MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 25 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 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

According to the CSO's preliminary release, Hungary's gross domestic product grew by 2.2% (by 2.1% after adjusting for calendar effects) in 2008 Q2 compared with the same period of the previous year. Based on the longer-run trend, the recovery which started in mid-2007 continued in 2008, and even picked up more pace, according to revised data for the first two quarters. Presumably, however, this year's economic recovery has also been underpinned by significant, though transient, factors and, consequently, the rapid recovery is unlikely to continue over the longer term.

Hungarian industrial production and foreign trade slowed considerably in May–June 2008, mainly reflecting the sharp slowdown in the global economy in the second half of the year. Seasonally adjusted industrial production fell by 3.2% in 2008 Q2 compared with the previous quarter. The slowdown in industrial production growth in recent months has affected a wide range of industries rather than just one single sector. On the forecast horizon of the *Quarterly Report on Inflation*, euro area business activity is seen to slow, directly influencing Hungarian economic activity.

In July 2008, annual inflation increased by 6.7% on the CPI measure and by 6.0% on the core measure. Compared with June, consumer prices remained unchanged and core inflation rose by 0.2 percentage points. The July outturn was slightly above the level expected by the Bank, essentially due to movements in food prices: in the past five months food price inflation has not fallen materially. Tradables prices have had a downward effect on inflation, with food and service price inflation having an upward effect. Service price inflation rose higher, breaking out of the 5%–7% range seen in the past few years, which may be a sign of inflation persistence.

Private sector gross average earnings grew by 9.7% in June 2008 compared with a year earlier, according to the seasonally adjusted monthly data released by the CSO. Government sector earnings rose by 12.7% and private sector earnings by 8.7% over twelve months. Annual rates of gross average earnings growth in the private sector have been fluctuating between 8%–9% in recent months, associated with a sharp correction in the numbers employed in June. Sustained strong wage growth adds to the risk of a slower-than-expected fall in inflation in the period ahead.

Financial markets

Since the MNB's interest rate decision in July, the world's major central banks have shifted their focus to the deteriorating growth outlook. The sharp fall in the price of oil, despite the risks associated with oil extraction (e.g. hurricanes, geopolitical tensions in Georgia), may have played a role in this, which, in turn, has contributed significantly to an improvement in the outlook for inflation. Yields declined sharply in both the USA and the euro area in response to falling inflation expectations, although the fall in euro area yields was much more pronounced than in US yields (the 2–5 year euro yield has fallen by some 70 basis points in the past month).

The US dollar has appreciated strongly vis-à-vis the euro in recent weeks, with some analysts suggesting that this may signal a reversal of the multi-year appreciation trend of the single European currency. An argument in support of prolonged euro weakness is that, while the US economy is expected to recover slowly and the market is anticipating an interest rate increase by the Fed by end of the year or early next year, slow growth is likely to continue in the euro area, coupled with a fall in official interest rates. If the USD appreciation is sustained, there is a risk that emerging countries' carry currencies may also weaken. As carry positions are often funded with dollars, there is a risk that the reversal of the US dollar/euro exchange rate trend may trigger a rise in the risk premia required on currencies, for example, the Hungarian forint.

The recent shift from upside risks to inflation towards concerns about growth has not only characterised the major central banks' monetary policies and communications. For example, the Czech National Bank referred to the excessive appreciation of the koruna on several occasions, before finally reducing its policy rate by 25 basis points. And the Governor of the National Bank of Poland intervened verbally in support of a weaker zloty. In Hungary, expectations of an interest rate reduction have intensified, due to worse-than-expected industrial production data and the downward effect on inflation of falling oil prices. Currently, forward rates are consistent with a 25 basis point lower policy rate by the end of the year. Analysts polled by Reuters unanimously expect the Monetary Council to leave interest rates on hold at its next policy meeting. The average of forecasts for the base rate at the end of the year is 8.25%. Long-term bond yields have fallen by 20–30 basis points in the last month. This, however, has been less than the falls in yields in the euro area, and the Czech and Polish markets. Foreign currency bond spreads have also increased, although less strongly than spreads on forint-denominated bonds. At five years, the CDS spread rose by 10 basis points. Swap spreads continue to fluctuate around 50 basis points, suggesting that the functioning of the bond market has not yet returned to normal. Non-residents' holdings of Hungarian government bonds have not changed significantly since the last policy decision.

The policy actions by CEE central banks have weakened the currencies in the region, as a result of which the forint has also depreciated. The downward shift in the expected path of interest rates has played a major role in the forint's weakness, in addition to regional factors and negative international sentiment. In addition, technical factors may also been behind the fall in the exchange rate, as the appreciation of the forint in recent months has been virtually uninterrupted. The rise in non-residents' forint positions, observed earlier, did not continue in the last month, as non-residents reduced their total exposure by more than HUF 300 billion since the last interest rate decision.

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, members of the Council agreed that the projection in the August issue of the *Quarterly Report on Inflation* had not changed significantly compared with the May *Report*, and concurred that inflation might ease back close to the 3% target in 2010 at the earliest.

In the members' judgement, prospects for growth had remained unfavourable recently and, looking forward, there were few signs of a turnaround. Looking ahead, a pick-up in external demand was unlikely to be a driver of economic recovery over the medium term, due to the deterioration in the outlook for business activity in Europe and at the international level. The domestic macroeconomic environment, however, continued to be supportive of the disinflation process.

Members agreed that upside risks to inflation had diminished as a result of the reversal in commodity prices and, consequently, the risks to the inflation projection were more symmetrically distributed. Some members noted, however, that the projection could shift strongly upwards or downwards in the coming months, due to the high volatility of commodity prices. Several other members pointed out that services price inflation and wage inflation continued to exceed the level consistent with the inflation target, suggesting that inflation expectations remained elevated. On another view, however, the high degree of uncertainty surrounding wage data did not permit solid conclusions to be drawn regarding the future course of inflation expectations. In addition, the rate of wage growth in manufacturing was more moderate than in the services sector.

For members it was goods news that yields on forint-denominated assets had fallen recently. However, several members noted that CDS spreads continued to be higher than in other countries of the region; and the uninterrupted rise in spreads suggested that the risk premium on forint assets had not fallen.

Several members noted that there may have been structural breaks in economic time series recently, which made it more difficult to analyse the prospects for inflation based on past data. In this regard, some members pointed to the budgetary adjustments, the improvement in the country's external financing position and the effects of changes in the monetary policy regime. Others stressed that the Council should be prepared for negative surprises, as in the current global environment central banks were facing more difficulties in their efforts to reign in inflation.

The majority of Council members judged that, due to the uncertainty surrounding commodity prices which had a strong impact on the outlook for inflation, monetary policy should take a wait-and-see stance, leaving open the possibility of changing interest rates either up or down. Several members emphasised that reducing inflation persistence was the most important challenge for Hungarian monetary policy. Since 2001, inflation had fallen to close to 3%, the Bank's target, only once, at the time of Hungary's joining the EU, when cheap goods imports contributed to the disinflation process. Consequently, meeting the inflation target required a tighter policy stance than in previous years. On another view, however, the current tight monetary conditions might lead to a further deterioration in net exports and a slowdown in economic activity.

After the discussion, the Chairman invited members to vote on the propositions. Eleven members voted to maintain the base rate at 8.50% and one member voted for a 25 basis point reduction.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 8.50%	**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 reducing the base rate to 8.25%	**1**	Tamás Bánfi

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
Júlia Király
György Kopits
Judit Neményi
Gábor Oblath

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

The Council will hold its next policy meeting on 29 September 2008. The minutes of that meeting will be published at 2 p.m. on 10 October 2008.