MINUTES

OF THE MONETARY COUNCIL MEETING

24 JANUARY 2011

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

In December 2010, annual CPI inflation stood at 4.7% and core inflation at 2.0%. The annual average inflation rate was 4.9% in 2010. Measures of underlying inflation settled in at around 3%. Services inflation remained subdued in December, reflecting the discipline exerted by weak domestic demand and high unemployment on pricing decisions. Higher industrial goods prices also contributed to the increase in inflation to some degree, in addition to higher vehicle fuel and food prices. The pass-through to processed food prices of the increase in unprocessed food prices has so far been weaker than expected. The sharp rise in vehicle fuel prices was consistent with recent developments in global oil prices. Households' inflation expectations remained high when viewed over a longer horizon.

Rising economic activity abroad continues to be the driving force behind Hungarian growth. According to preliminary trade in goods data, exports rose robustly again and the rate of import growth remained broadly unchanged relative to previous months. The goods surplus rose to a record high in November, owing to the pick-up in industrial goods exports. The cumulative goods surplus for January–November amounted to EUR 3.3 billion. There was a further improvement in Hungary's terms of trade relative to the previous month.

Industrial production growth accelerated in November 2010, after being subdued for several months, with an increase of more than 4% in production relative to October, according to seasonally adjusted data. Manufacturing exports continued to be the source of industrial production growth. Output of the sectors mainly producing for export markets increased, but growth in domestic sales stalled, suggesting that the recovery in domestic demand is still patchy. The October retail sales data confirms that the recovery is likely to be fragile and protracted and is consistent with the projection that consumption will probably recover only slowly. Indicators of economic activity suggest that external demand may continue to support the recovery of the Hungarian economy at the turn of 2010/2011.

Earnings growth remained subdued, due to the loose labour market. Private sector average earnings grew by 1.6% and regular pay, excluding bonuses, grew by 3% relative to the same period a year earlier. Moderate earnings growth continued in both manufacturing and market services. In addition, bonuses in market services, usually paid in the month of November, fell sharply. Companies may postpone part of wage increases and bonus payments to 2011, in response to the changes to personal income taxes effective from January 2011, rendering it difficult to interpret the earnings data. After a temporary reversal, the number of people in employment continued to rise in November. Most of this increase was associated with manufacturing, which was in line with developments in industrial activity in the final months of the year. The unemployment rate remained at a historically high level of around 11%.

Financial market developments

Sentiment in international financial markets has been generally positive in the period since the

Council's December interest rate decision. Most risky asset prices rose, developed and emerging country equity indices closed higher and the increase in commodity prices continued. Risk indices as well as corporate CDS indices in developed countries fell and the EMBI Global, measuring the risks associated with bond markets in emerging economies, edged down. The euro strengthened by more than 2% against the dollar.

Releases of benign macroeconomic data in the US and Europe and improved confidence in the global economy were the backdrop to these positive developments, but loose fiscal and monetary policies in the US also boosted investor optimism. In Europe, problems with the peripheral economies remained, but CDS and bond spreads of the region both fell as a result of rising investor appetite. During the period, expectations that Portugal would request financial assistance intensified, although the bond auctions conducted in January were viewed by market participants as successful.

The details of the structural reforms to be announced by the Government in February will be a key determinant of market sentiment towards Hungary and its financial position. Market reception of the preliminary announcements during the period indicating a tightening of fiscal policy was favourable, albeit participants did complain about a lack of the details on the programme. The credibility of the economic programme may be a determining factor for rating agencies in their decision whether to downgrade or maintain current ratings and also whether Hungarian financial assets will be rated investment grade or speculative grade. Meanwhile, domestic financial market developments continued to be shaped by global factors. Hungarian CDS spreads rose temporarily by nearly 30 basis points to 402 basis points in early January, before returning to their initial levels in the middle of the month. Although with lower amplitude, this pattern was also reflected in CDS spreads and exchange rates of most of the CEE countries, as well as in the German DAX index and the EUR/USD exchange rate. Investors were mainly concerned with escalation of the debt crisis at the time the risk indicators reached their highest values, with this global factor being the most important in driving movements in CDS spreads and the exchange rate. Over the period as a whole, Hungary's five-year sovereign CDS premium was little changed relative to its initial level of 375 basis points, standing at 386 basis points at the end of the period. The spread on five-year Hungarian euro-denominated bonds over German bonds fell by some 17 basis points, and the spread of the five-year ahead five-year money market rate over the comparable euro-area rate edged down by 7 basis points.

The forint changed little against the euro, falling from EUR/HUF 277 at the beginning of the period to 275. The CHF/HUF exchange rate fluctuated around 225 in the middle of the period, but moved back to below 218, reaching a low of 212 by the end. Risk reversal spreads followed movements in the EUR/HUF exchange rate and, consequently, fell in absolute terms. Indicators of the negative skewness in the probability distribution also fell.

Non-resident holdings of government bonds and MNB bills have risen by HUF 55 billion and HUF 8 billion respectively since Monetary Council's interest rate decision in December. In the FX swap market, non-residents' total net position rose by nearly HUF 100 billion, and they purchased some HUF 200 billion in the spot foreign exchange market.

The auctions conducted in the primary market of government securities were accompanied by the usual high oversubscription rates. Market analysts commented that demand for longer-dated government bonds issued in January was kept subdued by the absence of private pension funds. Government bond yields in the secondary market largely followed movements in risk indicators. The yield curve flattened. Yields at the short and long ends fell by around 10 basis points, while those at the middle of the curve fell much more sharply, by 20–40 basis points.

The yield curve, estimated on the basis of interbank rates, also flattened: at the long end and the middle of the curve, yields fell by some 10 basis points. The FRA curve became flatter. Interest rate increases of 25 basis points for each of the Monetary Council's policy meetings in January and February are priced in interest rate forward contracts beginning in one and two months' time. By contrast, FRA rates at one-year maturity have fallen. This implies that the market expects another 25 basis point increase in interest rates over the period to the end of the year, in addition to those expected for early this year. Compared with the money market yield curve, the short end of the government securities yield curve would be consistent with expectations of lower official interest rates; however, anecdotal information on the market suggests the short end of the government securities yield curve is currently biased downward by increased demand for discount treasury bills before maturity, a factor believed to be temporary.

The majority (19 of 25) of respondents to the Reuters poll expect the Monetary Council to raise interest rates at its meeting on Monday. Six analysts forecast that the base rate will be left on hold.

Position of the banking sector

Outstanding lending to companies continued to decline in December. According to preliminary data, total outflows from the banking sector amounted to more than HUF 30 billion. This negative outflow was closely related to a decline in the stock of outstanding forint loans. Unlike the pattern of previous months, there was also a significant outflow from short-term loans. There continued to be no signs of a turnaround in corporate lending, although outflows were much smaller in H2 than in H1. Bank lending is unlikely to contribute to growth over the short term. The household credit market continued to show little sign of a shift in the trend in December. The decline registered during the month, at some HUF 44 billion, was greater than in November.

In 2011, corporate borrowing may begin to recover first, followed by an upturn in lending to households. There is, however, a high risk that the turning point will occur later than anticipated, and December data have added to that risk. 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. Risks may arise on the supply side as well. Uncertainty caused by the special levy on banks, on the one hand, and a deterioration in loan quality, due to the strength of the Swiss franc and the resulting credit losses, on the other, may have a negative impact on credit supply.

As far as the assessment of liquidity risks is concerned, the volume of foreign liabilities and outstanding swaps of banks remain a key factor. According to preliminary data, banks' foreign liabilities fell significantly again in December, following the massive outflows in the previous month. With the sharp fall in the sector's foreign liabilities in the month, outstanding swap contracts rose significantly, as banks closed their on-balance sheet foreign currency positions. The resulting risks were mitigated somewhat by inflows of liabilities in the early days of January. The was a slight drop in the ratio of liabilities maturing within one year to total liabilities.

Non-performing corporate and household loans rose to above 12% and to 10.6%, respectively, of the total outstanding amount by the end of September 2010. In September, loan-loss provisions as a share of the total amount of outstanding loans, at 3% for both corporations and households, remained at the high level of June. Rising loan losses in the corporate sector are explained by the weak performance of project financing and, in the household sector, by the strong Swiss franc, persistently high unemployment and the pass-through of the high external funding costs to debt servicing burdens.

In contrast to the Bank's earlier expectations, 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 at which banks are restructuring their portfolios, which is currently considered very low, may greatly influence developments in the ratio of non-performing loans. Provisions as a percentage of total outstanding loans may start to fall this year as the economy recovers, due in part to lower loan losses and in part to stronger credit growth than currently.

The profitability of domestic banks deteriorated in December, mainly on account of the second instalment of the bank levy due in the month. The sector's capital position continued to be adequate, with the aggregate capital adequacy ratio standing at 13% at the end of November.

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

The majority of Monetary Council members judged that inflation was likely to be considerably above the Bank's 3% target in the coming quarters, due to the significant cost shocks hitting the economy. That, in turn, might make it difficult to anchor inflation expectations and add to the risk of second-round inflationary effects. It was therefore necessary to tighten monetary conditions further.

In assessing recent and prospective inflation developments, members agreed that the speed and scope of the pass-through of the cost shocks to consumer prices was surrounded by a great degree of uncertainty. However, members' views were divided as to how to assess the likely impact on wages, consumption as well as on macro demand and inflation of factors such as movements in the exchange rate, rises in unprocessed food and commodity prices and the Government's measures.

Members judged that changes to personal income taxation might have a significant influence on consumption through household income. Several members thought that the consumption demand of mainly those with higher income might rise this year as a result of the tax changes; and the probability that households' propensity to save would increase was low. Some other members, however, cautioned that high instalments on debt continued to be an important impediment to household consumption expenditure growth. Expectations of more extremely weak lending activity also represented a downside risk to the outlook for consumption.

Some members emphasised that the output gap might close faster than assumed in the November projection, due in part to a pick-up in consumption and in part because the level of potential output might be much lower than previously assumed, primarily as a result of the persistently low level of capital accumulation.

Members agreed that developments in wage inflation involved a great degree of uncertainty. Some of them felt that the historically low earnings data for recent months were evidence that wage inflation had eased after having been stuck at a high level. Several other members, however, thought that the slowdown in earnings growth might reflect the effects of postponed increases in bonuses and pay, in response to the changes to personal income taxation. A sharp adjustment might be expected after the tax changes took effect in January, which might also be reflected in retail sales and consumption data, in addition to earnings.

Members felt that the consumer price index had risen as expected in response to the cost shocks, but that the increase showed a different composition in December. Several members noted that the food and oil price shocks might well lead to stronger inflationary pressures over a sustained period and that upside risks to inflation had increased relative to the November projection. On another argument, however, core inflation was lower than the path outlined in the November projection, due to the slower pass-through of the unprocessed food price shock, which was positive news in terms of the longer-term outlook for inflation. Some members added that other factors might dampen the second-round effects of the increases in unprocessed food prices. For example, the experience of the past year suggested that subdued demand and loose labour market conditions had changed the speed and strength of the second-round effects of external shocks. Other members stressed that there were few signs of a material reduction in inflation expectations and a sustained change in previous price and wage-setting practices. It could not be assumed therefore that the second-round effects of external shocks on the Hungarian economy would be different now than they had been prior to the crisis.

Some members argued that industrial goods inflation was beginning to reflect the effects of the weaker exchange rate, which was a source of concern considering the key importance of the direct exchange rate channel. Others also emphasised that inflationary pressures in Europe could be expected to pick up. In presenting their views, several members referred to the measures announced by the Government earlier and warned that the special levies were likely to have inflationary effects.

Considering the various interest rate policy options, arguments for raising or maintaining the central bank base rate were largely in balance, with one member proposing an interest rate reduction. Several members thought that an argument for raising interest rates was that, based on information gathered by the Bank and market forecasts, there was a high risk of consumer prices being persistently above the Bank's inflation target as a result of the cost shocks. However, monetary conditions had not tightened materially despite the November and December interest rate increases; the one-year ex ante real interest rate had fallen and the exchange rate had not appreciated due to the increase in perceptions of risks since the tightening cycle began. Those arguing for a rate increase stressed that raising interest rates would help drive down and anchor inflation expectations and strengthen the credibility of the inflation target.

Those favouring no change in interest rates this month agreed that it had been justified to start a tightening cycle, but they judged that a cautious, measured tightening cycle was warranted due to the significant uncertainty surrounding the outlook for the economy and inflation. Members arguing for maintaining rates judged that more time was needed to decide whether meeting the inflation target required a further tightening of policy. Leaving interest rates on hold would contribute to reducing the risk of an excessively tight monetary policy being priced in by the markets.

An argument for reducing interest rates was that such an option would contribute to investment growth and an increase in lending activity, which would serve the wider interest of the economy.

Members agreed that the Government's measures might strongly influence the Council's monetary policy actions in the coming months. Measures to improve fiscal sustainability and macroeconomic balance might lead to a reduction in perceptions of risks, exchange rate appreciation and, ultimately, might give more room for manoeuvre in monetary policy. Some members, however, believed that robust monetary policy actions might be needed in the absence of such measures.

After the discussion, the Chairman invited members to vote on the propositions put to the Council. Before the vote was taken, members' proposals for the interest rate decision indicated a 3:3:1 balance of votes, in the order shown in the table below. The Chairman asked members to reconsider their proposals in order to achieve a balance of votes required for taking a majority decision consistent with the MNB Act. To facilitate a decision, Péter Bihari supported an increase of 25 basis points in interest rates. Four members voted to raise the base rate by 25 basis points, two members voted to leave the base rate unchanged, and one member voted for a reduction in the base rate of 25 basis points.

Votes cast by individual members of the Council

In favour of raising the base rate to 6.00%	**4**	Péter Bihari, Júlia Király, Judit Neményi, András Simor
In favour of maintaining the base rate at 5.75%	**2**	Csaba Csáki, Ferenc Karvalits
In favour of reducing the base rate to 5.50%	**1**	Tamás Bánfi

<u>The following members of the Council were present at the meeting:</u>

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

Dániel Palotai, 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 21 February 2011. The minutes of that meeting will be published at 2 p.m. on 18 March 2011.