MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 23 MARCH 2009

Article 3 (1) of the MNB 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 February 2009, annual CPI inflation increased by 3.0% and core inflation by 3.3%. Both measures of inflation fell by 0.1 percentage point compared with January. Declining demand and the weakening exchange rate have had increasingly clear-cut effects on inflation developments recently. While the smaller-than-usual increase in services prices continued to indicate a break in the inflation inertia characteristic of previous years, tradables inflation rose sharply in February, reflecting the offsetting impact of forint depreciation. In contrast with previous periods, items excluded from the core inflation measure (i.e. unprocessed foods and vehicle fuels) contributed to the increase in inflation in the month. Overall, the outcome for inflation in February was consistent with the projection in the February issue of the *Quarterly Report on Inflation*. Nevertheless, the latest data and the weaker exchange rate relative to the projection point to the risk that the inflationary effects of exchange rate depreciation may be stronger than envisaged in the *Report*.

According to the second release by the CSO, Hungary's gross domestic product fell by 2.3% (by 2.5% adjusted for calendar effects) in 2008 Q4 compared with the same period of the previous year, implying annual growth rates of 0.5% and 0.3%, respectively, in 2008 as a whole. Available indicators suggest that Hungarian economic activity deteriorated more rapidly from the middle of last year, reversing a slight pick-up in the first half. Analysis of the data by sector and industry shows that this significant decline in output has been characteristic of all sectors of the economy, except for agriculture and construction, which account for relatively minor shares in terms of output. The decline in domestic demand and tighter credit conditions were also reflected in the fall in household consumption expenditure and firms' investment spending. This was only partly offset by government consumption expenditure and the improvement in net trade. Over the short term, the effects on Hungarian growth of the deterioration in general macroeconomic conditions may be stronger than expected and are likely to be felt during the remainder of the year. Consequently, they represent a significant downside risk to the path of 2009 growth presented in the February *Report*.

In December 2008, industrial production and trade in goods both dropped off sharply, but no further decline was observed in January 2009 compared with previous months. Imports of goods fell more sharply than exports, coupled with an improvement in Hungary's terms of trade in the final month of the year compared with November. This improvement in the trade balance towards the end of 2008 did not continue in the first month of the new year.

In January 2009, private sector gross average earnings growth continued to slow: earnings grew by a seasonally adjusted 5.8%. This slowdown in earnings was also reflected in regular pay growth. Earnings growth fell markedly in manufacturing, where the number of hours worked and overtime both declined sharply. In the service sector, similar developments took place in both regular pay and gross average earnings, but the adjustment through hours worked was not yet significant.

Financial markets

Over the last month, global investor sentiment has changed significantly. In the first part of the period, market sentiment deteriorated further, due to news about the nationalisation of US banks and mounting fears of recession. However, a turnaround occurred in markets in the second week of March. The improvement in market conditions, which was mainly attributable to better-than-expected results reported by a few US banks at the beginning of the year and announcements of additional government measures, led to an increase in risk tolerance: stock market indices recovered, CDS spreads and risk indices fell, and market sentiment towards emerging markets improved. However, the majority of analysts do not expect a trend reversal: prospects for economic activity are still weak, with professional forecasters continuing to revise down their growth forecasts for this year and the next.

Central banks in developed countries continued to reduce interest rates in response to growing fears of recession. The European Central Bank, the Bank of England and the Bank of Canada reduced rates by 50 basis points to near zero. In addition, new measures, e.g. expansion of asset purchase facilities, foreign exchange market interventions to weaken the exchange rate and further quantitative easing measures, were announced in a number of countries, including in Japan, Switzerland, the UK and the US. All of these actions are intended to achieve a significant reduction in yields on long-term assets and to ensure that the private sector has easier access to finance. In developing countries, interest rate cuts also continued, with several central banks in Latin America and Asia deciding to lower interest rates further. And, in emerging Europe, the National Bank of Poland also reduced official interest rates.

The weakening of currencies in Central and Eastern Europe stopped at the end of February and was followed by appreciation. The Czech koruna and the Polish zloty both traded 9%–10% stronger than their previous historical peaks. This may reflect several factors, including more concerted efforts by the countries of the region, i.e. their willingness to use all instruments at their disposal in order to halt the decline in the value of their currencies, in addition to the more benign global climate and increased country diversification by investors. Movements in the forint exchange rate diverged from those in other currencies of the region in the first week of March, due mainly to a deterioration in sentiment towards the Hungarian economy, with the exchange rate falling to another all-time low at EUR/HUF 317. However, as a result of determined central bank action and other supportive external factors (e.g. measures by the Swiss National Bank to weaken the franc), the forint recouped some of its losses and its movements became more closely aligned with those in other currencies of the region. Market turnover increased perceptibly, but exchange rate volatility remained high. With the strengthening of the exchange rate, non-residents were again actively buying in the spot foreign exchange market and increased their total position by some HUF 350 billion.

The market continues to be divided over future exchange rate movements. Respondents to the Reuters poll conducted in early March expect the exchange rate to be between EUR/HUF 280–305 over a protracted period, before strengthening to EUR/HUF 282 over a one-year horizon. However, there is a wide gap between foreign and Hungarian analysts' expectations. In foreign analysts' projections the exchange rate remains weak below EUR/HUF 300 for several months, strengthening to just EUR/HUF 292 over a one-year horizon. Domestic analysts are more optimistic, expecting the forint to appreciate gradually to EUR/HUF 276 by the end of January 2010.

Tensions in the domestic FX swap market increased in the first half of March: implied forint yields fell sharply. The wedge between forint yields derived from euro and US dollar transactions opened up, with the former reaching their lowest level at around 6% and the latter at around 2.8%. Increasing the attractiveness of the MNB's FX swap facilities for counterparties contributed significantly to an improvement in market conditions: implied yields rose quickly to levels around 8% against both currencies, accompanied by increased recourse to those instruments. The total size of non-residents' outstanding FX swaps changed considerably in the past month: as the exchange rate weakened, their net position rose by some HUF 400 billion, and then with the forint beginning to recover, it fell back by around the same amount.

The weakening of the forint exchange rate also had a significant impact on the Hungarian government securities market. Accompanied by low liquidity, yields rose to their October level by the first week of March. However, as an effect of exchange rate strengthening, market conditions improved. Participants reported increasing turnover, with benchmark yields on 6–12 month securities falling by some 100 basis points and those on 3–5 year bonds by more than 200 basis points. In the primary market, yields fell and demand surged in the final two weeks of the month. The ÁKK's schedule of issues for the second quarter contributed significantly to the decline in yields.

CDS spreads were volatile throughout the period: the five-year spread rose to a new record at 638 basis points, then it fell substantially to 535 basis points in a couple of days. This decline was consistent with movements in yields in other emerging countries showing similar characteristics in terms of risks.

Interest rate expectations changed markedly over the past month. As the exchange rate continued to weaken, markets priced in the possibility that official interest rates would be raised significantly. By the end of the month, however, market expectations extracted from FRA rates again pointed to official interest rates remaining on hold. Seventeen of the 21 economists polled by Reuters expect that the Monetary Council will not change interest rates. Of those expecting an interest rate increase, two expect that rates will be raised by 50 basis points and one expects a 100 basis point increase. One analyst expects a 25 basis point reduction.

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

Council members agreed that the global economic environment and the prospects for growth in Hungary both had continued to deteriorate. Consequently, the current recession might be deeper and more protracted than expected. Activity in the global and domestic economies was unlikely to improve significantly over the short term. Despite the weaker exchange rate, there continued to be no inflationary pressure in the domestic economy, due to the significant decline in domestic macroeconomic demand. Assuming unchanged monetary conditions, inflation could fall below the Bank's 3% medium-term target. The upside and downside risks to inflation appeared to be broadly balanced. Members agreed, however, that the current exchange rate level might have adverse effects on the Hungarian banking sector's loan portfolio quality over the medium term.

Central and Eastern Europe was particularly adversely affected by the global financial turmoil. Against this backdrop, monetary policy should take a wait-and-see policy approach. However, several members noted that liquidity problems had eased in financial markets over the recent period. In this context, some other members pointed out that the Bank's FX swap operations may also have contributed to an easing in strains in the domestic foreign exchange market, as they had injected a substantial amount of foreign currency liquidity into the financial system. At the same time, some members warned of the extremely fragile economic and financial conditions of the CEE region, which continued to pose significant financing and stability risks.

For several members it was good news that sentiment for the region had improved slightly in the recent period, which was also reflected in the narrowing of CDS spreads. However, some members warned that the problems facing the government securities market needed to be solved, in order for domestic market conditions to return to normal.

Members of the Monetary Council agreed that more determined economic policy actions by the Government were necessary to achieve a longer-term improvement. However, several members proposed a tightening of monetary policy, referring to the prolonged rise in the risk premium on forint-denominated assets. Others warned that the interest rate premium increased automatically, due to interest rate reductions by other central banks. Some members thought that the MNB's interest rate policy would only have a limited impact on the trends in the region. In addition, an interest rate increase would come as a negative shock for market yields, which would needlessly exacerbate domestic macroeconomic problems and not contribute to solving the country's financing difficulties.

In the Council's judgement, under the current circumstances monetary policy had to adopt a wait-and-see approach. Several members stressed that monetary policy actions could only play a marginal role in resolving the problems facing the region.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six members voted to leave the base rate unchanged and three members voted for a 100 basis point increase.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 9.50%	**6**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Judit Neményi
In favour of raising the base rate to 10.50%	**3**	Ferenc Karvalits, Júlia Király, András Simor

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
Judit Neményi
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 April 2009. The minutes of that meeting will be published at 2 p.m. on 8 May 2009.