MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

OF 25 OCTOBER 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/Monetaris_politika/decision-making/mnben_mt_jegyzokonyv

1 Macroeconomic and financial market developments

The domestic economy

Annual CPI inflation stood at 3.8% in September 2010, up 0.1 percentage point on the previous month. Core inflation remained unchanged at a historically low level of 1.5%. The data were consistent with the projection in the August *Quarterly Report on Inflation*, which implied that the moderation in inflation was likely to come to an end in the third quarter.

Unprocessed food prices levelled off in September, after having been driven up over the previous few months by adverse weather conditions. Food price inflation was flat. Services inflation turned out slightly higher than expected. The weaker exchange rate had a smaller-than-expected impact on industrial goods prices. This raises the possibility that the pass-through into prices of the exchange rate depreciation has been slower and/or less perfect than previously expected.

The latest indicators of real economic activity continued to provide a rather mixed picture. Industrial production increased further in August, driven by rising exports. Gains in production growth were quite similar in most manufacturing industries and across other countries of Central and Eastern Europe. The goods surplus changed little from previous months, associated with a marked increase in exports. Growth in imports continued to reflect exporters' demand for imports.

Growth in the volume of retails sales adjusted slightly downwards in August following the increase in July. However, the expansion of retail sales volumes over recent months may suggest that the recovery in consumption, expected for the end of the year, may occur earlier.

Earnings growth data for July suggested a somewhat faster labour market adjustment than previously thought. By contrast, earnings growth in August picked up slightly: whole-economy gross earnings grew by 1.9% relative to the same period a year previously, and within that, private sector earnings were 3.9% higher than a year earlier. Faster earnings growth in manufacturing was consistent with the cyclical position of the sector. Government sector earnings fell. In market services, the rate of earnings growth remained low. On balance, the data may indicate that the restraint on earnings growth from relatively loose labour market conditions has been stronger than expected.

The slow turnaround in the number of people in employment has continued. Employment rose slightly in August after stagnating in July. The upturn in employment was most pronounced in the private sector. Employment also picked up in manufacturing and market services, although the increase in the latter was fully accounted for by labour leasing. Adjusted for this effect, employment remained unchanged in market services, consistent with information derived from the CSO Labour Force Survey. Government sector employment was unchanged. The number of hours worked per capita remained at a historically high level.

A number of revisions to past data were made at the time of the release of Hungary's balance of payments for 2010 Q2. That, however, did little to alter the Bank's view of the underlying picture. The country's external financing capacity fell in Q2, although it still remained in a substantial net saving position equivalent to 2% of GDP. The fall in external financing capacity was closely related to an increase in the income account deficit, which, in turn, reflected rises in the estimated profits of foreign-owned Hungarian companies. The real economic and transfer account balance remained unchanged. In addition to the current account, the capital account also showed a surplus. Despite the outflow of funds, the debt-to-GDP ratio did not fall, due to the depreciation of the forint.

The partly preliminary and partly estimated balance of payments data for August showed that

Hungary continued to maintain a high, though falling, external financing capacity. Substantially less EU transfers were recorded in the balance of payments in the month than previously, which was the main factor explaining the decline.

According to national accounts data, non-financial corporations accumulated significant savings in 2010 Q2. Contributory factors included the decline in investment and high inflows of EU funds. At the same time, there was a sharp fall in the amount of outstanding bank lending to the corporate sector. Households' net savings rose slightly in August, according to preliminary and partly estimated data.

Financial market developments

Global market sentiment has essentially been positive since the Monetary Council's last interest rate decision. Heightened expectations that the Fed would continue to ease monetary policy further, on the one hand, and better-than-expected quarterly corporate reports, on the other, helped to sustain investor optimism. The decline in risks related to the Irish banking sector and the easing in concerns about other euro-area Member States with relatively greater fiscal imbalances may have been the major factors contributing to an improvement in investor sentiment towards the euro area. In developed economies, the decline in yields continued and yield spreads on risky assets narrowed. Commodity prices rose further. The US dollar depreciated significantly against other major currencies in foreign exchange markets.

International investors expect that the maintenance of loose monetary conditions in developed markets will further stimulate capital flows into risky financial assets and, ultimately, towards emerging markets. In each of the emerging regions of the world, risk premia fell and currencies appreciated. Perceptions of the risks associated with the economies of Central and Eastern Europe decreased slightly over the past month, in line with the positive shift in global investor sentiment. Importantly, during the first week of the period, country risk premia in the region fell amid cautiously optimistic investor sentiment, while from the second week of October rising appetite for risk may have driven movements in asset prices. The impact of global events was benign in the first half of the month, but weakened somewhat in the second half. No information which could have caused a significant decoupling of exchange rates and risk premia from global trends became available in the region.

The news about Hungary addressed questions that had long preoccupied investors. Asset prices moved in various ways in response to these news events. Movements in the exchange rate, the five-year ahead five-year forward premium and the foreign currency bond spread continued to reflect global trends, but in the government securities market yields rose sharply after announcement of the Government's proposed measures affecting Hungarian private pension funds. The five-year Hungarian sovereign CDS spread has fallen by 52 basis points since the last rate-setting meeting in September. But although the Hungarian spread declined much more sharply than those of other countries in the region, it did not cause a dramatic change in the country's relative position. The spread of the five-year forward rate five years out over the euro fell by 30 basis points and the spread of the five-year foreign currency bond by some 80 basis points. The forint performed better than other currencies of the region over the period as a whole. The EUR/HUF exchange rate strengthened from 278 at the beginning of the period to 270, then returned close to its initial level.

Non-residents' total forint position increased significantly over the period as a whole: they purchased more than HUF 300 billion in the spot foreign exchange market to buy government securities (HUF 66 billion), MNB bills (HUF 51 billion) and shares (HUF 53 billion) and, presumably, to satisfy their forint liquidity needs arising from their maturing FX swaps involving sales of foreign currencies in the spot market.

Yields on long-term government securities rose by 40–45 basis points following a temporary decline of 25–30 basis points. Currently, they stand above levels seen at the beginning of the period, with the ten-year yield at 7% and the five-year yield at 6.8%. The majority of the bond auctions conducted in the past month were successful, with the amounts sold by the debt manager at some of the discount Treasury bill auctions exceeding expected levels, as the issues were significantly oversubscribed.

Short-term yields fell sharply in the first part of the period, and upon bottoming out on 8 October the short end of the money market yield curve was consistent with a constant interest rate path. Short-term interest rate expectations have changed little since then. FRA rates for the periods beginning in one, two and three months' time are 9 basis points, 11 basis points and 13 basis points higher respectively than the central bank base rate. Economists polled by portfolio.hu unanimously expect the Council to leave interest rates unchanged at its upcoming meeting, and they do not expect that official rates will be changed over the period to the end of the year. Forecasts for the end of 2011 range between 4.75% and 7.00%.

Respondents to the Reuters poll conducted in October are unanimous in expecting official interest rates to remain on hold at the Monetary Council's meeting on Monday. They do not expect interest rates to be changed over the remainder of the year either. However, the overwhelming majority of them expect the Bank to start a tightening cycle during the course of next year. On balance, they believe there is a nearly equal probability that the base rate will be 5.5% or 5.25% at the end of 2011. According to the results of the poll, opinions are strongly divided over the beginning of a tightening cycle. At present, more forecasters expect that the first interest rate hike will take place later, in the second half of 2011, than at the time of the previous poll.

Position of the banking sector

Consistent with the main messages of the *Report on Financial Stability*, to be published on 17 November 2010, the most important findings on the stability of the banking sector are the following.

Outstanding lending to companies fell sharply in 2010 H1, but the pace of decline slowed in the third quarter. By contrast, there is no sign yet of a turnaround in the household market, with the rate of decline remaining high in the third quarter, similar to the previous two quarters. The decline in outstanding loans to the private sector was large in a regional comparison, reflecting continuing tight credit conditions, in addition to weak demand for credit.

Next year, corporate borrowing may begin to recover first, followed by an upturn in lending to households. However, the risk that the turning point will occur later than anticipated is high. In the corporate sector, the fragility of activity abroad and, in the household sector, the protracted adjustment process due to the large amount of outstanding debt and high debt-servicing costs may pose a risk to the recovery of demand for credit. On the supply side, risks may arise due to uncertainty caused by the special levy on banks and a deterioration in loan quality due to the strength of the Swiss franc and the resulting credit losses.

The liquidity position of Hungarian banks is judged to be strong and the share of liquid assets adequate. At the same time, however, developments in the funding structure are likely to lead to an increase in rollover risks. Domestic banks are still heavily reliant on external funding and the FX swap market. The vulnerability arising from this factor is aggravated by a shortening in the maturity of on and off-balance-sheet funding.

Non-performing corporate and household loans rose to 12% and nearly 10% respectively of the total outstanding amount by the end of H1. The cost of provisioning as a share of the total amount outstanding of loans reached 3% for both corporations and households during the period. Rising loan losses in the corporate sector are explained by the weak performance of project financing and, in the household sector, by the pass-through of the strong Swiss franc and high external funding costs into high debt servicing burdens. Mortgage loans account for the largest proportion of lending to households, and the percentage share of non-performing mortgage loans was 6.7% at the end of 2010 H1. Banks have already set aside provisions for 25% these non-performing assets. However, the high loan-to-value ratio of above 100% of non-performing loans and the around 13% decline in real estate prices since the outset of the crisis mean it is likely that banks will suffer additional losses in collateral sales.

The ratio of non-performing loans may reach its peak later than expected, and may slightly exceed 15% next year for both companies and households. The speed with which banks restructure their portfolios, which is currently judged to be very low, may greatly influence developments in the ratio of non-performing loans. Contrary to the Bank's expectation, provisions as a percentage of total outstanding loans may peak at around 3% this year, and decline gradually next year as the economy recovers, due in part to lower loan losses and in part to stronger credit growth.

The profitability of domestic banks is falling sharply. Return on assets (ROA) and return on equity (ROE) were 0.7% and 8.6% respectively in the 12 months to August 2010, a considerable deterioration since the end of 2009. The decline is even more pronounced if the instalment of the bank levy due at year-end is taken into account. Adjusted ROA and ROE, at 0.5% and 6.0% respectively, are low not only in a regional comparison, but also compared with the performance of parent banks. Differences in profitability across domestic banks have been increasing. In August 2010, 16 banks posted losses. Their aggregate balance sheet total accounted for 20% of the banking sector total.

Banks are only able to partially offset rising loan losses and the bank levy by raising their interest margins. As a consequence, their profitability has fallen to a low level. Banks' adequate capital position ensures that the financial system is still able to absorb shocks (the sector's capital adequacy ratio stood at 12.8% at the end of August). In the baseline scenario, there is only a minimal need for capital injection. The sector's capital adequacy ratio remains above 13% and rises further by the end of 2011. In the stress scenario, the aggregate capital adequacy ratio would be falling in both 2010 and 2011, but its value would still exceed 12% and a manageable additional need for a capital injection on the order of HUF 40 billion would arise, which is judged to pose little risk, both in terms of its amount and the commitment of banks' owners to their subsidiaries.

Banks may restore their capital adequacy ratios not only by increasing capital, but also by asset-side adjustment and/or raising their interest margins. As no additional need for capital injection is expected in the macroeconomic baseline projection, the risk of balance sheet adjustment arising from an increase in capital adequacy is judged to be low. Along the risk path, i.e. in the stress scenario, however, the risk of balance sheet adjustment by the banking sector and the ensuing risk of a reduction in lending to the corporate sector is high. All this may result in negative feedback between the banking sector and the real economy, which may lead to output losses.

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

Monetary Council members agreed that the Hungarian economy had started to emerge from recession in 2010, but that output was only likely to slowly return to potential. Weak domestic demand continued to exert a dampening impact on inflation. The measures announced by the Government could significantly alter the macroeconomic outlook and add to upside risks to inflation and lead to increased investor uncertainty. The Council would assess the quantitative effects of those measures in light of the November *Quarterly Report on Inflation*.

During the discussion of inflation developments, Council members treated the assessment of the Government's package of measures separately from other issues. Recent macroeconomic data were in line with the Council's assessment from September. Several members thought that the adverse economic environment had been a stronger factor dampening the pass-through of the exchange rate depreciation into prices than had been expected. On another argument, loose labour market conditions, slower-than-expected earnings growth and the continued sharp adjustment by households were factors contributing to a further decline in inflation. Some members, however, were of the view that households had responded to the economic recession in part by reining back consumption spending and that latent inflationary pressures might arise once consumption picked up as the economy gradually recovered.

Council members agreed that the effects on growth of the measures announced by the Government were uncertain and, at this juncture, it was particularly difficult to make a judgement about the possible future impact of unconventional economic policy tools. However, the measures could have adverse effects on inflation in a number of ways. For example, the special levies on some sectors might put downward pressure on the future profitability of Hungarian firms, which, in turn, might lead to price increases over time. Low profitability in some sectors, however, did not provide scope for adjustment and, consequently, firms might pass the cost of taxes on to customers over the short term. Some members were of the view that the inflationary impact of passing the costs of the taxes on to customers might be partly offset by adjustment through wage-setting, due to loose labour market conditions. It was also argued that the changes to personal income tax rates might lead to higher household income, which might cause higher inflation through a stimulus to consumption. Several members noted that the fiscal measures might result in lower investment in the private sector and, therefore, the probability that employment could increase as the Government expected was very low. The deterioration in the economic outlook and increased investor uncertainty might have an adverse impact on potential output, and the narrowing of the output gap might lead to price increases in the economy.

Council members agreed that the changes to the private pension fund system would reduce confidence in long-term savings, which, in turn, might impede households' ability to develop financial goals for their future and align their present and future consumption accordingly.

Some members noted that perceptions of the risks associated with the economy had fallen over the past six weeks, due mainly to an improvement in global appetite for risk and the Government's commitment to meeting this year's deficit target of below 3%. In assessing recent positive developments, several members referred to the fall in CDS spreads and the reduced volatility of the forint exchange rate. In the Council's judgement, however, there had been some reversal in perceptions of the risks associated with the economy since the announcement of the Government's package of economic policy measures. Several members pointed out that the second round of quantitative easing measures announced in the US would lead to a significant expansion of liquidity worldwide, which might increase investor appetite for emerging market assets.

Members agreed that the importance of the Government's recent measures would be greater than other factors influencing future developments in the economy and inflation in the coming months. There was a very high degree of uncertainty about the medium and long-term effects of the measures, particularly of the unconventional policy actions and, therefore, the Council should adopt a wait-and-see approach. Increasing the base rate might become necessary if the outlook for inflation deteriorated or there was a sustained increase in perceptions of the risks associated with the economy. Members were of the view that it would be useful for the Council to base its monetary policy responses on an overall assessment of events, which would be facilitated by publication of the November *Quarterly Report on Inflation*.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Five members voted to maintain the base rate at 5.25%, one member voted to raise it by 25 basis points 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%	**5**	Csaba Csáki, Ferenc Karvalits, Júlia Király, Judit Neményi, András Simor
In favour of raising the base rate to 5.50%	**1**	Péter Bihari
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 29 November 2010. The minutes of that meeting will be published at 2 p.m. on 8 December 2010.