiment towards Hungarian assets. Meanwhile, S&P revised down its outlook for Hungarian government debt to negative, explaining the move by heightened political risks and the increased costs of debt financing.

In this situation, it is more difficult to infer investors' expectations regarding the interest rate path from market data than under normal circumstances. Presumably, government securities yields have deviated from interest rate expectations, with FRA quotes and short-term swap rates better reflecting expectations. The money market yield curve, fitted to FRA and swap data, suggests that the market expects interest rates to be raised by 100–125 basis points by mid-summer, and it expects a 50–75 basis point increase at the meeting in March. Forward rates have fallen from their peak reached in early summer.

The interest rate paths, priced into yields, slightly differ from analysts' views. Investment banks commenting on the January wage data believe that the expectations of interest rate increases are exaggerated. Two banks expect rates to be maintained, two expect a 25 basis point increase and three expect rates to be raised by 50 basis points.

The expectations of analysts and foreign currency dealers polled by Reuters for the path of official interest rates are divided. Eighteen respondents expect a 25 basis point increase, seven expect a 50 basis point increase and one expects that rates will be left on hold. Reflecting the degree of uncertainty surrounding the future course of monetary policy, forecasts of interest rates for the end of the year vary in a wide range between 5.75% and 8.5%, around an average of 7.5%. One of the foreign exchange dealers polled expects rates to be maintained, six expect a 25 basis point increase and six expect a 50 basis point increase.

Whereas the market has priced in a 50–75 basis point increase, economists expect a 25–50 basis point increase. Several factors may account for this difference. Analysts provide the most probable outcome in the poll, while pricing the expected values into financial assets. This may also include a scenario of a large increase in rates, i.e. there is an upward skew in the distribution of investors' interest rate expectations. Conceivably, the prices of short-term money market products contain a significant amount of term premium, and this is the reason they deviate from the price consistent with the expected path of interest rates. Finally, it cannot be ruled out either that the bank analysts responding to the survey would like to convince the market about the aptness of the pricing method that they prefer.

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 different amounts. Members agreed that information which had become available in recent weeks did not increase the likelihood of meeting the inflation target. Inflation was likely to be above target this year and the next, which underscored the need for further monetary tightening. Several members argued that monetary policy should take into account the recent rise in risk premia. Members were unanimous that they were ready to take the necessary steps in order to meet the 2009 inflation target.

The Council's collective judgement was that the prospects for growth had not improved materially in recent weeks: economic growth could remain below potential over the period to end-2009; however, the majority of members thought that it would not by itself be sufficient to contain inflationary pressures in the economy. Labour market conditions had eased somewhat, due to the fall in domestic demand, but wage inflation developments continued to be surrounded by a high degree of uncertainty. In this regard, several members noted that, following the reduction in bonus payments last year, there was little sign of the wage adjustment that the Council had earlier expected. That could pose a risk that inflation expectations would rise. Some members, however, argued that domestic firms were adjusting to increased costs predominantly through employment cuts, and therefore, labour costs were unlikely to put significant upward pressure on prices.

Members agreed that the slowdown in disinflation could be explained in large part by cost shocks that were beyond the scope of monetary policy. However, several members stressed that the Bank should react to the persistent rise in domestic energy prices, as higher prices were feeding through to the prices of other products. Several other members warned that the latest shocks could influence a wider range of prices and for a protracted period. Others emphasised that the consumer price index had not yet reflected any second-round effects of the recent cost shocks, and that the future outlook for inflation continued to be surrounded by a large degree of uncertainty. On one argument, due to improved crop yields expected for 2008, the recent fall in some processed food prices might spread to other areas.

Views were divided on investors' current judgement about the Hungarian economy. Several members noted that, due to the poor economic prospects, the country's vulnerability had increased, despite a fall in the external financing requirement. In addition, the rise in household foreign currency indebtedness, coupled with domestic political uncertainties, added to risks. It was argued, however, that foreign investor sentiment was only gradually adjusting to the observed significant improvement in the government budget and external balance over the recent period, which might contribute to a reduction in vulnerability.

The consensus view was that there had been a sustained rise in the required risk premium on forint assets, in which the disturbance in the domestic government securities market may have played a role, in addition to the drop in international investors' willingness to take risks. However, the problems in the domestic government securities market had abated after the portfolio reallocation by pension funds. Hungarian investments had underperformed recently compared with other countries of the region with better economic fundamentals. Some members noted that there was the danger of a sudden deterioration in foreign investor sentiment, due uncertainties in financial markets.

With regard to the size of interest rate adjustment, it was argued that the logic of the inflation targeting regime implied i) the start of a tightening cycle, ii) a sequence of small interest rate increases and iii) explicit communication. However, several members were of the view that, in

the current situation, the upside risks to inflation, combined with the rise in the required premium, made it necessary to take more aggressive monetary policy action.

After the discussion, the Chairman invited members to vote on the propositions. Nine members voted to raise the base rate by 50 basis points, two members preferred a 25 basis point increase and one member voted to maintain the rate at 7.50%.

Votes cast by individual members of the Council

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

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 28 April 2008. The minutes of that meeting will be published at 2 p.m. on 16 May 2008.