MINUTES
OF THE MONETARY COUNCIL MEETING
20 SEPTEMBER 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

Inflation data have been in line with expectations in recent months, but there has been a marked deterioration in the outlook for domestic and global economic activity, which in turn is likely to reduce inflation over the medium term. At the same time, inflation is likely to be significantly above the Bank's target in 2012, reflecting the upward pressure from increases in VAT and excise duties.

A number of factors have contributed to the deterioration in growth prospects.

The global slowdown is acting as a significant brake on Hungarian economic growth. Poor macroeconomic data and weakening confidence indicators have added to concerns about the fragility of the recovery in developed countries. The slowdown in the euro area, Hungary's largest trading partner, is weighing on export growth. While exports are still expected to be the main driver of domestic growth in the next two years, since the June *Quarterly Report on Inflation* the Bank has revised down sharply its forecasts for export growth for 2011 and 2012.

Domestic growth may turn out to be weaker than previously expected. Households are likely to show a degree of caution in their spending behaviour and seek to adjust their balance sheets. Uncertainty surrounding the outlook for incomes and high instalments on debt are impeding the recovery in consumption. The Government's fiscal adjustment measures also point to a lower path of incomes on the forecast horizon.

Constraints on the supply of credit also continue to be a drag on growth, but slow the increase in prices. In addition to the deteriorating outlook for growth, the weakening of the banking sector's capital position and the decline in its ability and willingness to lend are also contributing to the extreme weakness in lending. Lending to both households and companies is unlikely to pick up significantly in the near future.

Over the longer term, corporate investment activity is expected to be weaker than previously thought. Apart from a couple of large individual investment projects being implemented in manufacturing, investment activity is likely to be extremely subdued in the period ahead, reflecting tightening credit conditions and renewed uncertainty about economic conditions. Service sector investment is also unlikely to pick up, as capacity utilisation remains significantly below pre-crisis levels.

Part of the deterioration in the outlook for growth is believed to be permanent, and therefore the trend of potential output is falling. Even taking into account the role of this factor, however, the output gap is closing at a slower pace than previously thought. Consequently, the outlook for growth suggests that inflation may be even lower than the Bank previously projected.

The feed-through of the earlier cost shocks into core inflation may be completed by the end of the year, and the disinflationary impact of weak economic activity is likely to become the dominant factor in inflation developments over the medium term. The global slowdown and weak domestic demand will exert increasing downward pressure on prices, but in the coming months the lifting of the gas and district heating subsidy scheme and in 2012 the increases in VAT and excise duties will contribute to the overall inflation rate remaining well above the 3% target. Although the increase in excise duties will raise the price index, it is unlikely to have significant second-round inflationary effects in the weak demand environment. By contrast, the increase in VAT will affect a wider range of products, and may therefore raise the inflation rate even after the direct inflationary effects wear off, given that nominal wages may also grow along a higher path. As a result of these factors, inflation adjusted for taxes and overall inflation are expected to fall back to 3% in 2012 H2 and 2013 H1, respectively.

Financial market developments

The significant volatility experienced in international financial markets for some time remained in the past month. In September, investors began to increasingly focus on the risks surrounding the European banking sector, in addition to the deterioration in expectations for global economic activity and the euro-area sovereign debt crisis. As a result, asset prices in international financial markets have fluctuated widely in the period since the Monetary Council's August policy meeting, following slightly different paths in each region. In the developed markets, risky asset prices reversed part of the declines in the second half of August. Yields on low-risk assets continued to rise. In the foreign exchange market, the euro weakened and the US dollar appreciated through most of the period. As an important development, the Swiss National Bank set an exchange rate ceiling for the franc at EUR/CHF 1.20, in order to prevent further appreciation of the currency.

A number of country-specific data affecting Hungary's risk perceptions were released during the month, but it was difficult to clearly identify their effects. Although analysts' statements suggested that the announcement by the Swiss National Bank on the introduction of a ceiling for the franc against the euro was an important event for Hungary, domestic CDS premia hardly reflected the impact of this factor. The announcement by the Hungarian Government of an option for foreign currency debtors to pay off their outstanding debt led to significant shifts in certain economic indicators. Changes in investor sentiment towards Hungarian assets were similar to those in other emerging markets. Rises in risk premia and exchange rate depreciation were not associated with an outflow of capital. Based on movements in market prices and survey responses, the main scenario remains that the Monetary Council will leave the key policy rate unchanged in the coming months.

Position of the banking sector

In August, the total stock of loans to the corporate sector continued to decline after a pause in July, although the size of the fall was not significant. Outstanding foreign currency lending decreased and forint lending increased. Average interest rates on forint loans changed little in July, falling slightly (the August interest rate data were not available at the time of writing). The stock of lending to households continued to drop, reflecting the decline in foreign currency loans and the slow increase in forint loans. The average APR on housing loans remained broadly unchanged, but the APR on home equity loans continued to increase.

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 loan coverage ratio increased slightly. There was a sharp increase in non-performing corporate sector loans. The downward effect on earnings of loan loss provisioning was partly offset by the base effect. Consequently, the loan coverage ratio for corporate loans was slightly lower at the end of H1.

At the end of August, the pre-tax profits of the banking sector and branches amounted to more than HUF 230 billion. This was significantly higher than in the same period of last year, despite the fact that banks were not subject to the special tax in 2010. However, the large degree of asymmetry across banks (i.e. profits are concentrated at a couple of banks) paints a slightly different picture. The sector's capital adequacy ratio changed little in July (the August data were not available at the time of writing), standing at 13.8% at the end of the month.

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

Before taking a decision on interest rates this month, the Monetary Council reviewed macroeconomic and financial market developments and discussed the September *Quarterly Report on Inflation* prepared by Bank staff.

The Council held the unanimous view that there had recently been a marked deterioration in global growth prospects. Moreover, the further decline in domestic demand and the continued process of balance sheet adjustment by households had also contributed to the worsening in the outlook for Hungarian economic activity. The Swiss National Bank's measure to prevent further appreciation of the franc had mitigated Hungarian households' exposure to exchange rate risk, but the outlook remained, on balance, negative. Some members thought that investment activity might be weaker than expected over the medium term, partly reflecting a deterioration in economic activity, increased business uncertainty and constrained credit supply.

Council members agreed that the output gap would remain negative on the horizon relevant for policy and that disinflationary pressure might persist in the economy. Consequently, core inflation might drop below the target over the medium term, but the consumer price index might rise temporarily in 2012, reflecting the Government's planned fiscal policy measures. Members' views were divided on the second-round effects of next year's increases in excise duties. Several members argued that subdued domestic demand and strong market competition next year would prevent companies from passing a greater part of the tax increases on to consumers. Others, however, noted that companies would be forced to pass on the increase in costs into their own prices due to the deterioration in profit prospects, and price rises would raise wage inflation slightly. On one argument, based on past experience in Hungary the effects of the indirect tax increases should not be overlooked, given that the series of shocks might lead to higher inflation expectations. Some members noted that the Monetary Council should closely monitor developments in core inflation adjusted for taxes, in addition to the consumer price index.

Several Council members noted that the EUR/HUF exchange rate assumed in the September *Report* was significantly stronger than the current market rate, and therefore the upside risks in the inflation projection might be greater. Uncertainty in international financial markets related to the European debt crisis and the Government's plan to provide an option for household borrowers to pay off their debt might add to pressure on the forint exchange rate, which in turn might increase those risks. It was also argued, however, that domestic companies expected energy prices to fall further, which might help offset imported inflationary pressure generated by exchange rate depreciation.

Monetary Council members agreed that global risk appetite had fallen sharply, reflecting the slowdown in growth and risks related to the sustainability of debt paths and the euro-area debt crisis. The majority of members were of the view that the deterioration in economic conditions abroad and at home had limited the room for fiscal manoeuvre in Hungary. On one argument, the increase in perceptions of the risks associated with the Hungarian economy had also contributed to the rise in risk premia on forint assets in recent weeks, although to a lesser degree than global factors.

The majority view on the Council was that judging from real economic developments, the inflation outlook would provide room to ease monetary conditions; the sharp deterioration in global risk perceptions, however, prevented this from materialising. Several members noted that the temporary inflationary effect caused by the increase in excise duties also limited the room for manoeuvre in monetary policy. One member argued that taking into account both the inflation outlook and financial stability risks, an increase in interest rates would be needed in order to signal the stance of monetary policy. Other members emphasised that it would be unjustified to raise the base rate, due to the Bank's credibility and its commitment to stability as well as its programme to sell foreign currency by tender to be announced soon.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Six members voted to maintain interest rates at 6.00% and one member voted to raise them by 25 basis points.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 6.00%	**6**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, Ferenc Karvalits, György Kocziszky, András Simor
In favour of raising the base rate to 6.25%	**1**	Júlia Király

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

András Kármán, State Secretary of the Ministry for National Economy, was present as the Government's representative.

The Council will hold its next policy meeting on 25 October 2011. The minutes of that meeting will be published at 2 p.m. on 16 November 2011.