MINUTES

OF THE MONETARY COUNCIL MEETING

OF 20 APRIL 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 March 2009, inflation eased slightly compared with the previous month. The outturns for the consumer price index and core inflation were 2.9% and 3.1% respectively, with the trend inflation rate at around 3.0%. Consumer prices rose by 3.0% and core inflation by 3.3% in the first quarter of 2009. The data were consistent with the earlier expectations that inflation might drop back to around the target, net of the effects of changes in indirect taxes. Services price inflation remained broadly unchanged after falling at the beginning of the year, while the quarter-on-quarter rate stood at a historical low. Unprocessed food prices continued to rise at a moderate pace. But tradables inflation, which is more sensitive to exchange rate movements, fell substantially on the month, due in part to individual items. So far, exchange rate changes have only been passed through to durable goods prices, owing to weak demand. However, the Bank expects the effects of exchange rate depreciation to become more pronounced from the second quarter.

Industrial production dropped by a seasonally adjusted 2.7% in February 2009 compared with the previous month, suggesting that output stagnated in January–February after declining sharply in December 2008. Industrial activity also stopped deteriorating further in other countries of the CEE region. In Germany, industrial production continued to fall, albeit less sharply than in previous months. However, the expectations component of various German activity indicators (e.g. IFO and ZEW) showed some improvement. Looking ahead, all of this suggests that industrial production is likely to remain flat at current levels.

Recent Hungarian trade performance has been similar to production activity: after declining sharply in the final month of 2008, trade did not fall further in early 2009. Exports of goods at current prices rose by 1.4% and imports fell by 3.0% in February compared with the previous month. According to volume data, the trade balance began to improve in January. This improvement continued in February, as reflected in current price data.

In February, private sector gross average earnings grew by 3.0% compared with January. Within this figure, regular pay growth was 4.7%. The seasonally adjusted data are evidence that wage adjustment in the corporate sector is underway, reflected not only in bonuses but increasingly in regular pay as well. The number of hours worked and employment both continued to contract in the private sector. Available data suggest that adjustment through wages has been more pronounced than envisaged in the February issue of the *Quarterly Report on Inflation.*

Financial markets

Over the last month, global investor sentiment has been positive overall. The US authorities' package of measures, aimed at regulating the operations of markets, and the favourable market reception of the decisions taken at the G-20 summit, coupled with better-than-expected macroeconomic data and quarterly corporate data, all played a role in the surge in optimism. Fuelled by increasing risk tolerance, stock market indices rose sharply, implied volatility of securities yields fell, CDS spreads declined markedly and more risky financial assets appreciated. The Ted spread, an indicator of market tightness, fell further for the euro, while for the US dollar it continued to move around levels characterising the period before the failure of Lehman Brothers. However, as downside risks to economic activity remain, there is still uncertainty about the extent to which the current improvement in financial markets will be sustained.

Central banks in developed countries continue to ease monetary policy and are constantly seeking ways to encourage lending. As the scope for further interest rate policy actions has increasingly narrowed, a number of central banks – including the Fed, the Bank of England, the Bank of Japan and the Swiss National Bank – have implemented asset purchase programmes. The European Central Bank reduced its key policy rate by 25 basis points, which was below expectations. However, press statements by ECB officials and market expectations suggest that there is still room for further rate cuts. In the CEE region, the National Bank of Poland lowered its policy rate by 25 basis points to 3.75%, while the Czech National Bank and the National Bank of Romania left interest rates unchanged.

The improvement in global investor sentiment benefited Central and Eastern Europe in particular. This was fuelled by reports that the Governing Council of the ECB would soon consider accepting as collateral in its operations government securities issued by countries of the region in their own currencies. The improvement in sentiment towards the region was reflected both in substantial exchange rate strengthening and falls in spreads on sovereign debt and in CDS spreads. Hungary's five-year CDS spread has fallen by more than 100 basis points to 400 basis points since the Monetary Council's latest policy decision. There was, however, a deterioration in the country's relative position: several countries which had higher spreads just a month ago are now seen as being less risky than Hungary.

Despite negative country-specific developments (e.g. uncertainty surrounding the nomination of a new prime minister and ratings downgrades), asset price movements in Hungary did not deviate materially from the developments in other regional countries. The forint strengthened to below EUR/HUF 290 by mid-April, appreciating by 6% from its local minimum at the end of March. The Polish zloty was the only currency which outperformed the forint during the period.

Nevertheless, according to the Reuters poll conducted in early April, the forint may remain under pressure over the short term. Respondents expect the exchange rate to be at or just below EUR/HUF 300 in the coming months. Over the longer term, however, they anticipate a gradual appreciation (to EUR/HUF 290 over the next six months and to EUR/HUF 285 over the next 12 months). Considerable uncertainty remains about the outlook for the currency: forecasts for the exchange rate range from 280 to 315 on a one-month horizon, and from 265 to 330 on a twelve-month horizon.

Non-residents' total net forint position has increased by more than HUF 350 billion since the last interest rate decision, of which HUF 250 billion was related to spot forint purchases. Meanwhile, non-residents' net outstanding FX swaps fell by nearly HUF 400 billion, in which the build-up of long forint positions and the decline in short positions both played a role.

Developments in the domestic government securities market were mixed in the past month. In the secondary market, short-term yields have fallen by 60–130 basis points and longer-term yields by more than 200 basis points since early April. Despite the significant drop in yields, there remains ambiguity about these developments, as the fall in yields may have been caused in part by the Debt Management Agency's auctions to repurchase government paper from the market. However, the significant narrowing in interest rate swap spreads at every maturity is evidence of a substantial drop in the liquidity premium in the government securities market. Non-residents sold some HUF 50 billion net of government paper in the past month. It should be noted, however, that the outstanding total of government securities also fell significantly due to the repurchase auctions, and sales by non-residents were smaller compared with repurchases. In the primary market, demand for discount Treasury bill issues was adequate, with average auction yields slightly exceeding secondary market yields.

Market rates, reflecting future interest rate expectations, have changed markedly over the past month. Whereas FRA quotes implied interest rate increases of more than 100 basis points on aggregate in the following months, expectations of further interest rate increases were priced out gradually, reflecting developments in global sentiment and the appreciation of the forint, and the latest quotes suggest that the market expects official interest rates to remain on hold over the coming months. According to the Reuters poll of economists, the Monetary Council is expected to leave interest rates unchanged at its next policy meeting. Analysts generally expect the Bank's next move to be a slight reduction in rates; however, the majority expect this to happen in the second half of the year.

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

Monetary Council members agreed that while there continued to be no inflationary pressure in the domestic economy because of weak economic conditions, the risks to financial stability and the financing problems facing Hungary required a cautious, wait-and-see monetary policy approach.

Members of the Council concurred that although sentiment towards Central and Eastern Europe had improved somewhat recently, Hungary was in a particularly vulnerable position in the current turbulent money and capital market environment. Some members warned that the country's relative position had even deteriorated further compared with Poland and the Czech Republic. Several others noted that the deeper-than-expected economic downturn might lead to a sharper deterioration in the quality of domestic banks' portfolios than previously thought, despite the recent improvement in liquidity in financial markets.

Council members also agreed that, due to weak domestic economic activity, prices were likely to rise only moderately in Hungary and that inflation might be around 3% on the horizon relevant for monetary policy. In addition to the latest available inflation data, adjustment by firms through wages and employment also pointed to a reduction in upside risks to inflation. Some members thought that the subdued rise in tradable goods prices despite the exchange rate weakening was clear evidence of the downward effect on inflation of weak macroeconomic demand.

However, members were divided over the potential inflationary effects of the programme announced by the new Government. Some members judged that the upward effects on inflation of the VAT increase would only be temporary in a recession environment, while others did not rule out potential spillover effects. On another argument, medium-term global inflation concerns were growing in the wake of the crisis management actions, and import prices were also likely to rise in Hungary.

Discussing the macroeconomic outlook, several members pointed to the worse prospects for activity than in earlier forecasts. It was also argued that Hungary's macroeconomic balance was improving, which was also reflected in the fall in the country's external financing requirement. Several members stressed that Parliamentary approval of the new Government's programme could serve to improve the external balance further.

Council members judged that restoring the health of the domestic financial markets was essential to promoting financial stability, which required the government securities market to function smoothly. Several members warned that this, in turn, required dealers to commit to quoting two-way prices in the secondary market and turnover to increase gradually. It was also argued that the auctions to repurchase government paper might change the shape of the yield curve and, consequently, the fall in bond market yields did not necessarily reflect an improvement in expectations.

Members of the Monetary Council judged that the change in the direction of the new Government's economic policy was the most important factor possibly influencing the room for manoeuvre in monetary policy. For this reason, the Council should adopt a wait-and-see strategy approach pending Parliamentary approval of the Government's programme. Some members argued that after successful implementation of the Government's programme the risk premium on forint assets was likely to fall, which, in turn, would leave scope to ease policy. On another argument, in addition to restraining economic activity, the current high level of interest rates could be harmful over the long term, because the percentage share of higher risk debtors could increase within demand for credit, which might cause a further deterioration in banks' loan portfolio quality. However, several members warned of the inadequate supply of market funds to finance the economy and, referring to financial stability considerations, they preferred a very cautious approach to policy looking forward.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. The Council voted unanimously in favour of leaving the base rate unchanged.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 9.50%	**9**	Tamás Bánfi, Péter Bihari, Vilmos Bihari, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, Judit Neményi, 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

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 25 May 2009. The minutes of that meeting will be published at 2 p.m. on 12 June 2009.