MINUTES

OF THE MONETARY COUNCIL MEETING

OF 27 SEPTEMBER 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 August 2010, annual CPI inflation stood at 3.7% and core inflation at 1.5%, as CPI inflation fell by 0.3 percentage points and core inflation increased by 0.2 percentage points relative to the previous month. The August decline in inflation was closely related to some items excluded from the core measure, such as non-regulated goods, motor vehicles and market energy. Core inflation remains at a historically low level, but the short-run indicators of inflation point to increased inflationary pressures for the coming months.

Annual services inflation continues to be historically low, reflecting the effects of weak domestic demand. In August, prices in the service sector developed broadly in line with the usual seasonal patterns. Seasonally adjusted, industrial goods prices stagnated in July and August, after declining in the previous months. The depreciation of the forint has so far had little effect on inflation, but in the coming months it may cause a material rise in prices of industrial goods. The seasonally adjusted level of food prices rose in the month, following a decline in July, while that of unprocessed food prices was flat following the earlier increases. The weak exchange rate, combined with adverse weather conditions earlier in the year, may lead to further rises in food prices.

According to the detailed CSO 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, but stagnated on a quarter-on-quarter basis, after growing by 0.6% in Q1. Rising economic activity abroad continues to be the driving force behind Hungarian growth, whereas domestic demand growth was slightly weaker than the projection in the August *Quarterly Report on Inflation*. Accordingly, on the output side, industry was the only sector to contribute positively to the change in value added. On the expenditure side, the growth of net exports and the change in inventories continued to be strong, with the latter primarily reflecting the gradual pick-up in industrial production and exports. Household consumption expenditure and gross fixed capital formation both fell further in 2010 Q2.

The rate of industrial production growth eased slightly in July, rising by 9% relative to twelve months previously, but falling by 1.0% relative to June. Various confidence measures and new orders suggest that industrial production is likely to continue growing in 2010 H2, albeit at a slower pace than in H1. However, global economic activity may slow as the growth impetus from stockbuilding and fiscal stimulus measures fades. Consequently, Hungarian growth is expected to be slower than in H1.

The volume of retail sales rose slightly in July 2010 relative to the previous month, with the annual rate of growth showing a sharp improvement, due to base effects. Considering that the actual data also reflect one-off effects and the key macroeconomic variables affecting household consumption do not as of yet show evidence of much improvement, an earlier-than-expected turnaround in consumption cannot be inferred from one month's data.

The preliminary data do not yet show any sign of a turnaround, although imports grew more strongly in July than exports. This fast import growth may be explained in part by individual items; the seasonally adjusted trade surplus was broadly as much as in the previous months of the year.

Private sector earnings growth continues to be moderate: pay increases in July followed the usual seasonal patterns from previous years. Gross average earnings grew by 3.0% and regular pay by 2.9% relative to July 2009. Based on seasonally adjusted data, annual manufacturing earnings growth returned to the 4%–5% range seen in late 2009, after picking up temporarily in early 2010. At below 3% in July, earnings growth in market services continued to be

historically low. On balance, the latest data available suggest a somewhat sharper adjustment in the labour market than previously expected.

The number of employees barely changed in July relative to the previous month, with employment numbers stagnating across all industries. The latest data confirmed that private sector employment may have also bottomed out in the quarter, lagging behind the recovery in output.

Financial market developments

Global market sentiment has been mixed since the Monetary Council's last interest rate decision. Safe haven asset prices once again surged to historical highs, while the major equity indices rose only slightly on the month (the Euro Stoxx and the S&P gained 3% and 4.5% respectively). Expectations about possible future actions by the major central banks, particularly about the Federal Reserve's policy, as well as growing concerns about the euro area were the key factors determining movements in asset prices. The US macroeconomic data releases over the past month were broadly consistent with the picture of a gradually slowing recovery. Credibility of the published results of the stress tests designed to assess the resilience of the EU banking sector, the fiscal impact of the government's rescue plan for the Irish banking sector and fears about the debt path of countries in the Mediterranean were the major contributing factors to the deterioration in sentiment on the euro area. These led to sharp increases in yield spreads on Portuguese and Irish debt.

Central and Eastern Europe was only modestly affected by fluctuations in global investor sentiment in the past month. However, country-specific factors were also a key factor influencing movements in domestic asset prices. In the first part of the period, the refusal of the Government to roll over its agreement with IMF had a negative effect on perceptions of the risks associated with the economy, but market reaction to the Government's commitment to meeting the 2011 deficit target was positive. At the same time, market economists and two credit rating agencies warned that after the local elections in October, specific actions should be announced which credibly guarantee that the deficit target will be met, consistent with sustainable growth. In the absence of such commitment, downgrades of Hungary's credit rating and falling asset prices can be expected.

The Hungarian CDS premium has risen by 12 basis points since the Council's August policy meeting. Although this was slightly below rises in Polish and Romanian sovereign premia, it was largely comparable with changes in premia in countries at a similar level of economic development. Hungary underperformed in this respect in the first part of the period, but its premium fell markedly during the last two weeks, both in absolute and relative terms. The forint exchange rate was more volatile compared with other currencies of the region, but did not significantly underperform over the period as a whole. The EUR/HUF exchange rate weakened from 278 at the beginning of the period to 289.5 and then returned to its initial level. The forint depreciated more sharply against the Swiss franc in the first part of the period (from CHF/HUF 210 to above 226), due to the appreciation of the franc against the euro, but then moved back close to its level at the beginning of the month. The upward revision by the Swiss National Bank of its projections for growth and inflation, resulting in a weakening of the franc, played a role in this.

Non-residents' forint position changed little overall in the period: they sold nearly HUF 300 billion in the foreign exchange market during the first three weeks, but then repurchased a large part of that amount. During the period, their outstanding swaps increased by nearly HUF 170 billion, of which purchases of MNB bills and forint-denominated government securities amounted to HUF 80 billion and HUF 90 billion respectively.

Yields on long-term government securities also fell following a temporary rise, but remained above levels at the beginning of the period: the ten-year yield rose from 6.7% to 7.5% and then eased slightly to 6.9%. The bond auctions conducted in the past month were successful, with the amounts sold by the debt manager exceeding expected levels in some cases, as the issues were significantly oversubscribed.

Short-term yields rose sharply in the first part of the period, and the short end of the money market yield curve was consistent with an interest rate path rising in monthly increments of 25 basis points at the time of the month's peak on 9 September. Although expectations of an official interest rate increase have since fallen, yields rose by 20–30 basis points from their levels at the beginning of the period. Consequently, FRA rates for the periods beginning in one, two and three months' time are 11 basis points, 33 basis points and 44 basis points higher respectively than the central bank base rate. Economists polled by Reuters unanimously expect official interest rates to remain unchanged at the Council's upcoming meeting. There is also a fairly strong consensus that the Bank's easing cycle has come to an end: only two analysts believe that the base rate is likely to be lowered further. Although expectations of the base rate for the end of the year suggest that policy is most likely to remain on hold, economists' written comments accompanying their numerical forecasts indicate the probability of major tightening as a risk path. This is confirmed by the fact that opinions are strongly divided over the possible timing of the first interest rate hike: forecasts range from October 2010 and the first quarter of 2012.

Position of the banking sector

Outstanding bank lending to the corporate sector increased slightly in July–August after falling sharply in H1. By contrast, outstanding lending to households fell by around HUF 20 billion in August, broadly the same as in the previous month. Households' outstanding borrowing is expected to fall further, and the portfolio of loans to the corporate sector may start falling again.

The deteriorating macroeconomic and financial environment may prompt banks to further adjust their balance sheets. Credit losses on household and corporate sector loans are increasing sharply, because of the depreciation of the forint against the Swiss franc and persistently high unemployment, and because of the higher-than-expected default rate on commercial real estate loans. In addition to credit losses, the imposition of the bank tax is likely to lead to a deterioration in banks' ability to accumulate capital., prompting them to restore their capital adequacy by cutting back lending.

The curtailment of lending is likely to mainly affect the corporate sector for a number of reasons. First, the average maturity of corporate loans is much shorter than that of household loans. Therefore, when quick adjustment is necessary, it can be achieved by curbing lending to companies. Second, the average margin on lending to companies is smaller than that on household loans, and, therefore, in terms of profitability it is more reasonable for banks to cut back lending to the corporate sector. Third, corporate loans have a greater weight in risk-weighted assets (the denominator of the capital adequacy ratio) and, consequently, removing a unit of corporate loans will increase the capital adequacy ratio by more than removing a unit of household loans. The Bank's lending survey published in August is consistent with this picture. Although the tightening of standards on lending to the corporate sector since 2007 has come to an end, banks may maintain tight standards for a sustained period. All this suggests that the banking sector will continue to provide little impetus for the recovery.

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 the average of outstanding lending approached 3%, at the end of June and is estimated to have remained

around that level in August. In the household segment, the ratio of loans in arrears of more than 90 days was 9.4% on a borrower basis at the end of 2010 H1. At the same time, the value of loan losses as a percentage of the total portfolio rose to 3%, and is likely to have remained close to that level in August.

Pre-tax profits of the Hungarian banking sector (credit institutions operating as limited companies and branches combined) amounted to HUF 197 billion in the first eight months of 2010. Pre-tax profits were practically zero after the significant losses recorded in June. In August, banks had pre-tax profits of HUF 22 billion. Return on equity, calculated from pre-tax profits for the previous 12 months, fell to 8.4% by the end of August 2010 from 12.5% in 2009. The capital adequacy ratio stood at 12.9% at the end of July.

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

Monetary Council members agreed that the Hungarian economy had begun to emerge from recession in 2010, but that output was only likely to slowly return to potential. Due to the persistent weakness of domestic demand, inflation was expected to ease back to close the 3% target on the horizon relevant for monetary policy and, therefore, interest rate policy should adopt a wait-and-see approach until incoming data suggest otherwise.

Members concurred that the economic recovery might be slower than previously expected, and that domestic demand factors might play a key role in this regard. Several members noted that developments in households' outstanding borrowing were unfavourable considering the sector's wealth position and income. In addition to forced savings related to rising monthly instalments on loans, households' willingness to borrow may have fallen and, therefore, the sector's net lending was likely to rise on a sustained basis. Reduced lending by banks was likely to contribute to this process.

During the discussion of interest rates, members focused on reviewing recent inflation developments. The majority of members agreed that the latest data appeared to reinforce the Council's assessment of domestic inflation developments in the previous month. Some members noted that the change in industrial goods prices had been more favourable than expected, which pointed to slower or weaker exchange rate pass-through than previously experienced. In this respect, several members noted that the effects of the forint exchange rate on inflation developments may have changed recently: not only did the weaker exchange rate exert inflationary pressure through import prices, but it also acted to reduce income available for consumption and constrained investment spending. That, in turn, dampened the increase in prices on the demand side.

Some members noted that the increase in forced and precautionary savings might restrain consumption over the long term, thereby contributing to a further decline in inflation. In this context, others pointed to the decline in the import content of consumption, which might dampen inflationary pressure arising from exchange rate depreciation.

For several members, the decline in wage inflation was a positive development, which – if it proved lasting – could have a benign impact on inflation expectations and the long-term outlook for monetary policy. On another argument, macro demand might continue to fall due to the Government's commitment to meeting the 2011 deficit target, which would also support the Bank's disinflation policy.

Some members, however, pointed out the upside risks to inflation. The latest inflation data suggested that prices would rise more rapidly over the near term than in the baseline projection in the August *Report*; and inflationary pressure arising from postponed price hikes

might build up as the recovery proceeded. It was also argued that future developments in the prices of commodities and foods might be less favourable than in the *Report* projection, and this added further upside risks to inflation.

In the Council's judgement, the Government's commitment to meeting next year's 3% deficit target had been a factor preventing a further increase in perceptions of the risks associated with the Hungarian economy. Several members cautioned, however, that the specific actions underlying that commitment were not yet known. Fiscal balance was seen to be an economic policy step towards sustainability; however, the structure of the measures aimed at improving the balance also influenced the room for manoeuvre in monetary policy.

The majority of Council members took the view that the outlook for inflation had not changed in the past month and, therefore, interest rate policy should adopt a wait-and-see approach. Another argument in favour of waiting was that the Government had not yet released its economic policy plans to meet the fiscal deficit target. Consequently, monetary policy could only rely on neutral assumptions. Some members thought that domestic demand might fall back more sharply and for longer than in other countries, due to the high household debt and, therefore, the room for manoeuvre in interest rate policy was also different compared with other countries. Some members, however, noted that monetary policy should respond immediately to potential future rises in inflation risks, because at the moment inflation could be reduced at much lower costs as a consequence of the balance sheet effects for households.

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 reduction of 25 basis points.

Votes cast by individual members of the Council

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

Katalin Haraszti, Head of Department of the Ministry for National Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 25 October 2010. The minutes of that meeting will be published at 2 p.m. on 17 November 2010.