MAGYAR NEMZETI BANK

MINUTES OF THE MONETARY COUNCIL MEETING
OF 21 JULY 2008

Date of publication: 2 p.m., 15 August 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 determining the base rate.*

The 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

The domestic economy

In June 2008, annual inflation increased by 6.7% on the CPI measure and by 5.8% on the core measure. The figure for June turned out to be better than expected. The price growth of market services fell slightly, while the slowing inflation of unprocessed foods was offset by the price increase of processed foods, which was higher than expected. Despite the positive outcome in June, the level of inflation for the quarter slightly exceeded the level consistent with the inflation forecast in May.

In contrast with the positive data of April, May 2008 saw a significant drop in foreign trade turnover, which suggests that the growth of foreign trade turnover continues to slow, in line with global trends and the developments of domestic industrial production. According to data released by the CSO, the volume of industrial production grew by 2.2 per cent in May 2008 compared with the previous year. The relatively unfavourable figure for May is consistent with the gradual slowdown observed in global industrial growth. Regarding the prospects of industrial growth, it is expected to continue its gradual decline on a European, regional and domestic level simultaneously.

Due to data error, the CSO adjusted upward the regular pay data calculated in April for companies with over 250 employees, which are less affected by the distortion effects of whitening. According to data released by the CSO, in May 2008 gross average earnings were up 9.6 per cent on the previous year. Compared to the same period of the previous year, private sector and government sector earnings rose by 8.5 per cent and 13.0 per cent respectively. Based on seasonally adjusted monthly data, following a significant spurt in April, the growth of private sector earnings was adjusted downward, primarily for companies with over 250 employees and for the manufacturing sector. Even so, the overall growth rate of earnings continues to be high, with trend dynamics for gross average earnings moving within a range of 9-10 per cent. On the whole, actual data released in recent months for the private sector appear to somewhat exceed central bank projections, and there is still great uncertainty regarding the expected slowdown of wage growth projected for the second half of the year.

Financial market developments

While global market sentiment has shown a marked improvement since mid-March, a turnaround was observed in the risk appetite of investors around the end of May. The former optimistic outlook was shattered by news of further bank write-offs, and, partly triggered by rising energy prices, by the publication of an increasing number of analyses predicting a prolonged period of slow growth and high inflation. At the same time, while declining risk appetite has a tendency to be accompanied by the deterioration of developing market and high interest rate foreign currencies, the developments of recent weeks remarkably point to the contrary. This assumption seems to be corroborated by the increased premia of bank CDSs observed in recent weeks, while sovereign CDS prices of developing markets did not increase significantly.

Even though the growth prospects of large economies have not shown sign of any notable improvement, central banks have primarily focused on inflationary risks. On the other hand, the statements of the FED and the ECB following their interest rate decisions were not as strict as market expectations had predicted, which in both cases resulted in the moderation of interest rate increase expectations, despite the unfavourable growth data.

Notwithstanding gloomy global sentiment, the forint – similarly to other currencies in the region – has appreciated by nearly 4 per cent since the interest rate decision in June, and by a total of 14 per cent since the end of February. Recovering demand for the currencies of developing countries, the positive market reputation of the region and country-specific factors may also have contributed to a stronger exchange rate of the forint. High interest rate yields continue to make investment in forint assets attractive, while taking up speculative positions in foreign currencies is costly. While the fluctuation band used to limit the appreciation of the forint exchange rate, the potential for the sustained strengthening of the forint has become increasingly apparent and realistic for investors in parallel with the appreciation of the forint exchange rate, which is also reflected by the turnaround of analyst expectations (Reuters poll), and the previously uncharacteristic symmetry of exchange rate dispersion derived from option prices. In addition, improving economic fundamentals (government deficit, external balance) and improved central bank credibility have also contributed to the shift in long-term exchange rate expectations.

The forint positions of non-residents rose by HUF 300 billion last month, while their swap portfolio fell by HUF 400 billion, which is indicative of strong forint demand on the part of external investors. On the whole, a significant drop was observed last month on long positions: yields on bonds with maturities of 5 and 10 years declined by 100 basis points and 80 basis points respectively. On the other hand, bond yields still remained 20-30 basis points higher than those preceding the turbulence at the end of February.

The maintenance of the central bank base rate in June, in conjunction with the strong appreciation of the forint have priced out all expectations of an interest rate raise. According to the Reuters poll of economists, respondents unanimously expected rates to be maintained throughout July. Average projections for the end-of-year base rate declined by nearly 50 basis points compared to the poll conducted in the previous month. Expectations regarding average inflation for 2008-2010 showed a moderate decline.

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

Following discussions on the latest macroeconomic developments and the financial situation, members of the Monetary Council agreed that short-term inflation processes were consistent with the earlier expectations of the central bank. However, the sharp increase of global energy prices and the strong appreciation of the forint had an adverse effect on inflation prospects. The combined effect of these factors is hard to predict at present for the time horizon relevant for monetary policy.

The majority of members agreed that the price and wage trends of the previous period had not changed their view of the processes, and noted that prospects regarding their short-term paths were still surrounded by a significant degree of uncertainty. On the other hand, several members stressed that the most recent data appeared to contradict the persistency of certain negative signs observed during the previous month.

Several members judged that rises in oil market prices stemming from fundamental reasons were also aggravated by speculation, and thanks to the adjustment following episodes of overshooting, imported inflationary pressure may begin to subside over the medium term. On the other hand, several members pointed out that despite the external inflation shocks, the MNB cannot disregard the year 2009 while trying to reach its mid-term inflation target.

Members agreed that fundamental factors have largely contributed to the recent appreciation of the forint, including the improvement of the domestic equilibrium since 2006. The risk reputation of Hungary has also improved, and the risk premia of investments have declined. Declining CDS spreads and long-term interest margins appear to corroborate this. Some members added that a further contributing factor may have been the increased confidence in developing countries, which had been observed in the last period despite the capital market problems of developed economies. Some members pointed out that in parallel with the decline of domestic government bond yields, the selling wave in the government securities market had also subsided, and in fact appeared to have turned around. Several members argued, however, that the persistence of the exchange rate appreciation was still uncertain, considering the rapid pace of appreciation. The improvement of the exchange rate of the forint, along with other regional currencies, took place in a climate of deteriorating global investment, and such an investment climate had not been characteristic in the past.

According to the members' opinion, the prospective rate of growth of the Hungarian economy continues to slightly lag behind its potential. Some Council members thought that in parallel with the appreciation of the real exchange rate, economic prospects had further deteriorated in the previous period due to decreased export demand and increased import competition, which may lead to higher unemployment. Members agreed that forecasts regarding household consumption were hard to formulate, as household income and savings trends were surrounded by a high degree of uncertainty. It is possible that any material growth of the disposable income of households will take place at a slower pace than the official earnings figure.

Members of the Monetary Council agreed that the increases of the central bank base rate in recent months and the substantial tightening of monetary conditions should help in meeting the inflation target. Some members deemed that the abolition of the exchange rate fluctuation band has also contributed to the improved prospects, because a former technical limitation on the manoeuvring space of monetary policy has been successfully eliminated. Some members thought that the effect of monetary tightening would materialise rather slowly in the pricing behaviour of companies, therefore the key issue in the assessment of inflation prospects was the question of how permanent is the tightening of monetary conditions. The Council maintained its view that it should continue to pursue a tight monetary policy and was ready to take the necessary steps if the inflation target were jeopardised.

After the discussion, the Vice Chairman of the Monetary Council invited members to vote on the propositions. 10 members voted to maintain the base rate, and one member voted for a 25 basis point decrease.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.50%	**10**	Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Béla Kádár, Ferenc Karvalits, Júlia Király, György Kopits, Judit Neményi, Gábor Oblath
In favour of decreasing the base rate to 8.25%	**1**	Tamás Bánfi

<u>The following members of the Council were present at the meeting:</u>

Tamás Bánfi
Péter Bihari
Vilmos Bihari
Csaba Csáki
Ilona Hardy
Béla Kádár
Ferenc Karvalits
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 25 August 2008. The minutes of that meeting will be published at 2 p.m. on 19 September 2008.