MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 19 JANUARY 2009

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 December 2008, annual CPI inflation increased by 3.5% and core inflation by 3.8%. Compared with November, the consumer price index fell by 0.7 percentage points and core inflation by 0.3 percentage points. Reflecting the uninterrupted rapid fall in inflation, the annual rate of consumer price inflation eased to 4.3% in 2008 Q4 and to 6.1% in 2008 as a whole. As was the case in October and November, the low outturn for inflation in December was accounted for in part by declines in the items excluded from the core inflation measure, i.e. vehicle fuel and processed food prices. In terms of implications for the inflation projection, the price of oil nearly halving since the November issue of the *Quarterly Report on Inflation*, the depreciation of the forint and weakening domestic economic activity point to even lower inflation over the period ahead.

Similarly to other countries of the CEE region, Hungary's industrial production and foreign trade fell sharply in October–November 2008. The decline in industrial production spread across a range of industries and was greater in magnitude than that recorded during the recession of 2000–2002. Developments in foreign trade were consistent with the weak performance of industrial production; based on data available up to October, the volume of goods exports dropped off sharply. In both Germany and Hungary new orders declined markedly, and euro area confidence indicators dropped back to their historically low levels of 1993. All these factors suggest that domestic economic activity may fall further and perhaps even more sharply than anticipated at the time of the November *Report*.

According to seasonally adjusted data, neither labour market activity nor its components showed any material change in November compared with the previous period. Although this observation does not fit the downward trend of employment in recent months, the data is in line with the short-term implicit forecast in the November *Report*, also taking into account the marked slowdown in October.

Financial markets

Fears of recession in international financial markets have continued to strengthen in the past month, and there are now more signs that the disinflation process may be picking up. Global investor sentiment improved slightly in December, in response to news of a substantial economic stimulus package being drawn up in the United States. In addition to a slight increase in risk appetite, sovereign bond issues in several emerging market economies were heavily oversubscribed in early January. More recently, however, risk tolerance has fallen back again, as an effect of weak labour market indicators, sluggish industrial production data and downward revisions to profit forecasts for companies: stock market indices have fallen, with a reversal in the downward trend of implied securities market volatilities and risk indicators. The series of interest rate cuts continued in response to growing fears of recession and the pick-up in disinflation: among the developed countries, in the UK the Bank of England reduced its key policy rate by 50 basis points to 1.50%, a historical low. In emerging markets, in India official interest rates were lowered by 100 basis points, in Poland, Israel and Thailand by 75 basis points, and in Indonesia, Taiwan and South Korea by 50 basis points. The Bank of Turkey cut interest rates by 200 basis points, exceeding market expectations. The European Central Bank reduced rates by 500 basis points to 2%, largely as the market expected, and broadened the interest rate corridor to 200 basis points. A statement by ECB President Trichet suggests that the current easing cycle may be beginning to slow, with market participants expecting interest rates to remain on hold in February.

Tensions in developed country interbank markets eased further, as reflected in the prolonged decline in both short-term euro and dollar interest rates and a narrowing of the gap between Treasury bill yields and Eurodollar deposits (known as the ‘Ted spread’). Recourse to instruments offered by central banks has fallen somewhat, while liquidity in interbank markets has improved further, although it still remains far below pre-September levels.

Liquidity in the Hungarian government securities market improved slightly in January, with a significant reduction in the gap between bid and offer prices, although turnover continued to be low. An important development has been the more than HUF 110 billion increase in non-residents’ holdings of government securities in the past two weeks. The discount Treasury bill auctions were hugely oversubscribed, with the total amount offered allotted in full. However, there was a significant rise in yields in the secondary market of government paper. Yields rose by some 60 basis points at the near end of the curve and by 35–40 basis points at the middle. Ten-year yields rose by 80 basis points. The spread of government securities yields over interest rate swap yields began rising, simultaneously with the increase in yields, and once more climbed above 100 basis points at five and ten years. The spread of Hungarian foreign currency bond yields over equivalent German bond yields narrowed to 500 basis points. The five-year Hungarian sovereign CDS price fell to 370 basis points.

The forint depreciated by some 5% against the euro over the past month and has been one of the weakest performing currencies in the region: the Czech koruna has fallen by 3%, the zloty by 2% and the Romanian leu by 9%. The weakening in the forint occurred mainly in the second week of January, when its value fell close to October’s EUR/HUF 286 level, accompanied by a significant increase in exchange rate volatility. Market rumours about the visit to Hungary by the IMF’s Managing Director, central bank communications about the exchange rate and the depreciation of currencies in the region which began in December all contributed to the weakness of the forint. Non-residents’ outstanding swap contracts rose slightly, which, however, was only partly associated with a fall in their spot positions (synthetic forward forint sales), with some half connected with a drop in FX swaps involving the sale of forints. It is important to note that with the rise in yields and the exchange rate weakening in recent weeks there has been no disruption to the money markets: the premium shock has occurred without the emergence of market frictions. The survey conducted by Reuters suggests that despite the significant weakening in the forint in recent days, economists’ long-term exchange rate expectations have not changed significantly: the consensus forecast of around EUR/HUF 264 for the end of 2009 is broadly comparable with the outcome of the previous month. However, the exchange rate expected for the end of February is significantly weaker, with an increase of HUF 11 to EUR/HUF 273 in analysts’ consensus forecast.

FRA rates are consistent with a much more moderate decline in official interest rates compared with December: the market attaches equal probability to a 50 basis point and a 75 basis point reduction. An 8% official interest rate is priced in for the end of May and one of 7% for the end of this year. Respondents to the Reuters poll expect official interest rates to be reduced by 50 basis points. Only three of the 22 the analysts expect interest rates to remain on hold. The average of forecasts for the base rate at the end of 2009 has remained unchanged: economists continue to expect the base rate to be 7%, equal to the level of market expectations implied by FRA rates.

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

Members of the Council agreed that the outlook for inflation had recently improved significantly, due to a fall in imported inflation and a deterioration in the prospects for real economic activity. According to the latest forecasts, under the assumption that monetary conditions remained unchanged, inflation might fall below the 3% target in the medium term.

In the Council's judgement, the prospects for growth in Europe were likely to deteriorate and the economy was expected to fall into a protracted recession. In addition to external factors, the decline in domestic demand, closely linked with slowing lending activity, would exacerbate the decline in Hungarian economic performance.

Members agreed that the inflation target was likely to be undershot, assuming that monetary conditions remained unchanged. The fall in imported inflation, simultaneously with the downward correction of oil prices, and the easing in demand-pull inflationary pressure might be contributing factors to the faster-than-expected decline in inflation. This, by itself, would be sufficient to warrant an easing in monetary policy. Some members saw more moderate downside risks to inflation towards the end of the Bank's target horizon.

Council members noted that money markets in Europe were undergoing a slow consolidation process, and interbank lending activity was picking up. However, several members warned that conditions in Eastern European markets continued to be much more turbulent, with the reduction in risk tolerance mainly affecting this region. For several members the renewed increase in non-residents' holdings of government securities was good news, but they warned that it was difficult to judge how long that upturn would last. Others noted that the various economic stimulus packages and government support for banks increased significantly governments' financing needs in developed countries, which, in turn, would generate increasing competition for debt managers, due to the significant role played by foreign investors.

Members judged that in the current situation the Council, when making its policy decisions, should also focus on financial stability risks, in addition to the inflation outlook. Domestic banks' liquidity position had improved and market frictions appeared to have eased. However, the prolonged fall in the forint exchange rate, coupled with a rise in funding costs, might lead to a deterioration in domestic banks' portfolios. It was also argued that, in addition to the central bank's measures to further enhance liquidity, commercial banks would need to increase their willingness to take risks, in order to mitigate the adverse impact of the credit contraction. There was a risk that the debt-to-GDP ratio of both the country and the government could rise further, due to the depreciation of the forint's real exchange rate and negative economic growth, which some members thought could constitute an adverse development. Several members warned that the recent movements in the real exchange rate did not necessarily converge with its equilibrium path and that a further depreciation was not justified by economic fundamentals.

Members agreed that the central bank base rate should be driven down to levels more appropriate over the long term, in order to secure stable financing for the economy. Based on money market instrument prices, market participants clearly expected the base rate to be reduced by 50 basis points, although some market analysts, in contrast with previous months, proposed maintaining interest rates at their current level. However, several members argued that monetary policy would need to be eased as quickly as possible, due to the change in the circumstances which had led to the extraordinary interest rate increase in October. It was also argued that the latest interest rate cut by the ECB had further increased the room for monetary policy manoeuvre in Hungary. Others, however, warned that in the current turbulent international environment the Council should be careful in lowering interest rates and that financial stability risks also justified cautious policy action. Several members pointed out that, if the fiscal position improved and further fiscal reforms were implemented, it would increase the room for monetary policy manoeuvre.

After the discussion, the Deputy Chairman invited members to vote on the propositions. Five members voted to reduce the base rate by 50 basis points, two members voted for a 75 basis point reduction and two members voted to reduce the base rate by 100 basis points.

Votes cast by individual members of the Council

In favour of reducing the base rate to 9.50%	**5**	Péter Bihari, Ilona Hardy, Ferenc Karvalits, György Kopits, Gábor Oblath
In favour of reducing the base rate to 9.25%	**2**	Vilmos Bihari, Csaba Csáki,
In favour of reducing the base rate to 9.00%	**2**	Tamás Bánfi, Judit Neményi

The following members of the Council were present at the meeting:

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

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

The Council will hold its next policy meeting on 23 February 2009. The minutes of that meeting will be published at 2 p.m. on 6 March 2009.