MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 19 OCTOBER 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 September 2009, annual CPI inflation was 4.9% and core inflation was 5.1%, with the quarter-on-quarter trend indicator for inflation falling below 3%. This is consistent with the view that recent inflation developments have been dominated by the effects of subdued domestic demand. The positive surprise in September inflation can be attributed in large part to a weaker-than-expected increase in seasonal food prices, with the lower-than-anticipated increase in services prices playing a smaller role. The slow increase in services price inflation suggests that firms are likely to adjust to the recent adverse demand shock by reducing employment rather than by raising prices, which, in turn, may result in lower trend inflation outcomes on the forecast horizon.

According to seasonally adjusted data, the number of unemployed rose by 9,000 in September. Since June, the number of people employed in the 'Pathway to Work' programme has not increased significantly. The low number of vacancies is evidence of loose labour market conditions. Despite this, however, unit labour costs, measured in forint terms, rose to historical highs, due to the strong rate of earnings growth and falling output over the past few months. Higher-than-expected earnings growth was observed mainly in manufacturing. As firms are unable to restore their profit margins by raising prices, further employment and wage adjustments are expected in the labour market.

Hungarian industrial production fell by 19.8% in August 2009 compared with a year earlier. On a month-on-month basis, output has been growing in both the euro area and Central and Eastern Europe since the second half of the year. Despite the gradual pick-up in global economic activity, however, Hungarian industry has been unable to register growth since the beginning of the year. One reason why industry has been lagging behind is that the fiscal stimulus packages have produced stronger export growth in other countries of the region, owing to differences in product mixes. Another factor significantly contributing to Hungary's relative underperformance has been the sharper decline in domestic demand compared with elsewhere in the region, due to the procyclical behaviour of fiscal policy and the banking sector. The trade account again registered a large surplus in August, explained by a slow rise in exports and slack domestic demand.

The current account showed a surplus equivalent to 2.7% of GDP in 2009 Q2, significantly exceeding expectations. As a combined effect of negative income on debt and the appreciation of the forint, Hungary's net external debt fell from 62% to 55% as a percentage of GDP. Due to a data revision, the country's balance of payments for 2009 may turn out to be much better than expected. The revision suggests that the balance of payments may be significantly more cyclical than assumed previously – it does not necessarily contain any positive message in terms of the longer-term external financing requirement.

The government budget showed a deficit of HUF 146 billion in September, an increase of nearly HUF 100 billion from a year earlier, and a breakdown of the deficit figures shows that the risk of a higher deficit has increased. On the revenue side of the government budget, in recent months there have been somewhat different outcomes for a number of items compared with the Bank's forecasts: although VAT revenue was higher than expected, revenue from wage and corporate taxes was slightly lower than expected. On the expenditure side, spending by budgetary institutions exceeded the expectations of the Bank's staff, and data for Q1–Q3 suggest that the consolidation, required for achieving the deficit target, has only partly commenced. This implies that sharp reductions in expenditure will be necessary in the final quarter, and the probability has increased that the deficit target will be met in part by measures which could prove difficult to sustain over the longer term.

Financial market developments and the vulnerability of the banking sector

Financial markets

Improving investor optimism in the global financial markets, driven partly by positive macroeconomic data and the first positive results in corporate earnings for Q3, has had a favourable impact on perceptions of risks associated with the Hungarian economy. Adverse news on the region, and in particular renewed concerns about the Latvian economy, did not offset the effects of the improvement in global investor sentiment. The subdued impact of events in Latvia on emerging economies outside the Baltic raises the possibility that the danger of contagion within the region may have declined in investors' opinion. Stronger-than-expected data on Hungary's external balance also contributed to an improvement in investor sentiment towards the country. The five-year sovereign CDS spread fell from 215 basis points to 197 basis points, and the five-year ahead five-year forint premium, calculated from interest rate swaps, declined slightly more strongly, while euro-denominated foreign exchange premia fell by a similar amount.

The government securities auctions held in the past month were viewed positively by the market. Oversubscription rates remained at high levels, and bids submitted at the bond auctions and the amounts on offer both rose compared with previous auctions. Benchmark yields fell by 17–43 basis points. At the short end of the curve, yields are currently around 6.5%. For horizons out to 15 years, the yield curve rises progressively by nearly 1 percentage point as maturities lengthen.

Non-resident investors' holdings of Hungarian government securities fell by HUF 31 billion. The 2009/D bond matured in the period, which must have played a role in this, as it reduced non-resident holdings by HUF 112 billion. The substantial purchases of government paper by non-residents observed in recent weeks may have been strongly motivated by this bond maturing. In the spot foreign exchange market, non-residents purchased about HUF 157 billion of forints, mainly to close out their FX swap positions.

The exchange rate fluctuated in a narrow band between EUR/HUF 266–271 in the past month. Following an initial rise, the news from Latvia caused the exchange rate to weaken slightly, only to be offset by the benign impact of positive US corporate earnings reports towards the end of the period. According to the survey conducted by Reuters in early October, economists maintained their expectations that initially the exchange rate might depreciate, followed by appreciation over the longer term. However, respondents pushed out their expectations for the low point of the weakening from three months to six months. The median of the exchange rate expectations for October 2010 is EUR/HUF 266.

The interest rate path implied by market rates has changed little since the Council's policy decision last month. In the period following the September meeting, a reduction of 50–75 basis points was priced into FRA rates for the October meeting, but a 50 basis point cut appeared slightly more likely as late as Thursday. Based on market prices, the Bank's policy rate may reach a low of 6% in a period of 5–6 months, but rates are quoted higher at horizons beyond nine months.

The majority (21 of 23) of respondents to the Reuters poll conducted in October expect the Council to reduce interest rates by 50 basis points on 19 October. One economist expects that rates will be reduced by 25 basis points and another expects that they will be left on hold. Interest rate forecasts for this year range from 6 to 7 per cent, with the median at 6.5 per cent. According to economists' median forecast, the central bank base rate may be 5.75%–6.00% at the end of 2010.

The banking sector

The adjustment of the domestic banking sector through the loan-to-deposit ratio slowed significantly in August–September. The decline in deposits, especially those of the corporate sector, rather than a pick-up in the demand for and supply of credit may have been behind this development. As a result, the outflow of foreign funds and the decline in the banking sector's outstanding FX swaps stopped.

Banks are confronted with falling liquidity risks and rising credit risks. Loan losses arising from an increase in credit risk have been rising steeply in the domestic banking sector. As a consequence of the rising costs of risk, the sector's profitability is falling, but at 1%, the current ROA ratio continues to be high by international standards. All of this implies that Hungarian subsidiary banks continue to make a positive contribution to the performance of their groups. However, as earnings have been boosted by one-off factors, with the exception of efficiency improvements, this strong profitability is unlikely to be maintained in the future. Over the period ahead, banks are likely to try to price rising risk costs into the interest spread (i.e. the difference between lending rates and the funding costs), but this is unlikely to absorb loan losses entirely. Another risk is that financial enterprises may incur losses this year even, which may significantly reduce the consolidated results of banking groups with financial enterprises.

The banking sector's capital strength (and its shock-absorbing capacity) increased further, with the capital adequacy ratio at nearly 13.1% at the end of August. The core capital ratio (Tier 1) stood at 10.9%. Both indicators are viewed as high in international comparison.

The sector's capacity to absorb shocks appears strong, due to its robust income and capital position. Banks' capital adequacy ratio is expected to remain above 12% along the baseline macroeconomic path, while none of the systemically important banks are facing the need for a capital injection. The results of a stress test conducted by the MNB suggest that, even in a much more unfavourable macroeconomic scenario (assuming that the economic downturn will be 5 percentage points deeper than in the baseline scenario), the estimated amount of aggregate recapitalisation needs of the banking sector will be HUF 100–170 billion at the end of 2010.

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

Monetary Council members agreed that in the real economic environment characterised by subdued demand, the risk of undershooting the Bank's 3% target had increased. After considering the outlook for inflation and growth, members unanimously thought that it was necessary to reduce the central bank base rate. In addition, the reduction in risks to financial stability and the improvement in perceptions of risks associated with the Hungarian economy had also created an opportunity to use the room for manoeuvre of interest rate policy.

In the Council's judgement, the outlook for the real economy had not improved, and the risk that domestic macroeconomic consolidation would take longer than elsewhere in Europe had increased. Several members noted that the rise in unemployment and the labour market adjustment was strong. In assessing the risks to growth, some members pointed out that there continued to be a lack of consensus in the world's economic and policy circles as to whether the downturn would entail just one or several dips.

There was agreement among members that, based on the macroeconomic baseline scenario, the inflation target could be undershot significantly. Some members thought that the decline in domestic demand might place an excessive burden on the economy and, consequently, the improvement in the external balance might turn out to be greater than justified.

Council members agreed that the outlook for inflation and the economy had already made it possible to reduce the central bank base rate earlier, but during the past month there had also been a material reduction in risks to financial stability, which had further increased the central bank's leeway to conduct interest rate policy. After liquidity strains had eased markedly at the beginning of the year, solvency risks had also diminished, as suggested by the latest information. Some members were of the view that, if the environment continued to stabilise, raising funding in forints might be an alternative that domestic economic agents might choose to use. For several members, it was a positive development that Standard & Poor's had upgraded Hungary's rating outlook from negative to stable, and that the European Commission had placed Hungary in the medium-risk category in terms of the sustainability of general government balance.

Some members noted that conditions in financial markets remained very fragile and the resultant risks represented the greatest challenge for monetary policy looking forward. In this context, it was argued that there might be another leg of the financial crisis, and it was very unfavourable that investors viewed Central and Eastern Europe as one of the most vulnerable regions and Hungary as one of the most vulnerable countries.

On another argument, the pick-up in world economic activity was bolstered by the substantial stimulus from fiscal and monetary policy and it was difficult to tell when those measures would unwind. For the time being, the functioning of markets had not been restored fully in the world economy, and exchanges may have reacted more favourably than justified by economic fundamentals. In assessing the domestic markets, some members warned that normal conditions in the Hungarian government securities market had not yet been restored and that shifts in the yield curve might often be misleading, as demand for government paper remained weak.

Monetary Council members agreed that the past month had seen a stream of information which had given monetary policy more room to manoeuvre. However, there were divided views among the members over the degree to which interest rates should be lowered. The overwhelming majority of members thought that by reducing interest rates gradually the Bank was more likely to create stability in a volatile environment and reduce the risks of erratic market responses and potential overshooting. Several members warned, however, that the risk of undershooting the inflation target had risen to such an extent recently that it might make it possible to implement a larger reduction in interest rates, with special regard to the recent moderation in risks to financial stability.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Five members voted to reduce the base rate by 50 basis points, three members voted for a 75 basis point reduction and one member preferred a reduction of 100 basis points.

Votes cast by individual members of the Council

In favour of reducing the base rate to 7.00%	**5**	Péter Bihari, Ilona Hardy, Ferenc Karvalits, Júlia Király, András Simor
In favour of reducing the base rate to 6.75%	**3**	Vilmos Bihari, Csaba Csáki, Judit Neményi
In favour of reducing the base rate to 6.5%	**1**	Tamás Bánfi

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, Deputy 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 November 2009. The minutes of that meeting will be published at 2 p.m. on 9 December 2009.