MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 NOVEMBER 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 October 2008, annual inflation increased by 5.1% on the CPI measure and by 4.6% on the core measure. Compared with September, the consumer price index fell by 0.6 percentage points and core inflation by 0.5 percentage points. The low outturn for inflation in September was accounted for in part by one-off factors; however, no outliers were identified in October. The trend inflation indicator remained below 3% for the second consecutive month in October, reflecting the persistent decline in inflation. Looking at the components of inflation, the annual index of market services prices dropped further compared with September. Tradables price inflation rose on a month-on-month basis. Overall, the outturn for October was consistent with the sharp downward path presented in the projection, which suggested below-target inflation on the horizon relevant for monetary policy.

Seasonally adjusted gross average earnings rose by 8.4% in the whole economy and by 9.0% in the private sector in September 2008 compared with a year earlier. There were marked declines in average earnings in manufacturing and market services, which, however, were significant only in relation to the salient outturn for the second quarter. Regular pay in manufacturing trended lower gradually throughout 2008, but stagnated above 9.0% in market services. On balance, although nominal wage growth has been moderating, wage dynamics continues to be inconsistent with price stability, taking into account the slowdown in productivity growth.

According to Labour Force Survey data released by the CSO, the whole-economy seasonally adjusted employment rate was 7.8% in 2008 Q3, remaining flat at the level of the previous quarter. However, employment rose by 0.4 percentage points, probably affecting jobs in central or local government. Looking ahead, the current adverse economic conditions may lead to a sharp reduction in employment and a significant moderation in wage growth.

In the CSO's preliminary release, Hungary's gross domestic product grew by 0.8% in 2008 Q3 compared with the same period of the previous year (by 0.7% adjusted for calendar effects), indicating that the slow pick-up in GDP growth observed in the previous period was reversed. This adverse development is explained by the sharp, larger-than-expected slowdown in global economic activity, to which the Hungarian export sector responded more sensitively than its regional competitors. In addition to weaker export markets, the expected moderation in lending activity is likely to negatively affect Hungary's short-term growth prospects. Taking all these factors into account, the economy is expected to suffer a temporary downturn in 2009.

Financial markets

According to the latest risk indicators, international investor sentiment has deteriorated since the Monetary Council's extraordinary interest rate decision on 22 October. The mood was slightly optimistic on the markets in the first week of the month, which was reflected in a strengthening in emerging market currencies and developments in spreads. Major central banks introduced new facilities aimed to enhance liquidity and governments passed stabilisation measures, which played a significant role in this regard. But from the end of October, fears of recession, confirmed by negative economic data and confidence indices, both overseas and in Europe, began to dominate.

All of the largest central banks moved to reduce their key policy rates. Since the latest concerted cuts in interest rates, the Fed and the ECB have both reduced interest rates by 50 basis points, in line with market expectations. At its special meetings, the Swiss National Bank first reduced the key policy rate by 50 basis points and then by a further 100 basis points. The Bank of England cut rates by 150 basis points, exceeding market expectations, and the Bank of Japan lowered official rates by 20 basis points to 30 basis points. Several other central banks also eased monetary policy – interest rates were raised only in Iceland (by 100 basis points), Serbia (by 200 basis points) and Russia (by 100 basis points). Markets expect major central banks to continue easing policy: the Fed is expected to cut rates by another 50 basis points at its meeting on 16 December; and, in the euro area, a decline in official interest rates to 2% is implied by forward rates.

There has been a significant moderation in short-term US dollar and euro interbank rates, due mainly to actual and expected official interest rate cuts and signs of improvement in conditions in the dollar interbank market. As a consequence, interbank rates moved somewhat nearer to government securities yields of equivalent maturity.

Movements in the forint exchange rate were broadly in line with changes in global market sentiment. The currency briefly appreciated following the extraordinary interest rate decision, moving to EUR/HUF 270, but on the same day it then returned to the level prevailing prior to the interest rate increase. It strengthened considerably in the following week, reaching EUR/HUF 255, due to a temporary improvement in global market sentiment and the announcement of the loan facility granted jointly by the IMF and the ECB, which involved a much higher amount than earlier expected. Thereafter, however, the forint depreciated in parallel with other emerging market currencies, falling to levels around the current EUR/HUF 270 exchange rate. The average of forecasts of the exchange rate for the end of the year, provided by 17 respondents to the Reuters poll, is EUR/HUF 263 (interest rates are expected to remain on hold over the period) and EUR/HUF 256 for the end of 2009. Both forecasts are HUF 8 lower compared with the outcome of the survey conducted in the previous month.

Non-residents' forint exposure has fallen by a total of HUF 220 billion since the interest rate increase on 22 October. And although there was a brief reversal during the week following the policy decision, forint exposure subsequently continued to fall.

Conditions in the Hungarian bond market have not improved in the past month. Three-month discount treasury bill yields rose by 100 basis points after the interest rate increase at the Monetary Council's special meeting, and have recently risen by another 100 basis points. At the middle of the curve, yields are broadly static at the levels seen prior to the policy decision, with the 10-year yield lower by 60 basis points. Between the peak on 27 October (the Monday following the interest rate increase) and the turnaround on 5 November, yields fell by 180 basis points at the middle and at the far end of the curve, simultaneously with the improvement in global sentiment, probably reflecting the positive impact of the loan facility. Bid-ask spreads as well as asset swap spreads fell during the period; however, 5-year yields have since risen by 150 basis points and 10-year yields by 90 basis points. Average daily turnover in the secondary market fell off sharply in November, due to a decreasing number of deals rather than a change in the average size of transactions. So far, the MNB has purchased Hungarian government debt securities worth HUF 200 billion in nominal value terms. Non-residents' holdings of government paper have fallen by some HUF 300 billion since the latest interest rate decision.

The distribution of liquidity in the interbank money market continued to be uneven, as reflected by the simultaneous use of the MNB's two-way facilities. Transactions with the MNB continue to account for a declining share of turnover in the domestic FX swap market. Forint rates implied by euro-forint and US dollar-forint FX swaps moved significantly nearer to the key policy rate compared with the end of the previous month.

FRA rates are consistent with a 20 basis point decline in the key interest rate compared with the current rate level in the first three months of 2009, and imply a further 20 basis point fall every month thereafter. The overwhelming majority of economists polled by Reuters expect official interest rates to remain on hold at the Monetary Council's scheduled policy meetings next Monday and in December, with only one of them expecting a 100 basis point reduction each at the forthcoming two meetings. Forecasts for the base rate at the end of 2009 lie between 7% and 10%, with the average of expectations at 8.26%. Reflecting the easing inflation expectations, the forecasts are for inflation to be 3.44% on average in 2009 and 2.85% in 2010, down 37 basis points and 8 basis points, respectively, from the results of the survey conducted in the previous month.

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 outlook for inflation had improved recently, due to the worsening prospects for economic activity both at home and abroad and the downward correction in commodity prices. Consequently, the inflation target seemed likely to be met over the medium term. With the agreement concluded with the International Monetary Fund, Hungary's financing difficulties had been eased, but further consolidation required the efficient functioning of markets to be restored and stability risks to be materially reduced.

Members agreed that due to slackening domestic and external demand as well as the fall in commodity prices, inflation might fall significantly below target in 2010. On one argument, however, disinflation might prove even more pronounced than the pessimistic projection in the latest issue of the *Quarterly Report on Inflation*.

Risk premia on forint-denominated assets had increased, due to the global credit market crisis and the dramatic decline in investors' willingness to take risk. Market sentiment had improved slightly following the announcement of the international financial support package. Later, however, with the change in international sentiment, CDS premia on Hungary's debt had risen again slightly. Several Council members noted that, counter to the trend characterising Europe, Hungarian long-term government securities yields had continued to rise since the end of October, and secondary market turnover had remained modest.

Members were in agreement that the MNB's actions had helped to restore confidence in the domestic financial markets, but that more time was needed for the market infrastructure to return to normal functioning and to mitigate risks to financial stability. The reduction in the reserve ratio, effective from the December maintenance period, might contribute to reducing financial market disruption, through alleviating banks' funding problems. Some members warned that dislocation in the government securities market and the interbank money market continued to pose a risk to stability. On another view, in the absence of external funding sources, reducing the country's financing problems required that households' net savings increase. IMF funds were needed primarily to help confidence to return over the short term and to restore the state's ability to meet its cash flow needs. However, the financing needs of domestic sectors should be satisfied from other sources.

Members agreed that the Bank should adopt a very cautious approach to setting interest rates. However, with the easing in global financial turbulence and the conclusion of the agreement with the IMF, the Bank should have more scope to reduce interest rates. While the inflation target could be met even with a significant easing in monetary conditions, postponing a decision to reduce rates would lead to inflation expectations becoming stuck at a high level, which, in turn, would trigger a sharp decline in the credit market and exacerbate the economic recession. It was also argued that in the current circumstances the importance of the exchange rate channel in monetary policy decisions fell, while that of the interest rate and lending channels increased. Some members warned that high borrowing rates could increase adverse selection and moral hazard, and could ultimately lead to a deterioration in banks' credit portfolio quality. Several other members noted that the extraordinary 300 basis point increase in interest rates in October had been made necessary only temporarily by the rise in the risk premium and the need to rein in the unfounded speculative attack against the forint. The decision to raise interest rates had helped to improve market sentiment and restore investor confidence. However, the views on future interest rate policy actions were divided. Several members stressed that the Bank would have to ease policy to reverse the extraordinary interest rate increase more rapidly than had been the case with previous extraordinary rate increases, as a means to avoid the adverse effects on the real economy of the October policy decision. Others, however, warned that Hungary might face financial stability risks if the base rate was reduced too fast, which, in turn, might also add to real economic costs.

After the discussion, the Chairman invited members to vote on the propositions. Eight members voted to reduce the base rate by 50 basis points, two members voted for a 100 basis point reduction and one member voted to maintain the existing base rate.

Votes cast by individual members of the Council

In favour of reducing the base rate to 11.00%	**8**	Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, György Kopits, Judit Neményi, Gábor Oblath, András Simor
In favour of reducing the base rate to 10.50%	**2**	Tamás Bánfi, Vilmos Bihari
In favour of maintaining the base rate at 11.50%	**1**	Péter Bihari

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 22 December 2008. The minutes of that meeting will be published at 2 p.m. on 9 January 2009.