MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 23 AUGUST 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 July 2010, annual CPI inflation stood at 4.0% and core inflation at 1.3%. Both measures of inflation fell significantly in month-on-month terms – the core measure by 2.2 percentage points and the CPI measure by 1.3 percentage points – as the effects of the VAT increase in July 2009 faded. Within the components of core inflation, annual services inflation remained at a historically low level, as a result of weak domestic demand. In July, the sector's prices developed broadly in line with the usual seasonal patterns. Seasonally adjusted, industrial goods prices stagnated in July after declining in previous months. The depreciation of the forint is not yet reflected in inflation data, but in the coming months it may cause a material rise in prices of industrial goods. The seasonally adjusted level of food prices fell further in the month following the decline in June, with the downward pressure on prices due to weak demand likely playing a role in this regard. As in the previous month, unprocessed food prices rose sharply in July, reflecting adverse weather conditions.

At 4.1%, industrial production growth continued in June and, consequently, the sector may have contributed positively to GDP growth in Q2. The strong expansion of exports continues to fuel production growth. The recovery in Hungarian industry is following a similar pattern of production growth as in other countries of the CEE region and the euro area. Indicators of activity in Germany and export orders at Hungarian industrial companies point to a further pick-up, which is a positive development in terms of the short-term outlook. Consequently, industry is likely to contribute to the recovery of the economy in Q3.

As production grew further, so did goods exports in June. In contrast, imports showed signs of faltering. Hungary's cumulative trade surplus amounted to EUR 1.9 billion in H1, nearly twice the surplus recorded in the same period of 2009. The contribution of net trade to GDP growth may have been substantial in Q2. There was a slight deterioration in the terms of trade compared with previous months, in line with developments in the world price of natural gas.

According to the CSO's preliminary release, Hungary's gross domestic product grew by 1.0% (0.8% after adjusting for calendar effects) in 2010 Q2, relative to the same period of the previous year. The correction from Q1 suggests that the economic recovery continues to be fragile. On the production side, industrial production growth continued. However, the performance of some industries producing for the domestic market may have been poorer. Construction output may have fallen further in Q2. Crop harvests in agriculture were adversely affected by the bad weather. On the expenditure side, the divergence between the benign external environment and weak domestic demand is expected to remain. Household consumption may have fallen further, depressed by the effects of weak income growth, tight credit conditions and the weak exchange rate. This is reflected in the sector's net lending, which surged dramatically in Q2, as gross saving increased and borrowing fell.

Private sector earnings growth continued to slow in June. Gross average earnings grew by 2.8% relative to June 2009. In contrast to recent months, cuts in bonuses were not as sharp. Earnings growth may also have slowed in part because the positive base effects from last year's reductions in bonuses wore off. At the same time, regular pay growth decelerated in all private sector industries, in addition to the effects discussed above. Wage setting in the major private sector industries has been affected similarly in recent months, but pay increases show a rather mixed picture. Manufacturing earnings growth continued to slow relative to the previous month, but the annual rate of earnings growth remained around 5% in June. In contrast, earnings in market services continued to grow at a subdued pace.

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, with increases registered in virtually all of the private sector industries in June.

Financial market developments

Global market sentiment improved in the first part of the period since the Monetary Council's last interest rate decision, reflecting positive quarterly corporate reports, the publication of the results of stress tests designed to assess the resilience of the EU banking sector and successful bond auctions conducted in some Mediterranean members of the euro area. In the second half of the period, however, investor appetite for risk began to decline again, although to various extents across individual markets. Despite the deterioration in sentiment, however, the major equity markets retraced only roughly one half of the gains from the first part of the period, and in most cases CDS premia of higher risk countries fell throughout the period.

The perception of risks associated with the Hungarian economy increased significantly as a result of the suspension of talks with the IMF and EU, which, in turn, led to an immediate, sharp decline in Hungarian asset prices: the EUR/HUF exchange rate surged by 10 forints, the five-year CDS premium by 50 basis points, the foreign currency bond premium by 22 basis points and the five-year ahead five-year forward premium by 24 basis points. During the period, premia in most markets fell after rising to higher levels. However, the five-year ahead five-year forward premium remained at elevated levels and the increase in the CDS premium was larger and more sustained relative to other markets. Whereas the CDS premium fell in all of the countries of the region (e.g. by 30 basis points in Romania and by 60 basis points in Bulgaria), it rose by 11 basis points in Hungary over the whole period. However, despite the fact that the news on the euro area was mostly positive, CDS premia increased even more sharply in some peripheral euro area countries.

Exchange rates of currencies of the CEE region followed a somewhat different path than prices in developed bond and equity markets. The sharp fall in the forint early in the period led to an abrupt decline in the region, which was reversed gradually by the middle of the month; and currencies of the region proved surprisingly stable during the deterioration in sentiment in the latter part of the period. Overall, the forint appreciated by 1% relative to its level prior to the last interest rate decision, slightly underperforming the zloty and koruna, which appreciated by around 3% during the month. The forint fluctuated in a 200–214 range versus the Swiss franc, approaching its opening level (CHF/HUF 208) by the end of the period again. Non-residents' net FX swap positions changed little during the month. Forint sales by the sector amounted to HUF 160 billion as the forint depreciated following the suspension of talks, but part of this was then offset by subsequent purchases.

Yields on long-term government securities remained broadly stable, despite news that the talks between Hungary and the IMF and EU had been suspended. Indeed, for the period as a whole yields actually fell by around 60–80 basis points. The bond auctions conducted in recent weeks were successful, with a return to the oversubscription rates observed in earlier periods following weak demand in more recent months. Non-resident holdings of government securities fluctuated within a relatively narrow range and did not change substantially. Movements in the forint exchange rate and prices of forint-denominated bonds as well as market analyses suggest that the most likely scenario is that Hungary and the IMF and EU will reach an agreement in the autumn and the necessary fiscal adjustment will occur.

Movements in forward rates diverged from those in other market prices, and in many cases were opposite to changes in global sentiment and the forint exchange rate. Expectations of an interest rate increase, priced into the market, fell relative to the middle of the period, but rose compared with levels prior to the Council's interest rate decision in July. At present, market rates imply a 9 basis point and a 28 basis points higher level than the current base rate for the three-month period beginning in one month's time and the period beginning in six months' time, respectively. Forward rates are therefore consistent with a gradually rising interest rate path. Economists polled by Reuters unanimously expect official interest rates to remain on hold at the Council's upcoming meeting. Although expectations of the base rate for the end of the year have risen relative to the previous month, their average is still 6 basis points lower than the current level of the base rate. In the short term, the Bank's policy rate remaining unchanged appears to be the most likely market scenario, and the likelihood of an unscheduled interest rate increase or the beginning of a tightening cycle this year is smaller: this may explain the difference between analysts' expectations and market rates.

Position of the banking sector

Credit aggregates still show little sign of a change in trend. According to preliminary data, outstanding bank lending to the corporate sector stagnated in July 2010, following the sharp decline in the previous month. However, it is expected that outstanding lending will continue to fall, due to subdued domestic demand and the tight credit conditions. The Bank's lending survey published in August revealed that the tightening of standards on lending to the corporate sector since 2007 had come to an end, but at the same time banks may maintain tight standards for a sustained period. Outstanding lending to households fell by around HUF 20 billion, by broadly the same amount as in the previous month. Forint loans as a percentage of new lending, however, continued to increase in June, which is viewed as a positive development. Forint loans accounted for 80% of new lending in the month.

Credit quality deteriorated sharply in 2010 Q2, and the resulting loan losses increased. The reversal of the decline in loan losses on lending to households and companies in previous months was due to the depreciation of the forint against the Swiss franc and larger-than-expected defaults on commercial real estate loans, respectively.

Calculated on a borrower basis, the ratio of loans in arrears of more than 90 days was 9.4% for households at the end of 2010 H1. The value of loan losses as a percentage of the total rose to 3%, up from 2.4% expected by the Bank. The difference is accounted for by a 15% weaker exchange than that used to produce the forecast. Loan restructuring also contributed to the deterioration in the quality of household loans. The continued rise in re-defaults within restructured loans affects adversely the future outlook. Although renegotiations of debt may reduce losses over the short term, the risk of restructured loans becoming non-performing increases over the longer term, if the economic recovery is protracted. According to the latest lending survey, the ratio of household loans in arrears of at least 30 days rose to 25% by the end of 2010 Q2.

In terms of quality, loans to the corporate sector performed similarly to household loans. Calculated on a borrower basis, the ratio of loans in arrears of more than 90 days rose to 12.2%. The value of cumulative 12-month provisions as a percentage of total outstanding lending was close to 3%, significantly higher than the Bank's 2.5% forecast. Larger-than-expected losses on commercial real estate lending accounted for the entire difference between the actual and forecast values. The ratio of restructured loans changed little in 2010 Q2. According to the survey data, however, the restructuring of loans to small and medium-sized companies as well as of commercial real estate loans was much less successful. Following restructuring, the ratio of borrowers re-defaulting by being at least 30 days overdue reached 20%–25% in both segments.

Pre-tax profits of the Hungarian banking sector (credit institutions operating as limited companies and branches combined) amounted to HUF 176 billion in 2010 H1. This represented a sharp decline compared with the previous month, and, for the first time this year, the pre-tax profits of the banking sector were below the levels of previous years on a time-proportionate basis. Consequently, return on equity, calculated from pre-tax profits for the previous 12 months, fell to 10% by the end of the June 2010 from 12.5% in 2009. The fall in ROE was accounted for by higher provisioning for loan losses and an increase in other losses. In contrast, higher interest income due to the increase in the interest margin made a positive contribution to profitability. The capital adequacy ratio also fell, from 13.1% at the end of May to 12.6% at the end of June.

The deterioration in aggregate profitability and the capital adequacy ratio is viewed as a negative development. However, the increase in the asymmetry among banks also represents a risk to the banking sector. The three banks with the largest pre-tax profits accounted for 83% of the banking sector's earnings in June 2010, up from 60% at the end of 2009. Based on pre-tax profits, the number of loss-making banks increased from 15 to 17, and their ratio as a percentage of the balance sheet total jumped from 5% to 19% between late 2009 and June 2010.

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

Monetary Council members agreed that – despite the pick-up in economic growth this year – output would remain below its potential level and the unemployment rate would remain elevated on the horizon relevant for monetary policy. Members judged that the disinflation process could be expected to come to an end, but the future path of inflation may turn out to be better than the projection outlined by the Bank's staff in the latest *Quarterly Report on Inflation*, primarily because the output gap might be larger and might have a stronger effect than that assumed in the *Report*. Consequently, inflation might come close to the 3% target.

In assessing recent inflation developments, it was argued that the behavioural patterns observed in the economy, which underlay the projection in the *Report*, could well be overwritten by the events that had taken place in the wake of the crisis, namely stronger-than-expected balance sheet adjustment by the banking and household sectors. Accompanied by constrained credit supply, household saving might remain high, which might act as a brake on inflation on the demand side. Some members took the view that the lower-than-expected GDP data suggested the output gap might be larger than projected in the *Report*. Based on employment and earnings data, no inflationary pressure could be identified in the labour market. Several members noted that the distribution of risks around the baseline projection in the *Report* might be more balanced and it was encouraging that inflation expectations had fallen despite the adverse macroeconomic outlook, which had not been experienced before. Some members thought that, due to the recent volatility of the exchange rate, the depreciation of the forint had a weaker effect on the tradable sector and that the recent pattern of durables price inflation, contributing to the disinflation process, was not taken into account in the current projection model.

Others, however, argued that the higher inflation projection in the *Report* alone warranted policy tightening and the Council had no evidence that would point to a change in the future behavioural pattern of economic agents. Due to the depreciation of the forint and rises in prices of imported materials, inflationary pressures may have increased somewhat. Although a fiscal adjustment could affect positively the key assumptions of the *Report* in terms of the future path of inflation, the Monetary Council could not predict such an economic policy turnaround, and even such government measures would not be enough to bring inflation down towards the Bank's medium-term target. On another argument, the baseline projection in the *Report* might well underestimate future movements in commodity prices, which, in turn, might add to inflation risks.

Several members noted that perceptions of the risks associated with the Hungarian economy had increased since early May. The spread on Hungarian foreign currency bonds over German bonds had risen sharply, and movements in CDS spreads compared unfavourably with those in other countries of the CEE region. The rise in CDS spreads was particularly evident when looking back over a longer period.

The majority of Council members judged that policy tightening was not currently justified by the recent adverse developments. In the current uncertain environment, the Council had no adequate information to enable it to start a tightening cycle, and adopting a wait-and-see approach was likely to be a smaller mistake than deciding to start raising interest rates unduly.

Several members argued that fluctuations in the forint exchange rate, a key factor determining the risk premium and the inflation path, were driven by uncertainty surrounding the Government's economic policy. Consequently, any favourable shift could only be expected after the Government's plans were published. Some members, however, argued that increasing inflationary pressures, as discussed in the *Report*, could be contained at small real economic costs in the current environment, as the exchange rate appreciation associated with policy tightening could even stimulate the economy through a pick-up in domestic demand. Therefore, considering the potential costs and benefits, the Council should not delay in tightening monetary policy.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Four members voted to maintain the base rate at 5.25%, two members voted for a 25 basis point increase and one member voted for a reduction of 25 basis points.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 5.25%	**4**	Csaba Csáki, Ferenc Karvalits, Júlia Király, Judit Neményi
In favour of raising the base rate to 5.50%	**2**	Péter Bihari, 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 Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 27 September 2010. The minutes of that meeting will be published at 2 p.m. on 6 October 2010.