MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 19 JULY 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 June 2010, annual CPI inflation stood at 5.3% and core inflation at 3.5%. CPI inflation rose by 0.2 percentage points and core inflation fell by 0.5 percentage points relative to the previous month. Although headline inflation increased slightly compared to May, price increases for a wide range of items in the core measure continued to slow, as reflected by the measures of trend inflation. Unprocessed food prices were an important contributing factor behind the increase in inflation, as base effects, in addition to unfavourable weather, led to a sharp rise in this product group. Within the components of core inflation, the decline in tradables prices was a notable development: prices of both durable and non-durable goods fell again on a month-on-month basis in June after the drop in May. These falls in prices in two consecutive months are difficult to interpret in an economic context, and it remains to be seen how lasting they will be. One possible explanation is that weak demand and sharp fluctuations in the exchange rate may have prompted market participants to change their pricing policies, which, in turn, may have influenced the last few months' data. Services inflation continues to be historically low, reflecting the effects of weak demand, with prices in the sector developing in line with the usual seasonal patterns for the month of June. The seasonally adjusted level of food prices fell further after the drop in May. In July, the effect of the VAT increase in 2009 will drop out of the annual comparison, and consequently, inflation is expected to fall markedly in the next few months.

In May, industrial production grew strongly, up more than 5% on the previous month. Growth continued to be driven by exports, but domestic sales also picked up on an annual basis. Production growth increased in a number of sectors as well as in the other countries in Central and Eastern Europe. The recovery may continue in the next few months, but falling Western European confidence measures indicate deterioration in the longer-term outlook for industrial production in Europe. Foreign trade in goods continued to pick up as industrial activity improved. Hungary's overall foreign trade surplus in the first five months of the year was substantially higher than in the same period a year earlier.

After increasing in the first two months of the year, retail sales fell in March and fell further in April. The total volume of retail sales declined by 9.5% in April relative to twelve months previously. Durable sales continued to fall the most sharply, but sales of semi-durable and non-durable goods also dropped markedly. Despite the increase in net real wages, there was little growth in retail trade in the past months. Lending to households also remained very subdued.

Hungary's external financing capacity fell slightly in 2010 Q1 and stood at 3.2% of GDP. Foreign trade data available in the second quarter suggest that the external financing capacity may also remain high during the period ahead. The decline in the country's net savings vis-à-vis the rest of the world was closely related to an increase in the income account deficit. Non-debt-creating outflows were significant, amounting to nearly EUR 700 million, mainly due to net intra-group withdrawal of funds, similarly to previous quarters. In line with these developments, the net external debt of both the public and private sectors increased slightly. Net external debt rose to close to 55% of GDP, with the gross debt-to-GDP ratio at 110%. The decline in net savings vis-à-vis the rest of the world was slightly less than expected, due in part to much higher use of EU funds than justified by the seasonal patterns for earlier years and in part to the better-than-expected outcome for the real economic balance.

After the correction in April, the private sector wage index slowed significantly in May. The slowdown in gross average earnings growth to 1.9% year on year was mainly related to sharp cuts in bonuses, while the annual growth rate of regular pay also fell, although by less than total pay growth. Compared with the same period a year earlier, bonuses fell most sharply in market services, but there was also a decline in manufacturing. Within regular pay, earnings continued grow at above 5% in manufacturing, in line with gains in productivity, while earnings growth in the service sectors, which are experiencing weak demand, continued to be lower. The data support the Bank's view that the strong rates of earnings growth at the beginning of the year may have reflected one-off effects, and that earnings growth may moderate as those effects wear off.

The latest employment data are consistent with the view that private sector employment may have also bottomed out in the past quarter, lagging behind the recovery in economic output. Employment has risen slightly in recent months. Gains were realised mainly in manufacturing and some sectors of smaller significance (agriculture, electricity, mining and construction), and there continued to be little material change in service sector employment.

Financial market developments

Financial markets showed a mixed picture in the past month. During the first part of the period, concerns over sovereign risks in Europe and worries about the potential spillover of those risks to the financial sector intensified. Uncertainty about the outlook for growth in the world and the US economies increased due to far worse-than-expected US macroeconomic data, which amplified the effects of sovereign risks on global financial markets. Accordingly, equity indices in developed and emerging markets fell sharply, investor appetite for risk diminished, CDS premia and volatility indices rose and yields on US and German government securities, perceived as safe haven assets, declined.

In the second part of the period, however, concerns eased, earlier losses in equity indices were partially reversed, demand for risky assets picked up and yields on US and German government securities rose somewhat. European banks reducing their demand for liquidity from the ECB played a role in the turnaround at the middle of the month, which suggested that the stability risks facing the euro area banking sector were exaggerated. There was little news from the macroeconomy to foster market optimism. Consequently, the improvement in the second half of the month remained moderate, and, on balance, the key financial market indicators deteriorated during the period. The euro has strengthened against the dollar since the Council's last interest rate decision.

The relative assessment of peripheral euro area Member States improved slightly, with the successful bond auction of a relatively large amount by the Spanish debt manager as a contributory factor. The rating downgrade of Portugal's sovereign debt by two notches had little impact on the market.

Changes in perceptions of risks associated with countries of the region largely followed movements in global sentiment, but the region underperformed relative to other emerging country economies during the period. In the first part, the danger that Romania would suspend its agreement with the IMF, on the one hand, as well as the strengthening of the Swiss franc against the euro and, consequently, other currencies of the region, on the other, led to market uneasiness. Along with Hungary, analysts cited Romania and Poland as countries where appreciation of the franc could lead to a deterioration in the quality of banks' loan portfolios and an increase in the ratio of non-performing loans.

In the second part of the period, perceptions of the risks associated with the Hungarian economy improved modestly, reflecting the turnaround in sentiment at mid-month. The forint, along with the Polish zloty and the Romanian leu, strengthened gradually to levels around EUR/HUF 280, after depreciating by 3% in the first part of the month. Hungarian CDS prices rose from 300 basis points in the first part of the period to above 340 basis points, then fell gradually to 314 basis points by the end of the month. The spread of the five-year ahead five-year forward over euro rates rose modestly, by 6 basis points, but was still down 35 basis points from 308 basis points at the beginning of June. Spreads of Hungarian euro-denominated bond yields over German Bund yields rose slightly, mainly due to increases in German long-term yields.

Yields on Hungarian government securities changed direction during the month, similarly to other asset prices, but there was an overall improvement in this market segment which was not confined to the second half of the period. Short-term yields rose slightly, by some 10 basis points, whereas yields at the longer end of the curve fell by 2–25 basis points.

Tensions in the FX swap market affected the overnight segment, with implied spreads on overnight transactions rising from 40 basis points in the previous month to above 90 basis points. In parallel with this, the aggregate indicator of market liquidity shifted adversely.

The increase in non-residents' net FX swap positions was accompanied by forint sales in the spot market in the amount of approximately HUF 200 billion, which suggested the establishment of short forint synthetic forward positions. In the latter part of the period, net outstanding swaps fell, and non-residents were buyers in the spot forint market. Overall, forint purchases in the spot market amounted to HUF 23 billion. Non-residents' holdings of MNB bills rose significantly, by HUF 468 billion, with a slight increase in their holdings of government securities and quoted shares.

Analysts' interest rate expectations are divided. Some anticipate one or more interest rate cuts in steps of 25 basis points, while the majority view is that interest rates will remain on hold for the remainder of the year before the next tightening cycle begins. Analysts still expect that the first interest rate increase will take place around the middle of 2011. The gap between FRA quotes and analysts' expectations has widened recently. FRA quotes have risen by 10–40 basis points, suggesting that the market prices in an increase of 25 basis points in official interest rates over a 4–7 month time horizon.

Position of the banking sector

According to preliminary data, outstanding bank lending to the corporate sector fell significantly in June following the modest drop in May. In part, this reflected withdrawals of credit lines by banks and in part demand factors, i.e. reduced customer funding needs. In H1, outstanding lending to the corporate sector fell by some HUF 300 billion or 4%, after eliminating exchange rate effects. The decline in lending to households continued at the pace observed in earlier periods. Outstanding lending to the sector fell by nearly HUF 90 billion or 1.2% in H1.

The increase in forint lending as a percentage of new lending strengthens the interest rate transmission mechanism over the longer term. Whereas the stock of foreign currency loans has been falling due to transactions, forint loans have been steadily rising. In May, nearly 100% and 80% of new unsecured loans and mortgage loans, respectively, were denominated in forint. Due to low lending volumes, however, this has so far had little impact and does not significantly influence the foreign currency structure of outstanding lending.

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 the ability of banks 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 12.5% in 2009 to 14.7% in May, mainly reflecting lower provisioning for loan losses and high interest income. Banks' capital positions continue to be stable. The sector's capital adequacy ratio stood at 13.1% at the end of May, and would be close to 14% if interim profits were included in capital. Banks continue to hold high liquidity buffers (mainly in forint), but liquidity strains may emerge if a protracted shock were to hit the sector.

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

Monetary Council members agreed that the suspension of the review of the joint IMF/EU loan agreement with Hungary had an adverse impact on perceptions of the risks associated with the economy, but felt that more time was needed to judge how long this tendency would last. Sustained reductions in the government deficit, measures to raise the growth potential of the economy, improving the partnership with international organisations, in addition to a declaration of the Government's commitment to fiscal consolidation, would be required to achieve a significant change in market sentiment. In order to stem excessive fluctuations in the exchange rate, the Monetary Council decided to continue the conversion of EU funds in the domestic market. The Council was prepared to tighten monetary conditions by raising interest rates if a sustained increase in risk premia were to occur.

During the discussion, Monetary Council members treated the assessment of recent developments in the macroeconomy and inflation separately from the issue of the likely impact of suspending the talks with international organisations on Hungary's room for manoeuvre in economic policy.

The majority of members took the view that – prior to the suspension of the talks on the international loan package – economic performance had been broadly in line with the May projection and there had been little change in the outlook for inflation. Some members thought that the trend decline in services inflation might signal a break in inflation persistence and this process might be supported by falling household disposable income related to the appreciation of the Swiss franc. On another argument, however, since publication of the May *Quarterly Report on Inflation* the inflation path may have shifted downwards due to depreciation of the forint, and the uncertainty in relation to future economic policy actions increased the risk of higher inflation.

In the Council's judgement, the increase in country risk over the weekend might have a material influence on the outlook for the economy. Through a change in the key assumptions underlying the projection in the May *Report*, sustained depreciation of the exchange rate implied substantially higher inflation than expected, possibly exceeding the target, even if demand conditions remained persistently weak. Some members took the view that a continuation of this trend might have a negative impact on financial stability. Monetary Council members agreed that in the absence of an agreement with the international organisations the country's ability to obtain financing might decline.

In discussing interest rate policy issues, the large majority of members preferred to adopt a wait-and-see attitude, as more time was needed to assess the market reaction to the postponement of the loan review. This would allow the Council to judge the extent to which the country risk premium would change and how the factors influencing the inflation path would evolve. Several members pointed out that premature central bank action would contribute to a further deterioration in the already negative market sentiment, and from a potential rate increase market participants would unduly infer that the Bank possessed insider information on the situation of the government budget or financial stability. Several members argued that the Government would gradually take stock of the country's real situation and draw up action plans taking into account the markets' reactions, which would help reverse the negative trends in market sentiment. It would therefore be justified for monetary policy to adopt a wait-and-see approach.

The Monetary Council decided to continue the conversion of EU funds in the domestic market, in order to reduce undesired exchange rate volatility. Members agreed that it might also be necessary to raise the key policy rate should a sustained increase in risk premia warrant a tightening of monetary conditions.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. All members voted in favour of the only proposition which was to maintain the base rate at 5.25%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 5.25%	**7**	Tamás Bánfi, Péter Bihari, Csaba Csáki, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor

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 Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 23 August 2010. The minutes of that meeting will be published at 2 p.m. on 8 September 2010.