MINUTES

OF THE MONETARY COUNCIL MEETING

23 AUGUST 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 July 2011, annual CPI inflation was 3.1% and core inflation was 3.2%. Consumer price inflation fell by 0.4 percentage point and core inflation rose by 0.2 percentage point relative to the previous month. The July data were consistent with the projection in the June *Quarterly Report on Inflation* in terms of their level and composition. The fall in inflation in July was accounted for by lower unprocessed food prices. However, due to the pass-through of higher commodity prices, core inflation continued to rise in July, despite persistently weak domestic demand. Reflecting these divergent developments, the measures capturing underlying inflation developments remained within a range of 1.5%–2.5%.

According to the preliminary estimate for aggregate GDP which does not include its sub-components, Hungary's gross domestic product grew by 1.5% in 2011 Q2 relative to the same period of 2010 and stagnated relative to the previous quarter. This was weaker than analysts' expectations and the Bank's projection for GDP in the June *Report*. The slowdown was more marked than in other countries in the CEE region. Growth was uninterrupted in Slovakia and slowed slightly in the Czech Republic.

On the output side, the data for recent months had already pointed to a slowdown in domestic economic activity in Q2. Industrial production fell again in June and was down 1.6% in Q2 on the previous quarter. Manufacturing exports slowed in line with the weakening in external demand. And domestic sales declined again after rising slowly in recent months. On balance, the slowdown in industrial production reflected the steady decline in global activity in recent months, but one-off factors may have also been a factor in this weak performance in the quarter.

Hungarian foreign trade also slowed in June, in line with the developments in industrial production. According to preliminary data, exports declined by 2.9% and imports by 0.9% relative to May, while the goods surplus remained relatively high despite slower export growth.

Household investment in dwellings may have been more subdued than in previous months, and the decline in the housing market continued in 2011 Q2. The number of occupation permits issued was 36% lower and the number of building permits 18% lower compared with the same period of a year earlier. In the current macroeconomic environment, employment and lending activity are not expected to pick up markedly, and therefore household investment is unlikely to recover in the coming quarters.

The volume of retail sales, closely associated with consumption expenditure, rose by 1.1% in May 2011, but virtually stagnated in the first five months of the year relative to the same period of 2010. The real net wage bill, one of the most important macroeconomic factors influencing household consumption, increased significantly in the first few months of the year, due to the reduction in personal income taxation and the different size and timing of bonus payments from previous years. However, the growth rate of regular pay, a more reliable gauge of underlying labour market developments, remained subdued, and the number of full-time employees

stagnated. The appreciation of the Swiss franc has increased foreign currency debtors' monthly instalments, which in turn may result in a significant decline in disposable income in Q3.

The number of new jobs fell by 12.8% in July relative to the previous month. Within this, the number of newly reported non-subsidised jobs also declined relative to the previous five months and July 2010. The number of staff at companies with five or more employees fell by 0.4% in June 2011 relative to a year earlier. Monthly gross average earnings were 4.7% higher than twelve months earlier. Here, private sector average earnings grew by 4.1% and government sector average earnings by 4.9%. The latest available data confirm that loose labour market conditions continue to exert downward pressure on earnings.

Financial market developments

Investor sentiment in international financial markets has turned negative in recent weeks, as reflected in the unusually large volatilities in asset prices at times. Three main factors contributed to this negative sentiment: i) heightened sovereign risks in some euro-area countries, ii) the deterioration in the outlook for global economic activity, and iii) the downgrade of the United States' long-term debt rating. While the last factor did not cause financial markets to become dysfunctional, the first two factors may have an effect over the longer term and may directly affect the Hungarian financial system. This has been reflected recently in the appreciation of the Swiss franc and an increase in the Hungarian sovereign CDS premium.

Perceptions of the risks associated with the Hungarian economy have clearly increased since the Monetary Council's last interest rate decision. The sensitivity of risk premia in Hungary to increases in risks has been greater than in most countries of Central and Eastern Europe. In this regard, rises in risk premia in recent weeks have not been materially different from movements during periods of risk aversion observed over the past few years. There are fundamental reasons for this sensitivity, which have not changed markedly recently. In the past month, movements in asset prices have been dominated by global factors rather than by country-specific ones.

Nevertheless, the relative stability of non-residents' holdings of Hungarian government paper in recent weeks despite the rises in risk premia was a positive development. In addition, there was strong demand at the auctions of government securities held in the month. Although the increase in yields in the secondary market proved temporary and the yield curve is currently below its level a month ago, this should not be seen as indicating a fall in the risk premium. In assessing movements in the risk premium, it should also be taken into account that yields on German government bonds, regarded as a benchmark, have fallen by some 70 basis points in the past month. Consequently, yields on forint-denominated government securities reflect a similar increase in the risk premium to that seen in the CDS premium.

One positive development is that the forint has fluctuated in a relatively narrow range against the euro in recent weeks compared with fluctuations during episodes of risk premium shocks of similar magnitude to the current one. However, the skewness in the distribution of exchange rate expectations calculated from options prices shifted towards weaker levels, painting a

slightly more mixed picture.

Premia required by investors for holding risky assets rose. The European banking sector was facing increasing difficulty in accessing US dollar liquidity and interbank market participants became more cautious in lending in the euro. Along with this, there were signs of growing strains in the foreign currency liquidity of the Hungarian banking sector as well.

Short-term interest rate expectations, derived from three-month FRA rates, were little changed, but there was a clear shift in expectations towards lower levels at horizons of six to nine months. It also deserves mention that the rate on the two-year interest rate swap, which is often used to speculate on the longer-term path of interest rates, fell significantly. Economists polled by Reuters in August expected the Monetary Council to leave the base rate on hold at its meeting on Tuesday. Expectations were for the base rate to remain unchanged for the rest of 2011, with only three of the 20 respondents expecting a 25 basis point cut. Some market analysts were of the view that developments in inflation and the real economy pointed towards monetary easing, but the analysts polled by Reuters expected inflation to rise in the coming months relative to July, in line with the Bank's forecast, and maintained their longer-term interest rate expectations despite July's CPI inflation outturn of 3.1%. Consequently, expectations that official interest rates will remain at their current level are consistent with not only the higher risk premium due to the adverse external environment, but also with inflation expectations.

Position of the banking sector

In July, the total stock of loans to the corporate sector stopped declining. The mild drop in foreign currency loans was offset by an increase in forint lending. Data on non-price terms in July are not yet available. Average interest rates on forint loans were little changed in June. The decline in the stock of lending to households continued as a result of the fall in foreign currency loans and the slow increase in forint lending. The APR on housing loans remained unchanged and that on home equity loans continued to rise in June. On balance, there are no signs of a turnaround in the supply of bank credit.

The ratio of non-performing household loans continued to rise in Q2, due in part to the steady decline in the total stock of loans and in large part to a deterioration in the quality of outstanding loans. By contrast, losses as a percentage of the total stock of loans fell, due mainly to the base effect. The ratio of non-performing corporate loans rose sharply. The downward effect on earnings of loan loss provisioning was partly offset by the base effect. Consequently, the loan coverage ratio was slightly lower at the end of H1.

At the end of July, the pre-tax profits of the banking sector and branches were higher than a year earlier, despite the fact that banks were not subject to the special tax at this time last year and that the tax is levied evenly this year. But the asymmetry across banks (i.e. the large share of loss-making banks based on their balance sheet total and the concentration of profits at a couple of participants) paints a slightly different picture. The sector's capital adequacy ratio was little changed in June, standing at 13.8% at the end of the month.

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

The majority of Monetary Council members agreed that developments in consumer price inflation in recent months had been in line with the baseline projection in the June *Quarterly Report on Inflation* and that maintaining interest rates at their current 6.00% level over a sustained period would help to ensure that inflation fell back to the 3% target on the horizon relevant for policy. However, the latest domestic and international data on real economic performance had caused a negative surprise worldwide. The Council would evaluate the long-term, indirect effects of this on the macroeconomy and inflation at the time of discussing the Bank's September *Quarterly Report on Inflation*.

In the Council's judgement, the economic outlook had recently deteriorated significantly. Weaker-than-expected global and European activity had been reflected in the performance of the Hungarian export sector, consumption and investment activity and subdued net inflows of foreign direct investment. Several members were of the view that Hungary might be facing a sustained decline in demand and stagnating economic performance. Some members noted that the escalation of the euro-area debt crisis might weaken the funding position of the euro-area banking sector and of Hungarian banks and companies. That, in turn, might have an adverse impact on the outlook for domestic lending and the economy.

In the Council's judgement, the latest inflation data had been in line with expectations. The majority of members also agreed that downside risks to inflation may have increased due to weaker-than-expected domestic and global economic performance, but felt that more time was needed to evaluate the effects on the inflation outlook. Some members thought that mounting disinflationary pressures had already been reflected in the reversal in energy and commodity prices. Several members were of the view that the inflation target could be met earlier than in the baseline projection, before the end of 2012. In the short term, however, the consumer price index might increase slightly, due to seasonal effects. It was also argued that inflationary pressure from consumption expenditure and macro demand was weaker than previously thought, and the negative output gap was likely to close more slowly. Some members, however, cautioned that the increase in earnings over the past two months continued to be inconsistent with macroeconomic developments, which posed a risk to achieving sustained price stability. On one argument, persistently low consumer price inflation in recent months represented a significant achievement in a historical perspective. If the inflation data for August and September, considered particularly important in terms of future price developments based on past experience, were also benign, then inflation in Hungary might follow a lower path in the future.

Volatility in the prices of financial assets had increased due to uncertainty surrounding the real economic outlook and international debt problems. Members of the Monetary Council agreed that Hungary continued to be among the countries vulnerable to crises, and therefore a deterioration in sentiment had an amplified impact on risk premia on forint assets. Several

members thought that in the current economic environment, the banking sector was facing serious challenges, as the quality of loan portfolios could only be improved over the longer term.

In the Council's judgement, meeting the fiscal targets set by the Government and reducing debt were of key importance. In the current conjuncture, this challenge confronted Hungary with very difficult decisions and increasing social tensions. Members judged, however, that the Government should continue to implement its programme and take further measures in order to maintain or improve the market's current perception of Hungarian policy. It was also argued that managing the debt crisis was in the interests of all those affected, which might prompt the leaders of the world and Europe to develop decisive, long-term solutions. All this could lead to a gradual reduction in perceptions of the risks associated with the domestic economy.

In assessing the various interest rate policy options, members of the Monetary Council agreed that it was necessary to maintain the central bank base rate at its current level. Hungary was particularly affected by shifts in sentiment related to global debt problems, and increased perceptions of the risks associated with forint assets might continue to limit the room for manoeuvre in interest rate policy. Potential difficulties in achieving the Government's fiscal policy objectives might also require that monetary conditions be adjusted only gradually to the slower recovery in the economy and the reduction in inflationary pressure. Several members noted that the central bank base rate was high in absolute terms and by regional standards. It was also argued, however, that Hungary, unlike other European countries, had not yet met its inflation target, and it was forced to keep interest rates at a higher level due to its increased perceptions of risk. In addition, monetary policy should exercise caution, as the downward impact of weak demand on inflation by itself was not necessarily sufficient to meet the inflation target, as shown by the experience of the past few years.

Members agreed that particularly important events in the coming weeks, including summits of the world's leaders, the actions of the Hungarian Government and the macroeconomic assessment deriving from the September inflation projection, might determine the set of options for domestic monetary policy decision-making.

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 20 September 2011. The minutes of that meeting will be published at 2 p.m. on 5 October 2011.