MINUTES

OF THE MONETARY COUNCIL MEETING

OF 29 SEPTEMBER 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

In August 2008, annual inflation increased by 6.5% on the CPI measure and 5.8% on the core measure. Compared with July, consumer prices and core inflation both fell by 0.2 percentage points. The month-on-month annualised rate of inflation was 3.5%, down approximately 1.5 percentage points from the previous month. Tradables prices continued to fall on a month-on-month basis in August, which was attributable to the strength of the forint against the euro. The August outturn for inflation was broadly in line with the staff's expectations, both in aggregate terms and with regard to the majority of the individual components. Service price inflation was slightly lower and food price inflation slightly higher than had been expected.

According to the CSO's release, Hungary's gross domestic product grew by 2.0% in 2008 Q2, marginally lower than the preliminary estimate. GDP growth, adjusted for calendar effects, was also revised down to 2.0%. The detailed data provide evidence that, after the unwinding of the primary effects of measures to restore fiscal balance, the Hungarian economy has continued to grow at a subdued pace recently. Although the trend indicators paint a better picture compared with the previous year in terms of the quarterly and annual growth rates, these figures mainly reflect temporary effects. On the production side, the outstanding harvest results in agriculture and the correction in government sector output following last year's retrenchment deserve special mention. On the expenditure side, the contribution of government and private sector consumption as well as inventories (and statistical measurement error) to growth picked up compared with previous quarters. However, the macroeconomic environment shaping the longer-term growth path of the Hungarian economy has grown more unfavourable, due in part to the deterioration in the outlook for global business activity and in part to factors which have been retarding the potential growth of the domestic economy for some years now, such as low investment spending and weak employment.

According to the CSO's release, the number of people in employment continued to fall, although at a more moderate pace, in both the total economy and the private sector in 2008 Q2. This was consistent with the projection in the August issue of the *Quarterly Report on Inflation*. Data published by the Public Employment Service show that the number of vacancies continued to rise. Owing to this and the slight increase in unemployment, labour market tightness eased further.

By contrast, private sector earnings do not suggest an easing in labour market tightness. Although the rate of gross average earnings growth fell slightly in July, a more mixed picture emerges when the trend is analysed by sector. There was a strong moderation in the rate of earnings growth in market services, largely due to the one-off effect of lower-than-usual bonus payments in the financial sector. In manufacturing, the decline in wage inflation over the past few months did not continue in the reference period. This may be explained by the rise in the annual index of regular pay. However, the same indicator, excluding the financial service sector, stagnated at a high level.

Financial markets

There has been a new bout of financial turbulence in the wake of the sub-prime mortgage crisis in recent weeks. Several US financial institutions found themselves in a near-bankruptcy situation, which led to a sharp rise in risk premia and a steep decline in share prices. Despite the Fed's measures to provide liquidity, yields in the US dollar interbank market rose above the key policy rate, reflecting a lack of confidence. Meanwhile, yields on short-term

government securities, as safe-have investment assets, sank to close to zero, which resulted in an unprecedented widening in the interest rate differential. These events prompted the major central banks to take a number of liquidity-providing measures. At its scheduled policy meeting, the Fed left the target for the federal funds rate unchanged, but the market was expecting this outcome. The financial rescue plan worth USD 700 billion, agreed jointly by the US government and the Fed, brought about a positive turnaround. The package, however, is still subject to approval by the US Congress.

The decline in risk appetite led to depreciation for emerging country currencies and rises in yields. Then, following the announcement of the US package of measures, markets recouped some of their earlier losses. Since the Council's interest rate decision in August the forint has weakened by 2%–3% in total. Although this was higher than the losses sustained by other currencies in the region (e.g. the koruna and the zloty), high-yield currencies, such as the Icelandic krona, the Brazilian real, the South African rand and the Turkish lira, posted greater losses than the forint in the second half of the month. The weakening of the forint was not significant compared with the magnitude of global financial market turbulence. In the Reuters poll of economists, respondents' forecasts of the forint exchange rate have not changed significantly since the latest survey: expectations are for the exchange rate to be EUR/HUF 241 at the end of this year and EUR/HUF 242 at the end of 2009.

Non-residents' cumulative forint foreign currency position fell significantly in September, with a sharp increase in their outstanding swap contracts. This implies that they are financing their rising bond holdings through swap agreements, without taking forint exposure. The build-up of swap contracts, outpacing the increase in total bond holdings, associated with a fall in spot positions, suggests that non-residents are reducing their exposures arising from holding assets and/or are taking synthetic short forint positions. Implied volatilities derived from option prices rose in September, indicating increasingly uncertain market expectations.

Hungarian five-year CDS prices rose from a level of around 120 basis points, which was characteristic of the period between mid-July and the end of August, to 223 basis points in September, in line with the sharp rises in CDS prices for other sovereigns and banks. Compared with other sovereign CDS prices, this represented a relative deterioration, as Hungary shifted more towards higher-risk countries.

Bond yields also rose significantly in response to the recent global events, followed by a slight correction. Interest rate swap rates rose less sharply; however, the swap spread did not widen as much as it did in March, and market participants did not report a deterioration in bond market liquidity similar to what was seen in the spring. In September, non-residents' holdings of government securities rose by a total of HUF 350 billion; these holdings only fell by HUF 40 billion during the week of market turmoil.

The path of short-term yields was comparable to movements at the longer end of the curve. On certain days during the global turbulence, the market priced out the expected interest rate cuts, only to price in a 25 basis point reduction again for early 2009. Analysts polled by Reuters unanimously expect the Monetary Council to leave interest rates on hold at its next policy meeting. Forecasts for the base rate at the end of the year range between 7.75% and 8.50%, with the average at 8.33%.

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, based on data received over the past month, inflation

developments were in line with the projection in the August 2008 issue of the *Quarterly Report on Inflation*. The outlook for inflation had improved and the probability that the 3% inflation target could be met had increased, due to the lower commodity prices and deterioration in external business conditions. Nonetheless, the uncertainty in the international money and capital markets made it necessary to maintain a cautious wait-and-see approach to policy.

Members' judged that the prospects for growth had not improved materially compared with previous months and that the domestic macroeconomic environment was basically supportive of disinflation. Several members noted that there had been further deceleration in global economic activity and, therefore, external demand was unlikely to contribute to a pick-up in domestic economic growth. It was also noted that, based on the latest data on retail trade and imports, domestic demand remained subdued and that household consumption and investment spending would need more time to recover than previously thought. Some members judged that, as an effect of the international money and capital market crisis, the funding costs of the domestic banking sector were expected to increase, which, in turn, was likely to lead to further deterioration in macroeconomic prospects.

Members agreed that the outlook for inflation had improved in recent months, due to a reversal of the rise in commodity prices. Nevertheless, several members noted that, with the increased volatility of commodity prices, it had become increasingly difficult to identify trends and forecast inflation.

In the members' view, the high degree of uncertainty in wage data made it difficult to draw conclusions about inflation expectations. It was also argued that the recent rise in expectations could not be detected in the services price index excluding the effect of rises in energy and food prices, while the fall in the number of people in employment dampened demand-pull inflation pressures stemming from high wage growth. For some members, reducing inflation persistence was the greatest challenge to Hungarian monetary policy, and this would require a gradual reduction in wage inflation. Others emphasised that, despite the fall in numbers employed, there had been no easing in the labour market. Nor had the rate of wage growth moderated, as there was an oversupply of unskilled compared with skilled labour in the market.

Members stressed that uncertainty had increased recently in the money and capital markets. Some members were of the view that fluctuations were becoming increasingly wider during financial disruptions, the speed with which their effects appeared was faster and they occurred more frequently. Although Hungary was no longer among the most vulnerable countries, forint investments were not the safest assets for investors and, therefore, a potential worsening of financial disruptions might have a more pronounced effect on the prices of forint assets compared with other countries of the region. Several members noted that the uncertainty surrounding domestic politics and parliamentary support for next year's Budget Act could exacerbate those concerns in the near future.

Most of members thought that, due to the uncertainty in relation to commodity prices and the global financial environment, monetary policy should adopt a wait-and-see approach, preserving room to change interest rates either up or down. However, several members emphasised that, with a high probability, the recent improvement in the outlook for inflation would make it possible to ease policy, after the international financial environment had stabilised. One member thought that the fall in the number of employees, coupled with a deterioration in the trade balance, warranted an immediate interest rate cut.

After the discussion, the Chairman invited members to vote on the propositions. Ten 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%	**10**	Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, 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:

Tamás Bánfi
Péter Bihari
Vilmos Bihari
Csaba Csáki
Ilona Hardy
Ferenc Karvalits
Júlia Király
György Kopits
Judit Neményi
Gábor Oblath
András Simor

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 20 October 2008. The minutes of that meeting will be published at 2 p.m. on 14 November 2008.