MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 21 DECEMBER 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, in November 2009 annual CPI inflation was 5.2% and core inflation was 5.0%. CPI inflation rose by 0.5 percentage points and core inflation by 0.1 percentage point relative to the previous month. These increases in inflation were largely driven by a rise in the annual index of motor fuel prices, in which the base effect of the decline in prices last November played a major role. The November data do not point to rising inflationary pressures in the economy, as trend inflation has clearly been falling in recent months compared with the first half of 2009.

Market services prices, a component of core inflation, remained broadly flat in November compared with the previous month. Owing to the sharp decline in domestic demand and the modest rate of wage growth in the service sector (the annual index of unit labour costs in market services fell to 0), annual inflation of market services prices remained at a historical low. Tradables prices rose in November on a month-on-month basis as one-off effects wore off. Food prices continued to reflect the sustained weakness of domestic demand, but unprocessed food prices rose slightly in November, following several months of decline, mainly on account of higher prices for seasonal foods (fresh fruit and vegetables).

According to the CSO release, Hungary's GDP contracted by 7.1% in 2009 Q3 compared with the same period of the previous year. That was the same as the declines recorded in the first three quarters of 2009. The economy contracted by 1.8% relative to the previous quarter. This meant that Hungarian output continued to drop for the sixth consecutive quarter, accompanied by rising demand abroad and falling demand at home. Owing to a pick-up in external demand, industrial value added started rising again, after having fallen in the previous five quarters. By contrast, the decline in market services and construction continued, driven by weakening domestic consumption and investment. On the expenditure side, more significant declines in household consumption expenditure were observed. Second-quarter consumption data were somewhat more benign, due to households bringing consumption forward ahead of the VAT increase in July, but the sector's adjustment to the adverse economic environment continued in Q3. Net trade made a positive contribution to the change in GDP during Q3, reflecting the pick-up in external demand. Nevertheless, the negative impact of slack domestic demand was only partially offset by rising external demand.

October's industrial production data reflected the improvement in industrial output in previous months. Export sales continued to be the main driver of this rebound, although domestic sales appear to have stabilised as well. The impact of stronger external demand was also reflected in the high surplus on trade in goods, which was about the same as in the previous months of the year. Industrial production data for the euro area and Germany, however, suggest that external demand may be more subdued in the coming months.

According to the Labour Force Survey data published by the CSO, the unemployment rate stood at 10.3% in 2009 Q3, up 2.6 percentage points on the previous year. The drop in private sector employment was offset in part by an increase in government sector employment, closely linked to the 'Pathway to Work' programme. There was no significant change in the number of whole-economy full-time employees in October. By contrast, the number of employees working more than 60 hours monthly fell slightly. As an effect of the more benign economic environment, workers are moving back from part-time to full-time jobs in an increasing number of industries.

Earnings growth in the private sector continued to slow in October. Shifts across industries continue to vary widely. In market services, for example, wage moderation observed in the course of the year continued. Earnings growth in manufacturing, on the other hand, appears to be picking up, consistent with the improvement in economic activity. The rate of earnings growth in October was largely in line with the path outlined in the November issue of the *Quarterly Report on Inflation*.

Financial market developments and the vulnerability of the banking sector

Financial markets

International investor sentiment continued to have the greatest impact on developments in Hungarian financial markets. But in contrast to previous periods, in addition to news about developed economies and their economic policies, country-specific factors related to two smaller economies also played a key role: increased perception of risks associated with Dubai and Greece had a considerable impact on global investor sentiment and financial developments in Hungary. Based on the more important risk measures, assessments of risks associated with the Hungarian economy deteriorated somewhat over the past month. For example, the five-year sovereign bond spread rose from 214 basis points to 242 basis points. The spread over five-year euro forward rates five years ahead rose slightly more strongly, by 48 basis points, although this was caused in part by the flattening of the euro yield curve. And yield spreads on Hungarian foreign currency government bonds also reflected waning risk appetite, with an increase of 13 basis points in the yield spread on the five-year euro bond.

Developments in yields on government securities have been mixed since the Council's last policy decision. Yields at the shorter end fell modestly, by 5–12 basis points. But rises in the risk premium had a greater effect on yields, both at the middle and the long end of the curve. Benchmark yields at maturities over one year rose by 42–51 basis points. Investor demand was volatile at the auctions of government paper. The Debt Management Agency issued the usual amount of government securities on offer in previous months. Issues were oversubscribed by 1.5–4.8 times at the auctions. The repurchase and bond exchange auctions held in the month were successful.

The forint exchange rate has continued to fluctuate within the EUR/HUF 265–280 band since July. During October, the rate followed the shifts in sentiment on international markets, but volatility remained high compared with the other currencies of the region and even increased further relative to previous months. From an initial level of EUR/HUF 268, the exchange rate weakened by 3%, standing at EUR/HUF 276 on the Friday morning before the Council meeting. Non-residents' spot forint positions fell by some HUF 370 billion during the month. The sector reduced its total exposure to government securities by HUF 31 billion, its holdings of MNB bills by HUF 65 billion and its holdings of equities by HUF 60 billion. Non-residents' net FX swap positions increased by HUF 40 billion.

Interest rate expectations have increased by some 25–40 basis points since the last policy decision. Based on FRA quotes, the market expects interest rates to be lowered by 25–50 basis points at the December meeting. From 5.4%, interest rates implying the bottom of the current interest rate cycle rose to 5.85%. The MNB is expected to reach the end of the easing cycle in 2010 Q1.

The stability of the banking sector

Currently, the financial sector is not dampening the severity of the economic recession, but rather exacerbating the downturn by curtailing lending activity. Banks' lending capacity (i.e. their income, liquidity and capital positions) is adequate, but their willingness to lend is low. Due to weak demand for credit caused by the decline in economic activity and strong credit supply constraints, there has been a persistent decline in lending to the corporate sector. Consequently, the turnaround in lending activity, which was originally expected to take place in Q3, will come later. The turnaround in lending to the household sector is also likely to occur with some delay. However, according to lending survey evidence, this is due less to supply-side factors and more to demand-side factors (i.e. the decline in household income and consumption).

In the future, continued – and potentially stronger – deleveraging by parent banks may constrain bank credit supply. This process may be amplified by parent banks' low level of profitability, owners' plans to strengthen core activities, efforts by home country governments to support the economy by providing credit, and the gradual withdrawal of longer-term liquidity provision by the ECB. This, in turn, may force owners of Hungarian banks to further reduce the loan-to-deposit ratios for their subsidiaries. The decline in the loan-to-deposit ratio has stopped in recent months (i.e. during the period from end-September), due to a slowdown in deposit inflows, and the outflow of foreign funds has also stopped. If deposit inflows remain weak and banks' risk appetite remains low, the necessary reduction in the loan-to-deposit ratio may result in lending activity remaining restrained, particularly in the corporate sector.

This process may also be reinforced by the fact that global financial markets – including the Hungarian market – will react increasingly sensitively to negative news (e.g. Dubai crisis, rating downgrade of Greek sovereign debt, worries about the condition of Austrian banks, press rumours), as is clearly reflected in the recent rise in the number of turbulent periods. Additionally, the possibility of a rapid withdrawal strategy by the ECB presents a number of risks. On the one hand, excessively rapid withdrawal of unconventional monetary policy instruments by the ECB may trigger a new confidence crisis. On the other hand, in its relevant decisions the ECB focuses mainly on the euro area and may ignore the situation in non-euro area Central and Eastern European countries. Liquidity in the domestic money markets (mainly in the FX swap market) and domestic banks' funding position may deteriorate further, which, in turn, may force the Hungarian subsidiaries of foreign banking groups to further reduce their loan-to-deposit ratios. In addition, the ECB terminating its Term Auction Facility operations may lead to a shortening in the maturity of foreign funding for domestic banks.

As expected, the quality of domestic banks' loan portfolio has deteriorated further in recent months. The impairment of corporate sector loans was due to weakening profitability caused by declining economic performance. In the case of household sector loans, rising unemployment has played a dominant role in the deterioration in portfolio quality. It is important to note that loan restructuring has gathered pace recently. This allows banks to reduce the risk of loans becoming non-performing and the need to increase their loan-loss provisioning. In the case of a prolonged recession or persistently low economic growth, however, restructuring will not help banks to avoid losses, rather, it may lead to an accumulation of losses.

Despite the sharp rise in the costs of risk, the banking sector's profitability continues to significantly exceed expectations. However, this is a short-term phenomenon and may be explained by one-off items. The net interest margin, a dominant driver of profitability, has fallen further recently. Consequently, banks are likely to be less able to offset the negative impact of provisions on profits next year.

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

Monetary Council members agreed that, in the current real economic environment characterised by subdued demand, the outlook for inflation provided scope to reduce the central bank base rate further. The overwhelming majority of members thought that for the time being developments in global financial markets reduced the scope for interest rate easing to continue at the pace of recent months, even though such easing was justified by macroeconomic conditions.

There was agreement among members that the real economy was proceeding along the expected path: growth driven by domestic demand had not yet begun, and the performance of exports had been slightly better than expected. As regards external economic activity, the short-term picture was somewhat more benign than previously expected, but there was a significant risk that the fiscal stimulus measures taken by governments worldwide would not prove to be successful over the long term. The evolution of inflation was largely consistent with the previous favourable path, and the latest inflation data did not influence the outlook for future inflation.

In the Council's judgement, there had been no further improvement in external risk conditions over the past four to six weeks and, moreover, there had been some deterioration in the past two to three weeks. Several members noted the negative news about Dubai and Greece, which might caution countries with high external and domestic debt, such as Hungary. It was also argued, however, that looking back over the longer term Hungary's position had clearly improved and markets appreciated the changes that had taken place recently, particularly as regards stability and fiscal policy. Some members reaffirmed their view held at previous meetings that excess liquidity continued to concentrate in the liquid segments of the financial markets rather than in long-term financing opportunities, which, in turn, could lead to the development of new asset price bubbles. Large-scale fiscal expansion might affect adversely corporate finances and the outlook for growth through the crowding-out effect over the longer term.

Council members agreed that the previous interest rate decisions and comments on interest rate policy had made it obvious that, in view of the outlook for inflation, it was justified to continuously reduce interest rates, which the MNB had implemented gradually. However, at present slowing the pace of interest rate cuts was justified by recent developments. Several members noted that – despite the adverse international developments – a sudden change in the stance of policy would be unreasonable and would be inconsistent with the Bank's interest rate policy favouring a gradual approach to interest rate adjustments and predictability. On another argument, one could not ignore the effect of the rise in the risk premium as was the case with regard to the VAT increase, as it was impossible to tell how long the rise in the risk premium might last. Some members stressed that rate adjustments took time to affect the broader economy, while immediate market reactions might influence the country's financing conditions even in the short term.

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 25 basis points and one member voted for a 50 basis point reduction.

Votes cast by individual members of the Council

In favour of reducing the base rate to 6.25%	**7**	Péter Bihari, Vilmos Bihari, Ilona Hardy, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of reducing the base rate to 6.00%	**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 25 January 2010. The minutes of that meeting will be published at 2 p.m. on 10 February 2010.