MAGYAR NEMZETI BANK

# MINUTES

## OF THE MONETARY COUNCIL MEETING

## OF 21 JUNE 2010

*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 May 2010, annual CPI inflation stood at 5.1% and core inflation at 4.0%, 0.5 percentage points and 0.3 percentage points lower, respectively, than in the previous month. The marked decline in unprocessed food prices, due to a base effect from last May's sharp rise, made a significant contribution to the slowdown in inflation in the month. Food price inflation was flat. Services inflation remained at historically low levels, explained by weak domestic demand. Tradables inflation eased markedly in May, with the prices of both durable and non-durable goods falling. In contrast with increased volatility in previous months, sluggish domestic demand had a strong downward impact on tradables prices in May. Overall, the trend rates of inflation, which better capture underlying inflation developments, have continued to fluctuate in a range of 1%–2% recently.

The release of detailed GDP data suggested that the economy had posted a better-than-expected performance in 2010 Q1, consistent with the Bank's earlier expectation. On aggregate, the data were in line with the projections in the May *Quarterly Report on Inflation*. However, structural divergences within the economy remained. The pick-up in external markets continued to be the primary engine of domestic growth; and the decline in domestic demand slowed. This was also reflected in the structure of the production and expenditure sides of value added. On the production side, industrial output growth made a positive contribution to changes in value added and the decline in market services moderated. On the expenditure side, net trade continued to be a factor driving growth, with changes in inventories also making a positive contribution. Domestic expenditure components continued to make negative contributions to growth; and there was a moderation in the rate of decline in consumption and investment spending. However, machinery investment declined by less than previously, in contrast with construction investment which fell more sharply.

The annual and monthly rates of industrial production growth both picked up in April, with the former standing at 9.7%. The trend of domestic growth was consistent with developments in industrial production in Germany, Hungary's most important trading partner, and other countries of Central and Eastern Europe. In line with these developments in production, trade in goods continued to pick up in April, associated with a significant surplus. Due to continued weak domestic demand, growth in imports is likely to have reflected a higher import content of exports and faster stockbuilding. Trade in goods recorded a EUR 1.3 billion surplus in the first four months of the year, up significantly from EUR 0.5 billion in the same period of 2009. Confidence measures and the latest (May) data for new orders suggest a continued expansion of production. However, the fiscal austerity measures announced by Hungary's major trading partner countries pose downside risks to the medium-term outlook for growth.

Private sector gross average earnings growth did not accelerate further in April, with the rate of regular pay growth falling markedly after increasing in March. Gross average earnings growth in manufacturing continued to be rapid, explained in part by improving activity and a base effect. Wage growth in market services remained moderate. According to the latest employment data, private sector employment may have bottomed out, and the expected turnaround in manufacturing employment may have started in recent months, in line with developments in economic activity. The number of full-time employees in the sector has been rising gradually for some time, while the number of those in part-time work has remained historically low.

**Financial market developments**

Global markets have been characterised by mood swings since the Council's last policy decision. In most markets, the period can be divided into two distinct phases: during the first few days of June investors' appetite for risk diminished, followed by a subsequent recovery, which, however, was patchy. A number of key market exchange rates and yields (e.g. the dollar/euro exchange rate, and German and US yields) moved away from their initial levels for a short while, only to return to levels seen at the end of May. Equity indices rose on balance over the period, but yield spreads of PIIGS countries widened again. Country-specific factors, in addition to changing global sentiment, may have played a role in developments in Hungarian asset prices. The deterioration in the relative assessment of Hungary and the region was not fully corrected in the second half of the period.

With the reintensification of sovereign risks, yield spreads on bonds of peripheral euro area countries rose in the period. Initially, spreads rose in almost every country, in which the credit downgrade of Spanish debt to AA+- by the rating agency Fitch may have played a role. However, the subsequent correction was uneven: whereas the Italian spread fell sharply, significantly improving the country's relative position, spreads of the rest of the PIIGS countries began rising again towards the end of the period. In Spain, press rumours about work going on to draw up a joint EU/IMF rescue package as well as concerns about the health of the country's banking sector, and, in Greece, the downgrade of the country's debt to speculative grade contributed to the widening in spreads. The successful bond auctions conducted in Spain this Thursday helped reduce concerns and led to a fall in spreads.

As part of efforts to achieve fiscal sustainability in the euro area, EU finance ministers announced plans to tighten financial sanctions imposed under the excessive deficit procedure and to strengthen the scrutiny of Member States' government budgets. Further measures aimed at reducing deficits were announced in the past few weeks. This time, Germany and France, the two largest euro area economies, published fiscal consolidation programmes worth EUR 80 billion and EUR 100 billion, respectively. Presumably, these contributed to the sharp declines in the latest business confidence measures.

Exaggerated, ominous political statements about the state of public finances in Hungary led to a 5% depreciation of the forint over the span of two days towards the end of the first week of June. This meant that the Hungarian currency significantly underperformed relative to any other currencies, dragging currencies of the region down with it. The exchange rate rose from EUR/HUF 275 at the beginning of the period to over EUR/HUF 290. After the Government reinforced that it would remain committed to meeting the deficit target, a reversal in domestic assets prices, including the exchange rate of the forint, occurred in the following week. Market reaction to the Government's proposed 29 step economic action plan was also positive, although several assessments pointed out the uncertainty surrounding a planned levy on banks and its potentially detrimental effects, as well as the uncertainty related to the lack of details of the plan. Losses recouped by the forint may have been the biggest compared with other currencies of the region, but the Hungarian currency failed to move all the way back to the level seen at the end of May: the exchange rate currently stands at EUR/HUF 280, reflecting a 1.5% depreciation over the period as a whole (similar to the performance of the leu). By comparison, the zloty remained unchanged and the koruna lost 1% of its value. The forint registered greater losses against the Swiss franc, given the further appreciation of the franc against the euro since the latest Council decision. The CHF/HUF exchange rate rose by 5% to 203 during the period, reaching a local maximum of 208. The statement issued by the Swiss National Bank on its June meeting no longer made reference to efforts to stem any excessive appreciation of the Swiss franc against the euro, after official foreign exchange reserves increased by CHF 80 billion or 53% in May, according to data released recently.

Non-residents' total spot forint position fell by HUF 300 billion in the past three weeks. Forint selling peaked around the time of the disturbing political remarks. However, amid continued negative sentiment worldwide, investors continued to close out their positions even following statements to calm the market over the weekend. Non-residents' total position has increased by HUF 100 billion since the announcement of the Government's action plan.

The disturbing political remarks led to an increase in Hungarian CDS spread above 400 basis points from 280 basis points at the beginning of the period. This, similarly to the foreign exchange market, was far stronger than the rises in other countries of the CEE region, which, moreover, were related in large part to domestic events. However, the subsequent falls in CDS spreads in countries of the region were slower and smaller than in Hungary. Movements in countries with CDS spreads similar to that of Hungary were not especially large during the past three weeks: in Hungary, Romania and Bulgaria they rose by 64 basis points, 93 basis points and 67 basis points respectively relative to the end of May. In the case Romania and Bulgaria, country-specific factors may have also played a role: whereas in Bulgaria questions arose over the credibility of official statistics, in Romania domestic political tensions added to country risk.

Deviations in implied FX swap market rates from money market rates fell in June after rising in May, suggesting a normalisation of domestic foreign currency liquidity conditions. Despite this, Hungarian banks not only had recourse to the MNB's three-month FX swap facility at the beginning of the period, but also on several occasions subsequently, in a total amount of EUR 585 million.

The domestic bond market was also affected by investor concerns, as reflected in rises in yields and the drying up of markets. The five-year yield rose from 6.7% at the beginning of the period to above 7.9%, but only edged back to 7.25% during the ensuing correction. The ten-year yield, up 25 basis points, rose less sharply during the period. The bond market's liquidity indicator fell back to levels seen last summer, and traders reported an almost complete drying-up of the market following the remarks. At the auctions of treasury bills and bonds, securities on offer were around twice oversubscribed. The first twelve-month discount Treasury bill auction following the intensification of market concerns, where the amount on issue was only slightly oversubscribed, was an exception; however, bonds at auction were again more than twice oversubscribed during the last week.

The change in perceptions of country risk was also reflected in movements in money market rates. Expectations of interest rate cuts were priced out of FRA quotes as the forint depreciated and the CDS spread increased, and, moreover, the local maximum of forward rates six months ahead was 25 basis points above the central bank base rate. The near end of the curve flattened out around the current interest rate level by the end of the period.

**Position of the banking sector**

After the decline of some HUF 100 billion in April 2010, outstanding bank lending to the corporate sector fell by only HUF 10 billion. Including the May data which were better in terms of the role of the banking sector in supporting economic growth, total corporate lending by banks and their branches fell by HUF 237 billion or some 3.4% in the first five months of the year. The fall in outstanding household loans accelerated in January–April, bringing the decline in total outstanding bank lending to HUF 70 billion. According to available data, the pace of decline in the stock of lending slowed somewhat. Nevertheless, outstanding bank lending contracted by a net HUF 11 billion or nearly 1% relative to December 2009.

Forint loans have been rising as a percentage of new lending (nearly 82% of new lending was denominated in the domestic currency, according to data for May). This may strengthen the interest rate transmission mechanism over the longer term, but its short-run effects are insignificant due to the low amount of new lending. It is also positive that forint loans continue to rise as a percentage of new mortgage lending to the household sector: forint-denominated loans accounted for 78% of new loans in May. Available data suggest that the new regulation on prudent lending has not yet had a major impact on lending volumes, but may have contributed to the shift towards forint loans within the total.

The quality of bank loans to both the corporate and household sectors deteriorated further in 2010 Q1. The ratio of loans in arrears of more than 90 days increased broadly at the same rate as in previous periods, reaching 11.5% and 8.6% for companies and households, respectively. By contrast, the value of loan losses as a percentage of the total fell slightly. Consequently, loan loss provisions (2.4% for both companies and households) had a less marked downward effect on bank earnings than expected.

Cumulative within-year data indicate a significant increase in the sector's earnings, enhancing banks' ability to absorb stress. Pre-tax profits amounted to HUF 265 billion in the first five months of 2010, up from HUF 198 billion in the same period of 2009. Return on equity, calculated from pre-tax profits for the previous 12 months, rose from 12.52% in 2009 to 14.7% in May. The decline in provisioning and high interest income were the two major factors contributing to the increase in earnings.

Banks' capital positions continue to be satisfactory: the sector's capital adequacy ratio currently stands at 13.6%, due to the inclusion of interim profits in capital. Adverse exchange rate movements (primarily the appreciation of the Swiss franc) may lead to a significant deterioration in portfolio quality, but the stress tests conducted indicate a moderate need for external funding even assuming extreme exchange rate movements. Along the stress path, calculated taking into account the effects of the Government's planned levy on banks, additional capital needs of the sector may remain low. At the same time, the levy would reduce domestic banks' profitability, and may lead to a reweighting by parent banks of their activities in the region and their resource and capital allocation, the curtailment of activities (including lending) in Hungary and the withdrawal of part of liquidity, which may restrain economic growth.

The sector's short-term liquidity position is judged to be adequate. However, surplus liquidity is mainly available in forint, and, consequently, forint liquidity of banks with the largest amounts of outstanding swaps may be impaired by potential exchange rate depreciation, exposing them to risks. Banks' liquidity needs due to their outstanding swaps may be increased not only by the depreciation of the forint against the euro, but – assuming an unchanged EUR/HUF exchange rate – also by adverse movements in cross exchange rates (primarily the EUR/CHF rate). The sector has rolled over significantly its outstanding swap contracts since 2009 Q1 (the average remaining maturity of swaps entered into with non-residents has risen above two years). As a result, the amount under swaps banks will need to roll over this year is only EUR 2.4 billion.

Maturities of foreign funding, the dominant component in terms of securing funding for the domestic banking sector, have shortened this year (the share of funding with remaining maturities of less than one year rose to nearly 50% by the end of March 2010 from 48% at the end of 2009). However, risks related to banks' rollover needs (some EUR 17 billion this year) may continue to be mitigated by funding from parent banks, which rose gradually to exceed 60% at the end of 2010 Q1 as percentage of foreign funding and remained stable even during the financial crisis.

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

Monetary Council members agreed that the outlook for the economy had not changed materially during the short period since publication of the May 2010 *Quarterly Report on Inflation*, but felt that the scope to ease monetary policy had narrowed further, due to increased perceptions of the risks associated with the Hungarian economy.

In assessing the outlook for inflation, members of the Council agreed that the Government's measures affecting administered prices might have an overall neutral impact on inflation until the price-setting mechanism was transformed at the system level: those measures, while possibly leading to a slowdown in inflation over the short term, could create inflationary pressures on the horizon relevant for monetary policy. However, members were divided over the assessment of the latest inflation data. Some thought that the trend inflation measures, indicating a sustained fall in inflation, as well as better-than-expected readings of recent tradables inflation suggested that upside risks to inflation may have fallen since May. Others, however, judged last month's jump in services prices and the widening in the gap between manufacturing and service sector wage indices to be bad news for the inflation outlook.

Members pointed to the deterioration in perceptions of the risks facing the region and the European Union as a whole to be the most important factor affecting the current policy decision. In Europe, recent rises in risk premia may have been caused mainly by sovereign debt problems of Southern European countries. Communications by senior government party officials had also had an adverse impact on investor sentiment towards Hungary, in addition to the spillover of problems originating in other countries, which was only partially offset by the Government's announcement that it would remain committed to meeting the fiscal deficit target.

Council members agreed that market uncertainty could remain until full details of the Government's programme covering the entire spectrum of economic activity were established. A precise judgement about the likely effects of the Government's action plan on the fiscal budget and growth could not be formulated based on the official announcements made so far. The majority of Council members agreed that the introduction of a flat rate personal tax might help simplify the domestic tax system and might have a positive effect on economic agents' willingness to pay tax and the country's competitiveness, as suggested by the experience of countries of the region.

Commenting on the Government's plan to impose a levy on banks, several members noted that, unlike the experience in other countries, its purpose would be to raise additional revenue for the budget rather than to generate funds which could be tapped to resolve potential future crises. Furthermore, the amount the Government expected to collect from domestic banks through the levy was substantially higher than through schemes already implemented or considered elsewhere. Several members pointed out that the introduction of the bank tax might have an adverse impact on investor sentiment towards Hungary, and might also affect negatively foreign parent banks' willingness to provide funding to their Hungarian subsidiaries, thereby potentially leading to a narrowing of the credit supply.

In the Council's judgement, the medium-term outlook for the economy continued to suggest a path for inflation which would be around the Bank's target, although there were risks to that path. Currently, increased perceptions of risks were the primary factor limiting the scope for easing monetary conditions further. However, members' views concerning the risks to the inflation outlook and the persistence of increased risk perceptions were divided.

After the discussion, the Chairman invited members to vote on the propositions put to the

Council. Six members voted to maintain the base rate at 5.25% and one member voted for a 25 basis point reduction.

**Votes cast by individual members of the Council**

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| ***In favour of maintaining the base rate at 5.25%*** | **6** | Péter Bihari, Csaba Csáki, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor |
| ***In favour of reducing the base rate to 5.00%*** | **1** | Tamás Bánfi |

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

Tamás Bánfi
Péter Bihari
Csaba Csáki
Ferenc Karvalits
Júlia Király
Judit Neményi
András Simor

András Kármán, State Secretary of the Ministry for National Development and Economy, was present as the Government's representative.

**The Council will hold its next policy meeting on 19 July 2010. The minutes of that meeting will be published at 2 p.m. on 11 August 2010.**