MAGYAR NEMZETI BANK

MINUTES OF THE MONETARY COUNCIL MEETING OF 22 DECEMBER 2008

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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_statisztikai_idosorok

1. I. Macroeconomic and financial market developments

The domestic economy

In November 2008, the consumer price index was 4.2% and core inflation was 4.1%, respectively down by 0.9% and 0.5% on the previous month. Changes in the three main items of core inflation were consistent with those observed in October; the decline in the level of inflation observed in November is predominantly attributed to products not forming part of core inflation (vehicle fuel prices, unprocessed food prices). As was the case in October, month-on-month core inflation stayed at around 2 per cent. On the whole, inflation continues to decline significantly, and may in fact be lower next year than indicated by the latest inflation projection.

According to data released by the CSO, in October 2008 year-on-year gross average earnings in the national economy, public sector and private sector increased by 8.5%, 10.2% and 8.0% respectively. In the private sector the gradual decline of regular wages since the beginning of the year continued; in October it was mainly attributed to decreasing regular wages in the area of market services. However, this decline is no longer considered significant for the indices calculated from gross average earnings. The spectacularly high wage increase observed in October in the public finances sector was presumably triggered by temporary factors. The information received is broadly consistent with the wage projections presented in the November issue of the Report on Inflation.

According to detailed data released by the CSO, Hungary's year-on-year gross domestic product grew by 0.8 per cent in the third quarter of 2008, which is consistent with the figure presented in the previous data release (adjusted for calendar effects, the growth amounted to 0.7 per cent). All trend indicators clearly suggest that the slow recovery experienced by the Hungarian economy in the first half of the year has come to a halt. National economy investments continued to decelerate in the third quarter of 2008. The decline indicated by industrial production, manufacturing and sales data is broadly observed across the sub-sectors as well. Changes in the foreign trade data of the commodity market indicate a similar trend to industrial data. In the third quarter of 2008 a significant deceleration was observed in export and import dynamics. In an international comparison the performance of the Hungarian economy continues to be extremely restrained.

Financial markets

Global investment appetite improved slightly during the last month: security markets managed to generate a slight growth of a few percentages; implied stock market volatility significantly decreased, while risk indicators also declined moderately. At the same time, market sentiment is extremely fragile; even minor bits of negative information may lead to substantial exchange rate shocks. The somewhat more optimistic mood is primarily due to the announcement of various economic recovery programs launched by individual governments. Analysts estimate the additional demand effect of government programs announced thus far as 1.5 per cent of the total world production; and they expect further growth. Nevertheless, developments in global economic processes do not justify increased investor appetite; fears of recession continue to mount as analysts predict a rapid deterioration of the situation on the basis of released macro data and confidence indices. At the same time, the process of global disinflation accelerated, and developed countries continued to face growing concerns of disinflation.

Mounting fears of recession and faster disinflation resulted in further interest rate cuts. Among developed countries, the local central bank decided to cut the base rate by 100 basis points in the United Kingdom, 75 basis points in the United States and the euro area and 50 basis points in Switzerland. These cuts drove the base rate down to 2 per cent in the United Kingdom and 2.5 per cent in Europe, while the central bank target interest rate band shrank to 0-0.25 per cent in the United States and 0-1 per cent in Switzerland. As for emerging countries, the base rate was lowered in Poland, Slovakia, the Czech Republic, South Africa and Turkey by 25, 75, 50, 50 and 125 basis points respectively. At the same time, in an attempt to slow down the deterioration of the rouble, the Russian central bank increased its key policy rate by 100 basis points. Markets expect further interest rate cuts wherever it is still possible: according to market expectations, a rate cut in the order of 25-50 basis points is imminent following the next session of the ECB; based on current quotes the euro area base rate will hit a record low of 1.5 – 1.75 per cent at the beginning of next summer.

Following the peaks in October, tensions started to subside in developed interbank markets, which was reflected in both the short-term interest rates of the euro and the dollar and the narrowing of the TED spread, i.e. the difference between the yields on interbank money market and government securities of equal maturities. At the same time, the involvement of central banks decreased rather slowly; due to the reliance on central bank funds, the liquidity of interbank markets still significantly lags behind the levels observed before September. Another sign of low risk appetite is the fact that the yields on short-term American government papers dropped to a record low of 0 per cent in the course of last month.

Last month the forint proved to be one of the best performing emerging currencies: while it fluctuated within a relatively narrow band against the euro, it appreciated by more than 8 per cent against the zloty, and around 4 per cent against the Czech crown. Based on a Reuters survey, the short-term exchange rate expectations of analysts did not change significantly: the consensus regarding the forint - 262 forints as of the end of January - is essentially the same as the value projected last month. However, a steeper decline is expected for the exchange rate at the end of 2009; the analyst consensus predicted a level of 264, up by 8 forints from the value mentioned above. On the other hand, the larger part of the increase may be attributed to composition effects.

The domestic government securities market improved significantly last month. The volume offered at discount Treasury bond auctions was sold with significant overquotes and an increasing decline in yields. In fact, yields declined substantially in the secondary government securities market as well. The short end and the middle section of the curve dropped by nearly 300 basis points and around 350 basis points respectively, while 10-year and 15-year yields fell by 150 basis points. The yield decline was attributed to several factors: on the one hand, the unexpected interest rate decisions dampened investors' short-term interest expectations, and on the other hand, the existing single-sided selling pressure was significantly alleviated by the reduction of papers issued by the ÁKK. As a result of the yield decline, the spread between government paper and interest swap yields shrank to a fraction of the levels observed in October. Currently the spread is around 60-80 basis points across the 5-year maturity, and has a negative value for assets across the 3-month and 1-year maturity. At the same time, liquidity is still low in the domestic secondary market; market turnover fell significantly below the levels observed before September, and the difference between the buying and selling rates is extremely high. The role of non-residents in the market processes of the last period was negligible; the deterioration of their government paper portfolio practically came to a halt.

Changes in the yields of Hungarian foreign exchange bonds were much less spectacular. The 5-year euro bond yield currently stands at around 8.5 per cent, down by 150 basis points compared to the peaks observed at the end of October. Spreads on German bonds declined by only 100 basis points during the period.

Expectations regarding the future path of the central bank base rate have changed rather spectacularly compared to the previous month. According to the analyst survey conducted by Reuters, while the rate level expected by analysts for the end of 2008 remained unchanged at 11.5 per cent before the rate decision in November, the new survey suggests that since then, the analyst consensus has dropped to 10 per cent. This suggests that the majority of the twenty analysts interviewed expect a cut of 50 basis points, four analysts forecast a 100-basis point cut, and one analyst each projects a 25-basis point cut and maintenance of the current level. Similar shifts are predicted for the end of 2009: average analyst estimates forecast a decline by 110 basis points to 7.13 per cent. In the December forecast projections varied between 6 and 9 per cent.

A similar path is suggested by forward interest rate quotes: for the next six months the market expects a rate cut by 50 basis points each month, while for the rest of the year quotes project smaller cuts amounting to a total of 50 basis points.

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

Members of the Monetary Council agreed that no new information had become available since the extraordinary interest rate decision in December which would suggest that real economy and inflation prospects had significantly changed; according to forecasts, the inflation target could be achieved over the medium term even if monetary conditions were loosened.

According to the Monetary Council's opinion, monetary policy decisions should focus on the risks to financial stability and inflation perspectives in the current situation, and should strive to maintain the sustainability of external financing. In this respect, several members stressed the need for further economic policy actions to alleviate the fall in corporate borrowing. Some Council members thought that eliminating the moral risks in bank lending was increasingly difficult under the current interest rate conditions.

On the subject of inflation prospects, several members pointed out that weak demand led to disinflation in the service sector, which was clearly reflected by the factors determining the developments of wages.

Members of the Council agreed that extraordinary central bank operations contributed to the stabilisation of money market and capital market conditions, however, it would require a longer period of time to normalise market operations. The risk reputation of Hungary remained largely unchanged. Several members emphasised that the publication of portfolio shifts and flash reports in the first month of the year could change market sentiment – both negatively and positively – in a short period of time. Members of the Council thought that declining yields in the government securities market and the halting of the deterioration of non-resident investments were positive developments; however, they stressed that over the medium term, non-resident investor activity and a resumed growth of government security investments would be required to restore healthy operations in the government securities market. Some members believed that even though foreign exchange liquidity tensions had abated, the interbank market situation had not yet returned back to normal.

Members agreed that in order to ensure long-term financing across the economy, the central bank base rate had to approach a sustainable, lower level. Several members argued that changes in the conditions requiring the extraordinary interest rate increase demanded that tight monetary conditions be moderated as soon as possible. By contrast, others stressed that monetary policy steps should be taken gradually; prevailing market sentiment should be taken into account when potential interest rate cuts were considered and it was crucial to avoid frequent changes in direction in the interest rate policy. Some members thought that the reduction of interest rates in an unfavourable global money market environment required the improvement of the net lending/borrowing position of households and the reduction of the external financing requirement. In this respect, several members pointed out that the expected decline of corporate production and the deterioration of profitability should result in the gradual shrinking of the balance of payments deficit, which might mitigate external vulnerability.

After the discussion, the Chairman invited members to vote on the propositions. 5 members voted to lower the base rate by 50 basis points, 2 members voted to lower the base rate by 75 basis points, and 3 members supported a reduction by 100 basis points.

Votes cast by individual members of the Council

In favour of decreasing the base rate to 10.0%	**5**	Péter Bihari, Ferenc Karvalits, Júlia Király, György Kopits, András Simor
In favour of decreasing the base rate to 9.75%	**2**	Ilona Hardy, Gábor Oblath
In favour of decreasing the base rate to 9.5%	**3**	Tamás Bánfi, Vilmos Bihari, Judit Neményi

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

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

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 19 January 2009. The minutes of that meeting will be published at 2 p.m. on 13 February 2009.