MAGYAR NEMZETI BANK

MINUTES
OF THE MONETARY COUNCIL MEETING
24 JANUARY 2012

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 December 2011, the consumer price index stood at 4.1% and core inflation at 3.3%. Headline inflation fell by 0.2 percentage points and core inflation rose by 0.2 percentage points relative to the previous month. The outturn for CPI inflation was consistent with the projection in the December *Quarterly Report on Inflation*, while core inflation was slightly below the projection. The average annual inflation rate was 3.9% in 2011 (in line with the December *Report* projection). The decline in the consumer price index mainly reflected slower increase in the prices of processed food and vehicle fuel. Following the increase in November, the measures capturing underlying inflation developments turned out to be between 2%–3%, as seen in the previous period.

Industrial production picked up in November, with output growing by 3.5% relative to the same period of the previous year. Output increased across a wide range of industries on a month-on-month basis. Manufacturing exports continued to be the engine of industrial production growth; the decline in domestic sales continued in November. There was a sharp deterioration in external demand conditions. That suggests that industrial output is unlikely to pick up significantly in the short term, despite the upbeat data for November.

According to Hungarian foreign trade data for October, the volume of goods exports stagnated in 2011 H2 and that of imports fell slightly. The slowdown in exports was consistent with the weakening in external demand in H2. Although the volume of net exports continued to be significant, Hungary's terms of trade deteriorated sharply in October, mainly reflecting the increase in the import price of energy. The seasonally adjusted trade surplus has fallen slightly since mid-2011.

Based on the latest available data, there was no material change in household consumption expenditure. The total volume of retail sales stagnated in October relative to the previous month, as reinforced by the trend indicators. The projection in the December *Report* was for consumption to fall slightly in Q4, reflecting weaker activity, the strong Swiss franc and deferred consumption due to early repayment programme. The monthly consumption data for December was in line with the projection.

Private sector earnings growth rose slightly in November relative to previous months of the year. This may have been due to the pick-up in manufacturing earnings growth, probably driven by rising industrial activity in November. However, the November industrial production data was inflated by a strong working-day effect. Excluding the effect of working-day variations, private sector earnings growth was subdued, in line with developments in recent months of the year.

Financial market developments

Appetite for risk increased slightly in the period between the Monetary Council's policy meetings in December and January. Investors' decisions in international financial markets suggest that their cautious optimism rose further. This may reflect the recent relatively favourable set of real economic data, the easing of tensions in European financial markets and issuances of bonds by euro-area countries at much more favourable conditions compared to December. The European Central Bank's new instruments, aimed to boost liquidity, may have materially contributed to a recovery in confidence in the euro-are banking sector and to a narrowing in bond spreads between core and periphery countries. As a result, risky asset prices rose in global financial markets. However, the picture of the sovereign debt market is blurred by the fact that German and UK assets increased their safe haven status and that a number of countries, including those with an AAA rating, were downgraded. In addition, the risks surrounding Greece's bond swap programme rose.

Developments in Hungary's financial indicators were shaped almost exclusively by the events related to the loan agreement to be concluded with the International Monetary Fund. These included, for example, the change in the Government's communication about its intention to submit a formal request for an IMF loan and statements by government officials in response to messages calling for changes to legislation found to be in conflict with EU law. In general, financial indicators deteriorated in parallel with the gradual increase in tensions between the Government and the IMF and EU. Subsequently, after reaching its height during the particularly turbulent period of 4 and 5 January, this negative trend reversed and began to improve with the Government's communication in favour of an agreement.

In light of these events, perceptions of the risks associated with the Hungarian economy have increased since the Council's December interest rate decision, leading to a weakening in the country's relative position in the CEE region. The five-year CDS premium rose from 580 basis points five weeks earlier to near 620–630 basis points, while perceptions about other economies of the Central and Eastern European region generally improved. This deterioration reflected almost exclusively country-specific factors. On the critical day of 5 January, CDS quotes closed at 735 basis points, followed by a slight improvement. This deterioration in perceptions about the Hungarian economy was also reflected in credit agencies' decisions: first, Standard and Poor's and then, in January, Fitch Ratings downgraded Hungary's credit rating to BBB-. As a result of these moves, Hungary's credit rating was downgraded to non-investment grade at the three major credit rating agencies. The Government's increasing commitment in its communications to reach an agreement with the IMF and EU resulted in an improvement in perceptions about the economy, with this improvement in perceptions becoming dominant in recent days. However, high market volatility remained.

These country-specific events were also reflected in movements in the exchange rate. The EUR/HUF exchange rate decoupled from regional developments in the period between 20 December and 5 January, and while the exchange rates of benchmark country currencies weakened by 1%–2.5%, the forint depreciated by nearly 6% against the euro. With the turnaround in the Government's communications, the exchange rate recouped its losses accumulated over the period to the first week of January, appreciating sharply against the euro and rising to near the EUR/HUF 304–305 level. Nevertheless, the forint continued to underperform compared to the polish zloty, which appreciated by nearly 3.5% during the same five-week period. The significant depreciation of the forint and its subsequent appreciation were accompanied by a sharp increase in volatility.

Non-resident investors’ activity in the foreign exchange market may also have contributed to the sharp depreciation of the forint in early January. Non-residents sold some HUF 120 billion in the spot market and took short synthetic forward positions in the forint in a total value of some HUF 33 billion. It should be added that although these spot sales were large, they were not extreme: there were examples of sales involving similar or larger amounts in 2011. The amount of short forint positions, too, was not extremely high. Non-residents’ holdings of government securities increased significantly, reaching HUF 3,900 billion again. The increase in holdings following moderate sales during the critical first week of January probably reflected the fact that high yields may have been attractive entry points for investors undertaking higher risks in the interests of realising a higher return.

Interbank rates and government securities yields rose sharply in the period between the December and January interest rate decisions. Five-year benchmark securities yields closed 45–92 basis points higher before the January policy decision, with the three-yield rising the most significantly. The interbank yield curve shifted up by slightly less. As a result, interest rate swap spreads widened slightly, by 12–36 basis points. Increased perceptions of risks were also reflected in the weak results of government securities auctions.

As perceptions of the risks associated with the Hungarian economy increased, significant tensions developed in the FX swap market in the two weeks preceding the interest rate decision. Forint liquidity stemming from a decline in holdings of forint assets flowed to the FX swap market offering greater safety compared to unsecured interbank deposits, due to problems for some market participants arising from reductions in limits. That created relatively greater demand for the currency than previously, putting downward pressure on the implied forint interest rate. The one-week segment was the most affected by market turbulence. Swap quotes rose a little in the days preceding the interest rate decision, suggesting an easing in tensions.

FRA quotes also rose significantly in the period between the Monetary Council’s interest rate decisions in December and January. The difference between 1x4 FRAs and the current official interest rate level was 80 basis points and that between 2x5 and 3x6 FRAs and official interest rates was 106 basis points and 119 basis points respectively. Expectations of an increase in official interest rates were also reflected in movements in BUBOR rates: interbank rates stood at 7.26% at the one-month maturity and at 7.64% at the three-month maturity.

According the January Reuters poll, the majority of analysts expected official interest rates to peak in 2012 Q1, with the high point of the current interest rate cycle expected to be between 7.5%–8%. The average of expectations was 7.66%, up 49 basis points on the consensus forecast in the previous Reuters poll. Expectations for the end of 2012 also increased, with the average of forecasts rising by 32 basis points to 4.2%.

Position of the banking sector

Outstanding bank lending to the corporate sector fell sharply in December, reflecting declines in the stocks of both foreign currency and forint loans. Repayments due to the year-end balance sheet date may have played a significant role in the decline in outstanding loans. Average interest rates on large forint corporate loans rose slightly in November, while those on other loans remained broadly unchanged. Outstanding lending to the household sector continued fall sharply in December, as a result of early repayments of foreign currency mortgages. At the same time, net forint lending was strongly positive (due mainly to borrowing to finance early repayments). The average APR on new housing loans rose at the aggregate level in November after stagnating earlier. The increase in the APR on home equity loans in previous months stopped in December.

According to preliminary unaudited results, the banking sector recorded a loss in 2011. There remains a substantial degree of concentration and asymmetry across banks in terms of profitability. The special bank tax and losses related to early repayments over the period to 31 December contributed significantly to the sector's financial losses. At sector level, the capital adequacy ratio remained high at the end of November.

Looking forward, the agreement concluded between the Government and the Banking Association on 15 December 2011 may be an important factor contributing the a reduction in risks. The professional dialogue (Vienna 2.0) which began on 17 January, coordinated by the EBRD as a follow-up to the Vienna Initiative, may represent an important step forward. Its aim is to prevent the adverse cross-border effects of adjustment by the developed banking sectors of Europe by coordinating policy decisions made at national level. In the view of the Hungarian institutions participating in the dialogue (the MNB, the MNE and the HFSA), the Vienna 2.0 Initiative is an important step towards strengthening the economies of the region.

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

Members agreed that the macroeconomic data released since publication of the December *Report* had been in line with the projections in the *Report*; however, there was as division of views on the assessment of risks. Some members thought that the increase in perceptions of the risks associated with the economy, mainly reflecting greater uncertainty surrounding domestic economic policy, represented a material difference relative to the baseline projection in the December *Report*. By contrast, the majority of members judged that the turnaround in risk perceptions in January following the deterioration in December marked a sustained improvement.

Commenting on developments in perceptions about the economy, some members pointed out that there had been a significant deterioration in the 2–3 weeks following the Council's December policy meeting, which had been only partly offset by the correction beginning in second week of January. The latter was primarily reflected in movements in the forint exchange rate, while the CDS premium and required returns on government securities had fallen only slightly. The tension in the FX swap market in mid-January also suggested that confidence in the Hungarian economy had not been restored. By contrast, other members stressed that although the picture painted by the indicators was worse than in the previous month, the deterioration had ended after 5 January and indicators had improved significantly since they had reached their trough.

In terms of perceptions about the economy, some members pointed out that the deterioration between mid-December and the first week of January and the improvement beginning from the second week of January both could be related to country-specific factors. Although global and regional events may have played a role in the correction, perceptions about the economy could not have improved had domestic confidence not strengthened. That in turn was mainly related to the change in the Government's communication about its talks with the International Monetary Fund and the European Union. Other members took the view that while the deterioration in perceptions about the economy had been clearly related to domestic events, changes in risk appetite both globally and regionally had played a key role in the improvement in January, in addition to the rise in domestic confidence.

Members of the Monetary Council unanimously agreed that it was important that the Government and the IMF and EU reached an agreement as soon as possible in order to mitigate financing risks. Some members noted that until an agreement was concluded with the IMF and EU, the task of monetary policy was to create a stable financial market environment by tightening policy. By contrast, other members, being confident that the negotiations between the Government and the IMF and EU would soon be successfully concluded, were of the view that monetary policy tightening at this meeting was not warranted. The majority of members thought that in the current situation the Council should adopt a wait-and-see approach.

The majority of members of the Monetary Council voted to leave the central bank base rate unchanged. Members agreed that if perceptions about the economy and the outlook for inflation deteriorated significantly further, it might prove necessary to raise interest rates again.

Votes cast by individual members of the Council

In favour of maintaining the base rate to 7.00%	**4**	Andrea Bártfai-Mager, János Cinkotai, Ferenc Gerhardt, György Kocziszky
In favour of raising the base rate to 7.50%	**3**	Ferenc Karvalits, Júlia Király, 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

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 28 February 2012. The minutes of that meeting will be published at 2 p.m. on 14 March 2012.