MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 24 AUGUST 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 July 2009, annual CPI inflation was 5.1% and core inflation was 5.2%, up 1.4 percentage points and 2.0 percentage points respectively on June. The sharp increase in inflation relative to previous months was driven mainly by the changes in VAT and excise duties on a wide range of products. The actual outcome for July was significantly lower than expected, explained in part by a stronger-than-anticipated correction in unprocessed food prices and in part by surprisingly slow increases in the prices of items included in the core measure of inflation. This implies that, in response to the intense competition prompted by the economic downturn, firms raised prices by less than the VAT increase might have suggested. And although the VAT increase may take several months to pass through into prices, its effect may turn out to be smaller than previously expected.

In June 2009, gross average earnings grew by 1.1% in the whole economy and by 5.9% in the private sector. Private sector wages were higher than in previous months, with the acceleration in the rate of earnings growth attributable to manufacturing industries. In the private sector, the number of employees continued to trend downwards, while in general government employment continued to rise markedly in June, receiving further stimulus from the 'Pathway to Work' programme. Nevertheless, general government employment is expected to increase at a more modest pace in the coming months.

According to the CSO's preliminary release, Hungary's GDP contracted by 7.6% in 2009 Q2 (7.5% after adjusting for calendar effects) relative to the same period of the previous year. The adjustment of the economy to the changed global environment proceeded broadly along the path outlined in May. The economic downturn continued to deepen, aggravated by the procyclical behaviour of the financial sector and fiscal policy. On the output side, the deterioration in economic performance was most clearly reflected in the slowdown in industrial production and export sales strongly influenced by shifts in international economic activity. On the expenditure side, the downturn was driven mainly by weakening domestic demand. Domestic demand, however, fell more sharply than envisaged in the May projection. Consequently, the decline in output was accompanied by a marked improvement in the external balance.

The trade account registered a record surplus of EUR 315 million in June. The expansion of orders for Hungarian exports did not entail an increase in industrial exports, while exports of agricultural products may have contributed significantly to the strength of goods exports. With the fading of one-off effects related to imports, the improvement in the trade account points to a major adjustment by domestic economic agents and suggests that the risks to net trade are on the upside.

As in May, the August projection assumes that the output gap will remain strongly negative over a lengthy period. In line with developments elsewhere in Europe, the downturn in the Hungarian economy is still expected to last until mid-2010, followed by pronounced economic growth from 2011.

Financial market developments and the vulnerability of the banking sector

In the past month, perceptions of risk associated with the Hungarian economy were driven mainly by shifts in global investor sentiment, with country-specific factors playing a less important role. The Hungarian CDS spread fell from 275 basis points to 225 basis points by early August, but then rose once again to close to 270 basis points, in line with the worldwide deterioration in sentiment. There was a generalised increase in CDS spreads across emerging markets.

The recent favourable trends in the Hungarian government securities market were partially reversed. Demand continued to be strong, and yields fell at the auctions of government debt securities. The higher amounts on offer at the government bond auctions were fully subscribed, accompanied by strong buying interest from investors. In addition, further amounts were allotted at tenders for non-competitive bids. In the secondary market, short-term yields drifted lower by 100–110 basis points following the reduction in official interest rates, but yields stopped falling further at maturities beyond one year, and benchmark yields at maturities between 3–10 years remained at or above 8.50%. Interest rate swap spreads widened significantly at longer maturities.

Non-resident market participants' long positions in the forint rose overall in the past month. Their net forint purchases totalled some HUF 95 billion in the period since the previous interest rate decision, which they used in part to purchase forint assets and reduce their outstanding FX swaps. Non-resident investors' holdings of MNB bills rose by HUF 35 billion and their holdings of shares by HUF 50 billion. In addition, their net outstanding FX swaps fell by some HUF 50 billion as they closed out their short forint positions. However, their holdings of forint-denominated government paper have fallen by HUF 25 billion since the Monetary Council's July meeting.

The exchange rate fluctuated between EUR/HUF 265–275 in the past month. In the first part of the period, the forint continued its earlier upward trend, but then weakened from early August. Movements in the exchange rate were shaped mainly by shifts in international investor sentiment: the forint's movements were closely aligned with other currencies of the region, but continued to display greater volatility. According to the results of a survey on exchange rate expectations in Central and Eastern Europe by Reuters in early August, expectations shifted towards appreciation at all time horizons. Based on the consensus forecast, the forint exchange rate is expected to move around EUR/HUF 265–275 in the course of next year. The picture emerging from information derived from market prices about exchange rate expectations continues to be benign: implied volatilities have remained low, and negative skewness calculated on the basis of options prices has decreased further.

The forint and foreign currency liquidity of the domestic financial system is judged to be adequate. The deterioration in the quality of banks' loan portfolios has proceeded in line with the projection in the spring 2009 issue of the *Report on Financial Stability*. Seven per cent of private sector loans were in arrears of more than 90 days, and the downward effect on earnings of the deterioration in the loan portfolio also doubled, rising to 2%. Contrary to the staff's expectation, a number of factors offset the negative impacts on banks' earnings stemming from the deterioration in the quality of the loan portfolio in H1. One of these factors was strong earnings from financial transactions. Another was the substantial improvement in cost efficiency. As a result, the profits of the banking sector in H1 remained nearly unchanged compared with the same period of the previous year. Another favourable development was the improvement in banks' capitalisation, due in large part to parent banks retaining earnings in Hungary and increasing the capital of their subsidiary banks. At the system level the capital adequacy ratio was above 12% in June 2009.

The banking sector's forint and foreign currency liquidity risks are judged to be moderate. Although the financing of banks remains constrained at maturities beyond one year, particularly for banks which are not owned by a foreign parent, the availability of funding for banks appears to be adequate. Rollover risk plays a diminishing role in banks' lending decisions. The outflow of foreign funds, accompanied by a decline in the loan-to-deposit ratio, has resulted from the adjustment of the private sector to the recessionary environment, the decline in bank's appetite for risk and fierce competition for deposits.

The non-financial private sector and banks have continued to adjust to the new macroeconomic environment on both the asset and liability sides. The amount of credit outstanding to the corporate sector continued to fall in July. The stock of outstanding household credit remained static or fell slightly. Increasing recourse by households to overdrafts is offsetting the downward effect of maturing debt on the stock of outstanding borrowing. In the past month, the growth of corporate deposits slowed and that of household deposits picked up.

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

Monetary Council members agreed that there continued to be no inflationary pressure in the Hungarian economy, consistent with the assessment in the August issue of the *Quarterly Report on Inflation*, and that inflation could fall below the Bank's 3% inflation target on the horizon relevant for monetary policy. The outlook for domestic inflation and growth, as well as global financial market developments allowed the Council to ease monetary policy.

In the Council's judgement, the latest information was consistent with the picture of a deep and prolonged recession. Based on recent data releases, some downside risks had materialised, but the prospects for growth had not changed looking forward. In the current unfavourable economic environment, consumption and investment had fallen more sharply than expected, which, in turn, had a positive impact on the external balance. Some members noted that the outlook for growth in the global economy remained uncertain and it was difficult to tell whether the downturn would entail just one or more dips.

In assessing recent inflation developments, Council members agreed that, based on the current outlook, the inflation target could be met in 2010. Several members, however, pointed out that the outturn for the consumer price index in July 2009 had been better than the expectations of both the Bank and market forecasters. The weaker pass-through of the VAT increase into prices had come as a surprise. Several members thought that if the pass-through of the tax increase into prices was smaller than expected, then that would also affect firms' wage setting towards the end of the year, would slow future wage inflation, and that there would be less reason to be concerned about inflation expectations becoming anchored at a high level. Several members were of the view that the upside risks to inflation had diminished compared with the picture presented in the May *Report* and that even a significant undershooting of the Bank's medium-term inflation target could not be ruled out.

Members agreed that the current picture of the real economy and inflation provided the scope and reinforced the need for easing monetary policy. Several members thought that the sudden improvement in international financial markets had not continued in the period after June. On another argument, global markets continued to be characterised by high volatility and the risks of abrupt, large fluctuations should be taken into account in formulating interest rate policy. Some members thought that in view of the real economic outlook the largest interest rate reduction allowed by the circumstances was needed. Others, however, warned that unsustainable expectations of interest rate cuts could be priced in and monetary policy could be eased more than justified, if the pace at with which the Council reduced interest rates was too rapid.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Seven members voted to reduce the base rate by 50 basis points and one member voted for a 75 basis point reduction.

Votes cast by individual members of the Council

In favour of reducing the base rate to 8.00%	**7**	Péter Bihari, Vilmos Bihari, Ilona Hardy, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of reducing the base rate to 7.75%	**1**	Tamás Bánfi

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

Tamás Bánfi
Péter Bihari
Vilmos Bihari
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 28 September 2009. The minutes of that meeting will be published at 2 p.m. on 7 October 2009.