MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

26 JULY 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 the 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

In June 2011, annual CPI inflation was 3.5% and core inflation was 3.0%. Consumer price inflation was 0.4 percentage points lower and core inflation 0.3 percentage points higher than in the previous month. The fall in inflation was largely accounted for by lower unprocessed food prices and the base effect from the increase in 2010. However, core inflation rose further in June as a result of the pass-through of higher commodity prices, despite persistently weak domestic demand. Reflecting these divergent developments, the fluctuation band of measures capturing underlying inflation developments widened; however, it remained within a range of 2%-3%.

Industrial production fell slightly by 1.1% in May relative to the previous month and increased modestly by 7.6% relative to a year earlier. Industrial exports slowed as external demand weakened; however, domestic sales rose slightly. The performance of industry in May continued to be lower than the average of the CEE region. However, in recent months not only has the rate of domestic sales growth been lower than in other countries of the region but also export growth has been more subdued.

According to preliminary data, exports fell by 0.7% and imports by 2.0% relative to April. But the annual growth rates of exports and imports rose to 18.4% and 4.3% respectively, due to a base effect. The seasonally adjusted goods surplus was high, close to EUR 480 million. That brought the aggregate goods surplus for the first five months of 2011 to EUR 2.3 billion, compared with EUR 1.6 billion in the same period of 2010. Hungary's terms of trade deteriorated slightly in April relative to March and a year earlier.

The volume of retail sales, closely related to changes in consumption expenditure, rose by 0.2% in April 2011. Despite the increase, however, the value of retail sales was 0.8% lower in the first four months of the year than in the same period of 2010. The trend measures of monthly changes show a slight decline in retail sales. The data suggest that there continues to be little change in household consumption expenditure.

The number of new jobs fell further in June, which, however, resulted almost entirely from a decline in new subsidised positions. The number of newly reported non-subsidised jobs has remained broadly unchanged over the past two weeks and continued to be significantly below values recorded during the period prior to the crisis. Whole-economy gross average earnings rose by 6.7% relative to June 2010. Private sector earnings grew by 6.4% and government sector earnings by 6.5%. Government sector earnings growth continued to reflect the composition effect associated with public works. Excluding this effect, gross average earnings of government sector employees remained practically unchanged relative to May 2010. The latest available data confirmed the downward effect on earnings of loose labour market conditions.

Financial market developments

Perceptions of the risks associated with the Hungarian economy increased during the period to the EU summit regarded as a milestone in seeking a medium-term solution to the euro-area sovereign debt crisis, but then they started to fall as a result of the better-than-expected agreement reached at the extraordinary meeting. On balance, therefore, Hungary's risk perceptions barely changed in the period. The increase in perceptions during the period up to the EU summit reflected global factors, and the generalised increase in aversion to risk had an effect not only on the CEE region but also on Western Europe. However, increased risk aversion was only modestly reflected in movements in government securities yields and interbank rates. But swift changes in global market sentiment were clearly reflected in the wide fluctuations of the forint against the currencies of developed countries.

The rise and subsequent fall in aversion to risks associated with Hungary were reflected in almost all of the country's risk premium indicators. The five-year sovereign CDS spread rose by 20–30 basis points before falling back from 310–320 basis points; however, in aggregate, the spread moved only a couple of basis points. These movements did not represent a substantial change in Hungary's position relative to the average of the 10 Central and Eastern European countries. This time, risk aversion also affected countries of Western Europe, normally viewed as safe. Consequently, the relative position of the region, including Hungary, did not changed materially within Europe.

However, the developments discussed above had only a limited impact on movements in government securities yields and interbank rates. Spot yields for maturities out to one year remained broadly flat or fell slightly. But government securities yields at 5–10 year maturities rose by nearly 5 basis points and interbank rates rose by 5–15 basis points. Healthy demand at auctions and large purchases by non-residents may also have contributed to the period of relative calm in the government securities market.

The exchange rate of the forint depreciated against the currencies of developed countries in line with movements in other exchange rates of the region. Initially, the forint fluctuated in a relative wide range of +/-3% against the euro, US dollar and pound sterling, before returning to levels of a month earlier by the end of the period. However, it weakened by nearly 7% (to CHF/HUF 237) against the Swiss franc. Consistent with the improvement in sentiment following the EU summit, the franc lost some of its strength against the forint and eased to around CHF/HUF 230.

Interest rate expectations, derived from three-month FRA rates, were little changed, remaining 5–8 basis points above the Bank's base rate. That was broadly consistent with expectations that official interest rates would remain on hold. However, some FRA rates below the key policy rate by a couple of basis points for longer periods of six to twelve months have appeared in recent weeks. Economists polled by Reuters in July unanimously expected the Council to leave interest rates unchanged; however, longer-term interest rate expectations fell. Market analysts generally held the view that although developments in inflation and the real economy pointed to monetary easing, the adverse external environment, the high risk premium and the vulnerability of the exchange rate left little room for such a move.

In the FX swap market, tensions eased slightly after increasing nearly a month earlier, with FX swap spreads declining from 170 basis points to close to 140 basis points at maturities between three and six months; and overnight implied forint rates, derived from actual swap contracts, returned to the bottom of the interest rate corridor.

Position of the banking sector

Outstanding lending to the corporate sector again fell more sharply in June than in previous months, with forint loans accounting for most of the decline. Interest rates on loans to the corporate sector fell slightly in May. In the household market, foreign currency lending continued to decline and the stock of forint loans increased modestly in June. The average APR on both housing loans and home equity loans rose in May.

The latest available data point to the likelihood of downside risks to corporate lending materialising. As a result, the turnaround in lending may be delayed until after the end of 2011. Household lending is only expected to recover in 2012 H2.

In 2011 H1, pre-tax profits of the banking sector and branches were slightly higher than in the same period of 2010.

In May, the outflow of external funding from the Hungarian banking sector continued, with the result that by the end of May external funding fell below its level in December 2010. According to preliminary estimates, the outflow of external funding continued in June.

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

The majority of Council members agreed that developments in the macroeconomy and inflation had been in line with the baseline projection in the June *Quarterly Report on Inflation* in the period since the Council’s latest interest rate decision. Persistently weak domestic demand had continued to restrain price rises, offsetting the inflationary impact of higher commodity prices. The Monetary Council continued to judge that maintaining interest rates at their current 6% level over a sustained period would help to ensure that inflation returned to the 3% target on the horizon relevant for policy. In the Council’s view, risks related to the euro-area sovereign debt crisis, one of the risk scenarios considered in the June *Report*, had increased; however, developments in the period leading to the decision did not call for a policy response.

In terms of macroeconomic developments, several members noted that the downward effect on prices of weak domestic demand, driven in part by loose labour market conditions, had taken hold. That was in contrast with the first few years of the crisis when inflation had been high despite falling domestic demand. One member noted that by restraining administered price rises, the Government’s anti-inflation policy had greatly contributed to inflation falling to historically low levels. As a result of these factors, the chance that inflation would fall to the 3% target and remain at that level was the greatest since the introduction of the inflation-targeting regime. It was also noted that, in light of the low outturn for the price index in July and August due to seasonal factors, the September and October data could be used as a guide to expected future developments in inflation.

One member noted that the assumption in the baseline projection that commodity prices would fall was too optimistic and that developments in earnings over the past few months suggested a need for caution, given the slow but steady increase in measures of underlying inflation. Another member drew attention to the fact that the impact on Hungarian inflation of the global increase in food prices had been the greatest in Hungary compared with other countries of the CEE region.

It was noted that the possibility that commodity prices would increase and Hungary's risk premium would fall in response to the Government's spending cuts, one of the alternative risk scenarios considered in the *Report*, had remained. However, these scenarios would take longer to materialise, and therefore they did not influence the Council's interest rate decision. In contrast with these scenarios, the risk that the euro-area sovereign debt crisis would escalate had increased. Members noted that the potential intensification of the crisis would affect Hungary's economic outlook through several channels, and the various channels might make it necessary to take actions which might operate in opposite directions. One such channel was that safe haven currencies might appreciate further as risk premia continued to rise. For example, the steady appreciation of the Swiss franc would lead to further balance sheet adjustment by households indebted in that currency. This process might contribute to a further decline in consumption and ultimately to a pick-up in disinflation, which itself could require the Council to bring forward the first interest rate cut. Several members, however, argued that the potential intensification of the euro-area debt crisis would trigger non-linear processes, which might lead to a further rise in Hungary's risk premium and a depreciation of the exchange rate. In contrast with the channel discussed earlier, these effects might make it necessary to raise interest rates. In terms of this risk scenario, one member noted that due to its high level of debt, Hungary continued to be among the more vulnerable countries of the region, and therefore the country would not be able to isolate itself from the effects of the debt crisis if it were to escalate. However, Hungary's fundamentals had improved significantly as a result of the fiscal consolidation of recent years, with the result that the country had become less vulnerable. Consequently, the effect on Hungarian risk premia might be more moderate than in previous years, even if the financial crisis escalated. It was noted that developments of the past month appeared to support this view, as the forint exchange rate had not depreciated significantly despite the escalation of the euro-area debt crisis and the country's risk premium had risen only moderately. Finally, one member noted that the recovery in corporate investment might be delayed due to increasing uncertainty, which might lead to a further slowdown in potential growth. As a result, the output gap might close even if consumption did not pick up. That would adversely affect both economic growth and the outlook for inflation.

In the Council's judgement, maintaining interest rates at their current level over a sustained period was still justified. In terms of the outlook for interest rates further ahead, Council members differed to the extent to which they attached different probabilities to the risk scenarios materialising.

After the discussion, the seven members unanimously voted in favour of the proposition to maintain the base rate at 6.00%.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 6.00%	**7**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, Ferenc Karvalits, Júlia Király, György Kocziszky, András Simor

The following members of the Council were present at the meeting:

Andrea Bártfai-Mager
János Cinkotai
Ferenc Gerhardt
Ferenc Karvalits
Júlia Király
György Kocziszky
András Simor

Dávid Gulyás, Head of Division of the Ministry for National Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 23 August 2011. The minutes of that meeting will be published at 2 p.m. on 7 September 2011.