MINUTES

OF THE MONETARY COUNCIL MEETING

OF 23 NOVEMBER 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

According to the CSO, annual CPI inflation was 4.7% and core inflation was 4.9% in October 2009. Both measures of inflation fell by 0.2% relative to the previous month. After peaking in July–August on the back of the VAT increase, inflation has edged down slightly in recent months. Moreover, the month-on-month rates of inflation, which better reflect underlying inflation developments, also imply that disinflationary effects have become more intense.

The outturn for market services prices was consistent with the usual seasonal pattern for October, as the month-on-month change in the index was virtually zero. Weak domestic demand and the stable exchange rate point to lower tradables price inflation. Official data suggest that the decline in durable goods price inflation gathered pace in October. Movements in food prices were also moderate, with the seasonally adjusted index of unprocessed food prices falling back close to levels from the beginning of the year.

According to the preliminary release, Hungary's GDP fell by 7.2% in 2009 Q3 compared with the same period of the previous year. After adjusting for seasonal effects, the economy contracted by 8%, with a sharp decline of 1.8 percentage points on the previous quarter. Hence, the marked deterioration in the performance of the Hungarian economy continued for the sixth consecutive quarter. Stabilising external demand may have provided some stimulus for the domestic economy through industrial production and net trade, but this was only sufficient to partially offset the effects of the sharp downturn caused by very weak domestic demand. And while growth in a number of economies around the world and in the CEE region recovered on a quarter-on-quarter basis, the contraction in Hungary continued.

September's industrial production data well illustrate the diverging trends in economic activity abroad and demand at home. Hungarian exports continued to show a robust increase, in line with the rebound in activity in the country's export markets and developments in the CEE region. By contrast, there were only tentative signs of stabilisation in domestic sales following the severe declines.

The September surplus on trade in goods was broadly comparable with data reported in the preceding months. Hungarian exports continued to rise, consistent with the improvement in economic activity abroad. Imports of goods, however, also began to increase despite the continued decline in domestic demand, related in part to the import content of rising exports and in part to the changed seasonality of imports of natural gas.

Earnings in the private sector grew by 4.3% relative to the same period of the previous year. By contrast, government sector earnings fell by 7.4%. Developments in wages in the main sectors have diverged. For example, wage growth has slowed markedly in market services in respect of both regular pay and bonuses. In manufacturing, in contrast, wage growth has continued to accelerate, in line with the recovery of economic performance abroad since the beginning of the year. In more recent months, the bulk of the increase in wage growth has been accounted for by higher bonus payments.

According to LFS data, employment fell further in October, which, however, seems to be at odds with the institutional employment data released by the CSO, which reflect an increase in employment numbers, particularly in market services. But that increase has not been confirmed by other labour market statistics (e.g. data released by the Public Employment Service), nor can it be explained by cyclical developments.

Financial market developments and the vulnerability of the banking sector

Financial markets

The correction in global financial markets in early November and the subsequent improvement in investor mood both had a significant effect on the domestic financial markets. Nevertheless, ongoing uncertainty about the CEE region, amplified in the past month by the deadlock with the financial programmes of Ukraine and Romania with the IMF, barely affected Hungarian financial market developments. In addition, the impact of better-than-anticipated Q3 GDP data and lower inflation in October was only reflected in a further reduction in interest rate expectations. Based on CDS spreads, Hungary's risk assessment hardly changed in the past month. Nor were there large movements in yield spreads on the country's sovereign bonds: the spread of the five-year euro bond over German bonds of equivalent maturity narrowed by 20 basis points to 175 basis points. Yield spreads on sovereign bonds of the majority of emerging market economies developed similarly.

Fluctuations in sentiment in global financial markets were reflected most clearly in the exchange rate of the forint: from around EUR/HUF 265 at the time of the Monetary Council's previous policy meeting in October the exchange rate weakened to above EUR/HUF 280 by early November. Reversing this path, the exchange rate then strengthened to EUR/HUF 265 again over the past two weeks. A Reuters survey of the foreign exchange market was published just before the forint reached its weakest point in November. According to the results of the poll, analysts expect the exchange rate to strengthen gradually from around EUR/HUF 275 at the time of the survey to EUR/HUF 270 over the next six months and to EUR/HUF 264 over a twelve-month horizon.

The Hungarian government securities market closely followed developments in global financial market sentiment. Although in the primary market most recent issues have been heavily oversubscribed, investor demand weakened slightly and yields rose during the setback in the market in early November. With the improvement in sentiment, however, investor demand subsequently bounced back. Secondary market yields also fluctuated: following an increase of 40–50 basis points, yields at the longer end of the curve returned to levels prevailing at the time of the Council's interest rate decision in October, and to 7.4% at maturities between 10–15 years. After increasing slightly, yields at the shorter end were down nearly 10 basis points on a month earlier, at around 6.2%.

Shifts in non-residents' total position broadly mirrored movements in global financial market sentiment. In the spot foreign exchange market, non-residents sold some HUF 300 billion by early November, of which they repurchased about HUF 280 billion in the past two weeks. Their net FX swap positions rose by more than HUF 200 billion as selling continued in the spot foreign exchange market, suggesting a relatively large build-up of short forint positions. With the forint regaining its strength and the unwinding of short positions, however, non-residents' net outstanding FX swaps fell by a total of nearly HUF 100 billion. Non-residents' holdings of Hungarian government paper increased by HUF 20 billion in the past month, reaching around HUF 2,340 billion, after a fall of HUF 50 billion in the first two weeks and a subsequent rise of some HUF 70 billion in the latter two weeks. Their holdings of MNB bills rose more sharply, by nearly HUF 100 billion, in one month.

The expected path of domestic interest rates first moved up and then down, closely aligned with movements in the forint exchange rate. Currently, the path of interest rates stands slightly below the level seen immediately after the October policy decision. Based on FRA quotes, the central bank base rate is likely to reach its lowest point at 5.5% on a 3–6 month horizon, with most market economists' forecasts in a range of 5%–6%. In a Reuters poll published in November, market participants almost unanimously expected the Council to reduce interest rates by 50 basis points: 22 of the 23 respondents expected a 50 basis point

cut, while one respondent expected a 75 basis point cut.

The banking sector

In respect of the financial stability risks of the banking sector, the negative effects of subdued credit availability (i.e. banks' procyclical behaviour) and rising credit risks deserve special mention. Although the sector's loan-to-deposit ratio stopped declining in September–October (remaining at levels around 145%), this was mainly attributable to simultaneous and comparable declines in corporate sector loans and deposits. Since the beginning of the year, outstanding lending to the domestic corporate sector has fallen significantly, dropping by a monthly amount of HUF 50 billion on average, with the pace of decline hardly slowing. The steady downward trend in corporate loans is not in line with the Bank's earlier expectations. Lending to the sector was expected to reach a turning point sometime in Q3. However, the changing trends in corporate lending may be explained in large part by supply-side factors. Banks continued to tighten credit standards on corporate loans in Q3, as reflected mainly by changes in non-price terms. Contrary to the Bank's expectations, the ratio of banks reporting further tightening continued to rise, suggesting that credit standards may have been tightened significantly. Banks apply tighter credit standards on loans to more risky clients, as reflected, for example, in higher collateral requirements as well as in stricter loan covenants and monitoring criteria. One particularly adverse development is that, with the tightening in credit standards, demand for loans perceived by banks rose mainly on account of higher demand for loans to finance inventories and accounts receivable (presumably in connection with the narrowing of the supply market).

Credit risks continued to rise. Based on data available up to September, the quality of household and corporate sector loans deteriorated further, while the dynamics of loan provisioning slowed. In September, loan loss provisions reduced banks' earnings by 2.2% in the household segment and by 2% in the corporate segment. This smaller decline in earnings compared with the Bank's earlier forecast suggests that the deterioration in the quality of loan portfolios may have slowed down, which can be viewed as an encouraging sign. All the same, the data should be treated with caution, as there has recently been a sharp rise in the ratio of restructured loans. Banks are attempting to avoid losses or spread them over time by restructuring part of their loan portfolios. Portfolio restructuring is a positive development, as it helps to reduce the monthly servicing costs of debt for clients, thereby increasing the probability of avoiding default on debt. At the same time, by restructuring existing loans, banks are able to reduce the size of their non-performing portfolios recognised in their accounts, and ultimately to reduce provisions for expected losses. This may, however, cause a sudden loss to the sector if the downturn were to last longer than expected.

The banking sector has retained its ability to absorb losses arising from a deterioration in the quality of loans. Profitability improved further in September, boosted by a slowdown in the increase in provisioning and higher financial profits. Nonetheless, profitability still remained significantly below the level recorded a year earlier. When comparing the results, however, it should be taken into account that the sale of one bank's insurance subsidiary last year led to a one-off increase of some HUF 120 billion in the sector's overall profits. Adjusting 2008 results for this one-off item, this year's profits are HUF 20 billion higher, which far exceeds expectations. The ROE ratio currently stands at 17%. Still, it is true that these favourable results are mainly accounted for by one-off items, and, consequently, this good profitability is unlikely to be sustainable in the future. The domestic banking sector's capital adequacy also increased, with the CAR at above 13% in September.

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% inflation 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 further. The reduction in risks to financial stability and a lasting improvement in perceptions of risks associated with the Hungarian economy had also created an opportunity to use the room for manoeuvre in interest rate policy.

In the Council's judgement, the outlook for the economy had deteriorated somewhat based on the latest set of data for GDP and employment. Some members noted that, due to the weakness of domestic demand, the global economic recovery would only have an impact on domestic economic growth with a lag compared with Hungary's neighbours.

There was agreement among members that, based on the macroeconomic baseline scenario, the inflation target might be undershot significantly. It was also argued that, although it contributed to economic stabilisation, the improvement in external balance, accompanied by a sharp decline in domestic demand, had resulted in a very painful adjustment process for economic agents.

Monetary Council members also agreed that there had been a sustained and significant improvement in perceptions of risks associated with the Hungarian economy over recent months and that the risk of contagion through CEE financial markets had diminished. It was also argued that the likelihood that conditions in global financial markets would take a significant turn for the worse had lessened since the last policy meeting. However, several members referred to the fact that an increasing number of economic experts around the world and at home believed that financial market indicators had improved faster than would have been justified by global economic fundamentals, and, overall, the probability of asset price bubbles developing had increased. Some members thought that one factor contributing to this may have been that the actions taken by central banks had created ample liquidity and led to an environment of low interest rates. The danger was that the abundant global liquidity would only boost lending to the real economy in developed countries to a limited degree, and that this liquidity might instead strengthen demand for more risky financial assets.

Some members warned that, as discussed in the November issue of the *Quarterly Report on Inflation*, the risks to meeting next year's general government deficit target had increased. Another problem was that in this prolonged recession the country's debt as a percentage of GDP might rise further. On another argument, demand-side factors might explain the weak credit activity of the domestic corporate sector, as in the current environment it was not possible to identify those investment opportunities that could be supported by lending.

Council members remained of the view that it was both possible and necessary to continue the interest rate easing cycle. However, they were divided over the size of the next interest rate reduction and the expected length of the easing cycle. The majority of members continued to hold their view that by reducing interest rates gradually the Bank was more likely to create stability in a volatile environment. On another argument, the sustained and substantial fall in the risk premium on forint assets as well as excessive disinflation, inconsistent with the objective of price stability, might justify accelerating the pace of interest rate cuts. Some members, however, warned that with the easing cycle drawing to a close, the risks of overshooting might increase. Several members were of the view that an overly predictable series of interest rate cuts might fuel speculation about further cuts. That, in turn, might lead to a decoupling of market prices from assessments of risks to forint assets over

the short term and might distort the information content of yields at the short end of the curve.

Monetary Council members agreed that the consolidation of the financial markets had provided some scope to restore the width of the interest rate corridor. The majority of members thought that the step to widen the interest rate corridor could at best only have a marginal and uncertain impact on monetary conditions; however, it could help the interbank market return to normal.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Six members voted to reduce the base rate by 50 basis points, two members voted for a 75 basis point reduction and one member preferred a reduction of 25 basis points.

Votes cast by individual members of the Council

In favour of reducing the base rate to 6.50%	**6**	Vilmos Bihari, Csaba Csáki, Ilona Hardy, Ferenc Karvalits, Júlia Király, András Simor
In favour of reducing the base rate to 6.25%	**2**	Tamás Bánfi, Judit Neményi
In favour of reducing the base rate to 6.75%	**1**	Péter Bihari

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 21 December 2009. The minutes of that meeting will be published at 2 p.m. on 13 January 2010.