MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

28 FEBRUARY 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 January 2011, the consumer price index stood at 5.5% and core inflation at 4.9%. Headline inflation rose by 1.4 percentage points and core inflation by 1.6 percentage points relative to the previous month. The increases in headline CPI inflation and core inflation turned out to be stronger than projected in the December *Quarterly Report on Inflation*. Higher fuel prices, reflecting the depreciation of the forint exchange rate at the beginning of the year, in addition to the increase in VAT in January and earlier changes to excise duties and other indirect taxes, contributed to the stronger-than-expected rise in inflation in the month. Moreover, the January data may also have reflected price increases brought forward to the beginning of the year, ahead of the rise in VAT. Inflation in January was also affected by methodological changes, in addition to the increase in indirect taxes. The measures capturing underlying inflation developments, adjusted for the tax changes, rose from levels of around 3% to a range between 4% and 5%. Although the latest available data point to greater inflationary pressures, it is important to note that due to the indirect tax changes, the evaluation of underlying inflation developments is surrounded by greater-than-usual uncertainty. Consequently, a more accurate picture can only be obtained after data for the next few months become available.

According to the preliminary release by the CSO which does not contain the components of GDP, Hungary's gross domestic product grew by 1.4% in 2011 Q4 relative to the same period of 2010 and by 0.3% relative to the previous quarter. This was higher than the projection of 0.9% contained in the December projection, in part reflecting significant improvements in the performance of a few sectors accounting for a smaller share of GDP. Consequently, it is difficult to judge whether better-than-expected growth figures reflect a lasting trend.

Although industrial production fell month on month due to more production stops than usual towards the end of the year, output nevertheless grew by 2.1% over the year as a whole. Industrial production rose by 5.4% in 2011 relative to the previous year. Within manufacturing, it was the machinery and chemical industries that contributed the most to industrial production growth. Industrial activity continued to be driven mainly by exports towards the end of 2011, while domestic sales continued to decline. Orders for Hungarian manufacturers' output continued to fall in December, reflecting the deterioration in external demand conditions in 2011 Q4.

Although the surplus on goods trade rose to EUR 3.2 billion in November 2011 from EUR 2.2 billion a year previously, the seasonally adjusted goods surplus fell steadily over the course of 2011 H2. This decline in the surplus reflected rising export volumes and deteriorating terms of trade. The latest available data suggest that net exports may have continued to contribute significantly to GDP growth in the final quarter of the year. Although euro-area GDP growth fell in Q4, forward-looking indicators appear to suggest that the decline in external activity may prove only temporary.

The total volume of retail sales, closely related to household consumption expenditure, rose by 0.6% relative to the same period of the previous year. This slight increase in sales may have reflected a number of factors. For example, the timing of bonus payments, purchases of consumer durables brought forward in anticipation of the VAT increase in January 2012 and shopping tourism boosted by the depreciation of the forint may all have contributed to the rise in sales. These effects may adjust back in the first few months of 2012. There appeared to be no material change in macroeconomic processes determining developments in household consumption.

Whole-economy earnings growth slowed significantly in December. This was due in part to companies delaying bonus payments at the end of 2010 to early 2011; a similar delay in bonus payments was not seen in the previous year. Regular pay in the private sector grew by 5.3% over the year as a whole. This growth in earnings, up 0.6 percentage points on the projection in the December *Report*, was due in large part to the temporary factors already discussed; however, even after adjusting for this effect, private sector earnings growth was faster than the staff expected, mainly reflecting the gradual increase in earnings growth in market services.

Financial market developments

Sentiment in international financial markets has been volatile but mildly optimistic since the Monetary Council took its policy decision. Movements in appetite for risk were largely determined by news about Greece. Following a long period of uncertainty, an agreement was reached on write-downs on private investors' claims and their bond swap programme as well as on a EUR 130–145 billion financial support package for Greece from multilateral organisations. However, implementation risks related to the austerity measures for the next few years continue to be significant, and therefore the announcements have had only a small positive impact.

In addition to the events in Greece, communications and monetary policy easing by the leading central banks of the world helped stabilise investor sentiment. The ECB's measures taken in December to enhance market liquidity probably continued to have an overall positive effect; and the approach of the new LTRO tender on 29 February also provided a boost to market confidence. Over the last few weeks the Fed has laid increased stress on communicating that decision-makers expect monetary policy conditions to remain loose over a sustained period; and the Bank of England and the Bank of Japan announced that they would expand their quantitative easing programmes.

Perceptions about the Hungarian economy improved substantially over the last month, as suggested by a drop of 70 basis points in the five-year CDS premium. In view of the latest movements in CDS premia, this may have been related mainly to external factors, similarly to the positive developments in the first half of January; however, favourable country-specific factors may also have contributed to the decline in the premium in February. Movements in the five-year spread over German Bunds of the same maturity paint a similar picture: the spread fell by 60 basis points to around 735 basis points in one month. A number of favourable country-specific factors also contributed to the decline in premia, in addition to cautious optimism in global markets. Strong market confidence about Hungary's negotiations with the IMF as well as better-than-expected GDP data and the announcement by the MNB that it would introduce new instruments to enhance market liquidity were greeted positively by markets. In terms of higher-than-expected consumer price inflation data, most participants adopted a wait-and-see attitude.

The negotiations with the IMF and EU are clearly the most important factor influencing perceptions about the Hungarian economy. Any news, either positive or negative, or a failure or delay in progress at the talks may cause substantial changes in perceptions about the Hungarian economy and asset prices.

Hungarian government securities yields continued to fall sharply, in line with the improvement in perceptions about the economy. Five and ten-year yields fell by 60–70 basis points and the three-month benchmark yield dropped by 40 basis points. The entire interbank curve shifted down by 60–70 basis points.

Non-resident holdings of Hungarian government securities increased by a total of HUF 75 billion over the period as a whole, approaching the historical peak reached last September. Purchases of securities with maturities of less than one year accounted for the greater part of the increase in holdings.

The forint continued to appreciate against the euro over the past month, with the exchange rate strengthening from levels around EUR/HUF 300 to 288. That was equal to an appreciation of 4% against the euro. In light of the fact that other currencies of Central and Eastern Europe appreciated by 1.5%–2.5%, the forint outperformed its regional peers. Consequently, movements in the exchange rate also reflected the correction of its earlier depreciation due to country-specific factors, in addition to favourable global and regional trends. The appreciation of the forint was boosted by purchases of HUF 460 billion by non-residents in the course of one month and by the build-up of speculative long positions in the spot foreign exchange market in excess of HUF 150 billion, anticipating an appreciation.

There has been a significant easing in tensions in the FX swap market at maturities of less than one year, and in particular at shorter maturities, since mid-January; however, there has only been a slight drop in basis swap spreads with maturities of over one year, the greater part of which occurring during the last few days. The five-year basis swap spread has fallen only slightly since the last interest rate decision, from 320 basis points to 270 basis points.

Based on FRA quotes, and taking into account the nearly 40 basis point differential between BUBOR and the base rate, the market's expectation of the base rate lies in a 0–25 basis point interval ahead of the Monetary Council's February meeting. According to the significantly more reliable Reuters poll, analysts clearly thought it more likely that interest rates would be closer to the bottom of the interval: all of the 24 respondents expected the base rate to remain unchanged. The majority of analysts said the Government's negotiations with the IMF would likely conclude in April-May. In terms of the longer-term path of interest rates, the majority of respondents expected the base rate to be reduced in the third or fourth quarter of the year, assuming that an agreement was reached with the IMF and the euro-area debt crisis did not escalate. Two analysts thought it likely that monetary policy would be tightened before the assumed date of agreement with the IMF.

The 12 analysts polled by Portfolio.hu also expected the base rate to remain unchanged at the Council's February meeting. All of the respondents noted that their expectations that interest rates would remain on hold before being reduced over the longer term were based on the assumption that the agreement with the IMF was reached in a relatively orderly manner. However, most analysts noted the high uncertainty surrounding the outcome of the negotiations, citing that there had been barely any concrete steps taken in that regard. All this suggested that negative risks were not fully priced in by the market.

Position of the banking sector

Outstanding bank lending to the corporate sector fell in January, although by significantly less than in December. Average interest rates on forint corporate loans rose in the month, after stagnating in the previous period. Outstanding lending to the household sector continued to fall sharply in January as a result of early repayments of foreign currency mortgages. Net forint lending was strongly positive (due mainly to forint borrowing related to early repayments of foreign currency mortgage loans). The average APR on new housing loans continued to rise in December, following the increase in November. By contrast, the APR on home equity loans remained broadly unchanged.

The stock of banks' external liabilities fell in January, although by less than in December. This outflow occurred mainly in forints. The net amount of swaps outstanding fell despite the outflow of external foreign currency liabilities, mainly reflecting the exchange rate effect due to the appreciation of the forint and lower margin requirements. Despite the fall, the net amount of swaps outstanding continued to be high; and there was a significant increase in banks' reliance on the MNB. It is important to note, however, that tensions eased in February and banks' recourse to the MNB's swap facilities fell.

The ratio of non-performing loans to total household loans rose further in 2011 Q4. Bank profits fell sharply, reflecting the downward effect of provisioning. This deterioration was mainly related to early repayments. Within outstanding lending to the corporate sector, the ratio of borrowers with arrears of more than 90 days rose as expected. The downward effect of provisioning on profits was also greater, probably due to a deterioration in the economic outlook and the depreciation of the exchange rate.

According to preliminary data, the Hungarian banking sector had a cumulative pre-tax loss of HUF 45 billion at the end of December 2011. The sector's twelve-month rolling ROA was -0.15% and its ROE was -1.7%, very low by international standards. These unfavourable results were due in large part to the bank levy and one-off losses caused by early repayments. There is a considerable degree of asymmetry in profitability across banks. The capital adequacy ratio rose from 13.3% in December 2010 to 13.5% at the end of December 2011.

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

Council members agreed that the latest data had not materially altered the outlook for the economy and inflation. At the same time, the improvement in investor sentiment had had a favourable impact on domestic and international financial markets over the past month. The Monetary Council continued to consider it important that the Government and the IMF and EU reached an agreement as soon as possible. That would have a positive impact on the outlook for the economy and inflation and increase the room for manoeuvre in monetary policy, in addition to mitigating the risks associated with financing the government debt.

Members agreed that data released since the last interest rate decision had not altered the picture for the economy, although the preliminary GDP data and the January consumer price index had been somewhat surprising. Several members therefore thought that the Council should wait with its strategic evaluation of economic developments until the March *Report* was finalised. Some members stressed that Hungary's 1.4% rate of growth last year had been higher than the EU average, despite the country's dependence on the German economy, and, furthermore, developments in domestic retail sales had been favourable. It was noted, however, that the fiscal stimulus measures had also contributed to domestic growth last year, which might be corrected this year. Some members cautioned that Hungary was near recession and was facing declining external demand. The risks of a further decline in potential growth may have increased, due to companies delaying investment plans. Another view was that household saving data and surveys of bank lending activity both suggested that conditions would continue to deteriorate.

Several members noted that inflation was likely to rise only temporarily at the beginning of this year due to the increase in indirect taxes. Some members, however, cautioned that if oil prices continued to rise, then global inflationary pressures and domestic imported inflation might pick up.

Members unanimously agreed that in the current situation the Council should continue to take particular care to evaluate financial market developments. There had been an improvement in risk perceptions since the January policy decision, due in part to the improvement in external conditions and the crisis management actions taken by the European Central Bank and other European institutions. As a result, CDS premia had fallen and the forint exchange rate had appreciated. Moreover, yields on Hungarian government securities had fallen, the gap between the central bank base rate and yields on short-term government securities had closed and tensions in the swap market had eased.

The majority of Council members also agreed that the reduction in perceptions of the risks associated with the economy had reflected, among other things, country-specific factors. All this may have played a role in the increase in government securities holdings. Some members pointed to the favourable reception of the Council's January interest rate decision and the Prime Minister's speech in January. However, several members cautioned that despite the improvement in the past six weeks, perceptions of the risks associated with the Hungarian economy were significantly higher than they had been around the middle of last year. Some members took the view that the market had only given a credit of trust to Hungary, and failure or delay by the Government to implement the measures expected by the market would increase the likelihood that foreign investors' perceptions of the risks associated with forint assets would once again take a turn for the worse going forward. Several members noted that despite the reduction in exchange rate risk posed by households' foreign currency debt, the currency exposure of the Hungarian economy had not been eliminated but had only been spread among sectors.

Some members noted the steady decline in the government deficit and the positive effects of the latest economic policy announcements. The further reduction in subsidies to municipal transport and the pharmaceutical budget, the imposition of a procurement ban, the planned introduction of an electronic road toll and parliamentary support for Hungary's approval of the European budget pact all might have a positive impact on the fiscal outlook and, ultimately, perceptions about the economy.

In discussing monetary policy issues, the majority of members agreed that the market had clearly accepted and confirmed the Council's decision to leave interest rates unchanged at its January meeting. Reviewing the Council's monetary policy options at this meeting, members agreed that the Council should exercise particular care in monetary policy decision-making. Members shared the view that it was crucially important that an agreement between the Hungarian Government and the IMF and EU on a financial safety net for Hungary was reached as soon as possible. It was also argued that, in terms of monetary policy decision-making, real economic risks remained moderate and uncertainty about future changes in risk perceptions were dominant. In view of the risks to inflation, the real economy and stability, the majority of members argued in favour of maintaining the base rate at 7.00%. However, several members thought that if the outlook for inflation and perceptions about the economy deteriorated significantly further, it might prove necessary to raise interest rates.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Six members voted to maintain the base rate at 7.00% and one member voted to lower it by 25 basis points.

Votes cast by individual members of the Council

In favour of maintaining the base rate at 7.00%	**6**	Andrea Bártfai-Mager, Ferenc Gerhardt, Ferenc Karvalits, Júlia Király, György Kocziszky, András Simor
In favour of reducing the base rate to 6.75%	**1**	János Cinkotai

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

Roland Nátrán, Deputy State Secretary of the Ministry for National Economy, was present as the Government’s representative.

The Council will hold its next policy meeting on 27 March 2012. The minutes of that meeting will be published at 2 p.m. on 11 April 2012.