MAGYAR NEMZETI BANK

MINUTES

OF THE MONETARY COUNCIL MEETING

27 MARCH 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 February 2012, the consumer price index stood at 5.9% and core inflation at 5.4%. Headline inflation rose by 0.4 percentage points and core inflation by 0.5 percentage points relative to the previous month. The pass-through of the weak exchange rate into consumer prices since last autumn has been greater than anticipated, and, coupled with high commodity and vehicle fuel prices, this may have contributed to the stronger-than-expected increase in processed food and tradables prices. The pass-through into prices of the January increase in VAT continued in February, possibly giving firms the opportunity to increase prices in a concerted manner. Consequently, some of the increase in prices reflected transient factors, but it also suggested that firms may have passed on a greater part of the increase in their costs than previously expected, despite weak domestic demand. Measures capturing underlying inflation developments, adjusted for tax changes, fell relative to January, but remained in a range between 3% and 4%. The evaluation of underlying inflation developments involves greater-than-usual uncertainty, which may be mitigated by data becoming available over the next few months.

According to the detailed release by the CSO, Hungary's gross domestic product, adjusted for calendar effects, grew by 1.5% in the fourth quarter of 2011 relative to the same period of 2010. The detailed release was consistent with the preliminary data and confirmed that the positive surprise was mainly due to one-off factors. In part, this better-than-expected outcome for GDP growth relative to the previous year reflected sharp improvements in agriculture and the construction sectors, with the latter driven by government spending on infrastructure investment. However, there are growing signs of a slowdown in general activity. Although the sectors producing for exports continued to support growth, value added declined across a wide range of private sector industries producing for the domestic market. On the expenditure side, exports continued to make a material contribution to GDP growth in the fourth quarter of 2011, while domestic demand fell.

The level of whole-economy investment continued to fall in the fourth quarter of 2011. Marked increases were seen in agriculture and in manufacturing, due to some major investment projects. By contrast, however, investment continued to decline in most other sectors, as well as in the government and household sectors. As a result of the large-scale projects underway in the car industry, investment growth is likely to continue in manufacturing.

Industrial production fell by 0.5% in January 2012 relative to the same period of the previous year. This slight drop resulted from a decline in machinery industry output. Export growth, the driving force behind industrial activity, also slowed. The decline in Hungarian and German export orders suggests that industrial production growth may have been subdued in the first quarter. By contrast, the decline in the goods surplus since the second half of 2011 was reversed in January. Hungary's terms of trade deteriorated sharply, accompanied by rising exports and falling imports, mainly as a result of higher commodity prices and the unfavourable developments in the terms of trade in industry. Net exports may have continued to make a significant contribution to GDP growth.

After picking up strongly in December, whole-economy annual earnings growth slowed in January, as gross average earnings in the total economy grew by 4.3%. However, there was a significant increase in regular pay in the private sector, reflecting the effects of the government's measures (increases in the minimum wage and the guaranteed minimum wage) taking effect from early 2012. Due to the administrative increases in wages, there is a greater-than-usual uncertainty about underlying trends.

According to the labour force survey data published by the CSO, the number of whole-economy employees stopped rising in the fourth quarter of 2011, reflecting a slight increase in private sector employment and a decline in government sector employment. The number of unemployed rose sharply in January. One reason for this is that the public works programmes, re-launched in a new framework at the beginning of the year, will be implemented with a delay. According to institutional statistics, employment fell significantly, due mainly to methodological reasons, but the data may have partially reflected the effects of weak overall economic activity. The labour market continued to be loose. Low demand for labour and the sharp increase in mass lay-offs suggest that the unemployment rate may remain persistently high.

Financial market developments

Sentiment in international financial markets has remained cautiously optimistic since the Monetary Council's previous policy decision. There was a general decline in risk premia and a rally in risky asset prices. Several closely watched market indicators of investors' risk appetite (e.g. the S&P 500 stock index and the VIX index) broke through technically important levels and are currently close to levels last seen at the time of the Lehman failure. The possibility of a disorderly default by Greece seems unlikely over the short term: the bond swap programme was conducted smoothly and the settlement of sovereign CDSs contracts triggered in its aftermath did not cause any tensions in the market; and the second financing package for Greece was officially approved.

The direct effects of the ECB's second long-term refinancing operation were moderate, with the amount of funding being consistent with preliminary expectations. Over the longer term, however, this instrument is likely to contribute significantly to the consolidation of euro-area interbank markets and peripheral sovereign debt markets. In the US, the latest set of macroeconomic data, particularly on the labour market, was positive. Although that reduced the likelihood of the Fed launching another quantitative easing programme, the improvement in business conditions helped stabilise financial markets. In terms of the outlook for global activity, the risks that oil prices will remain persistently high and heightened concerns about economic growth in China are most likely to have negative effects in the near term.

The global investor environment remained supportive overall, which was reflected in developments in emerging financial markets, including Hungary. Domestic asset prices and perceptions about the economy continued to be influenced mainly by news about a possible agreement between Hungary and the EU and IMF, in addition to the favourable underlying trends driven by the improvement in global sentiment. In this context, one unfavourable aspect is that no concrete date has been set for the start of negotiations. As a result, market participants not only view the delay in negotiations as becoming an increasingly important risk factor, they are also increasingly doubtful whether an agreement will be reached. The resulting negative country-specific effect, i.e. that Hungary is lagging behind other countries of the CEE region, is evident in several indicators.

This unfavourable one-off effect was also reflected in developments in CDS premia. The absolute value of the Hungarian five-year CDS rose slightly in the period (it was around 510–520 basis points at the end of February and 530 basis points at the end of the period), while perceptions about European emerging economies improved significantly, driven by favourable global sentiment. CDS premia of countries with risk premia closest to those of Hungary fell by 30–40 basis points. The differential between Hungary and other countries of the region increased significantly in the past month. Consequently, Hungary's rising CDS premium resulted from a positive global factor exerting downward pressure and a negative country-specific factor exerting upward pressure on the premium.

In terms of perceptions about the economy, it is crucially important that, despite falling over the past month, the five-year foreign currency bond spread is at very high levels of around 720 basis points, which is equal to a nominal euro yield of about 8.1%. Although it has fallen sharply since early January, the Hungarian spread continues to be several hundred basis points higher than comparable regional indicators.

Since the last interest rate decision, the exchange rate has been fluctuating between EUR/HUF 288 and 298, with the forint experiencing temporary episodes of both strength and weakness during the period. Overall, the forint weakened by some 0.5% against the euro relative to the end of February, to a rate of EUR/HUF 293–294. In a regional comparison, the forint underperformed other currencies: during the depreciation phase in the early part of the period, movements in the forint exchange rate decoupled from those of its regional peers and this was only partially corrected in recent weeks. The sharper depreciation relative to other currencies was consistent with the greater sensitivity of the domestic currency, whilst the fact that it appreciated less strongly than other regional currencies points to country-specific factors, in addition to its greater sensitivity.

Long-term yields in the government securities market fell at the end of February, but this decline came to an end in early March. With the significant increase in the last few days, reference yields at maturities of more than one year then rose to around 8.5%–9.0%, slightly above levels seen in February.

Market prices reflected a modest decline in expectations of an interest rate increase in the past month. The differential between BUBOR and the base rate narrowed from around 40 basis points at the end of February to near 25 basis points. Based on FRA quotes, market participants expect the three-month BUBOR to more or less remain at its current level over a 1–3 month horizon. Market expectations of the central bank base rate ahead of the March policy meeting are estimated to be in a 0–25 basis point range, with a greater likelihood that interest rates will be left unchanged.

The latest Reuters poll shows that respondents almost unanimously expect the policy rate to be maintained, with only one analyst expecting a 25 basis point increase at the March meeting. A large majority of analysts expect the tightening cycle to have peaked at the current interest rate level, while three analysts think it likely that monetary policy will be tightened further in the near future. Analysts expect the path of interest rates to be lower in the medium term: the median of expectations is for the base rate to be 6.5% and 6.0% at the end of 2012 and 2013, respectively.

Position of the banking sector

Forint and foreign currency lending by banks to the corporate sector continued to fall in February, although the decline in forint lending was very modest. Irrespective of loan amount, average interest rates on forint corporate loans rose in December and January, after stagnating in the previous period. Outstanding lending to the household sector in February continued to reflect the effects of early repayments of foreign currency mortgages. The average APR on new forint housing loans and home equity loans rose sharply in January.

Based on preliminary data, external liabilities of the seven largest banks are estimated to have fallen in February. That suggests a continued and increasing outflow of funds from the banking sector. The large outflow at the end of 2011 was not followed by a correction in the first two months of 2012. A large outflow of funds also occurred at the end of 2010, followed by a correction, in contrast to the turn of 2011–2012, suggesting that the outflow at the end of 2010 may have been an example of 'window dressing'. That may imply that banks will continue to reduce their lending going forward. The net amount of swaps outstanding also fell, in part reflecting the stronger exchange rate and the decline in banking sector assets. Despite the fall, the net amount of swaps outstanding continued to be high.

The ratio of non-performing loans to total household loans rose further in the fourth quarter of 2011. Provisioning reduced profits sharply. 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 deterioration in the economic outlook and depreciation of the exchange rate.

Capital increases and the appreciation of the forint at the beginning of 2012 improved banks' capital position.

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

The Monetary Council judged that the Hungarian economy was likely to stagnate this year, with growth expected to resume in 2013. The level of output would remain below its potential over the entire period. The consumer price index was expected to rise significantly, reflecting the effects of increases in VAT and excise duties as well as the rise in oil prices and the depreciation of the forint exchange rate in the second half of 2011. In the longer term, however, the path of consumer prices was likely to be dominated by the disinflationary impact of weak domestic demand. The Monetary Council continued to consider it important that an agreement between the Government and the EU and IMF be reached as soon as possible, in order to reduce the risks associated with financing government debt. That in turn would have a positive impact on the outlook for the economy and inflation, and increase the room for manoeuvre in monetary policy.

The majority of Council members broadly agreed with the baseline macroeconomic projection and risk scenarios in the March issue of the *Quarterly Report on Inflation* prepared by Bank staff. Some members noted that, in an adverse scenario, i.e. if investment and lending both declined sharply further, potential growth of the economy might be weaker than projected, which might pose a risk in terms of sustainability. Several members, however, cautioned that medium-term upside risks to inflation might be greater than in the projection, due in part to persistent rises in commodity prices and in part because the disinflationary impact of subdued macro demand in Hungary might prove weaker than estimated. One Council member cautioned that the impact of rises in commodity prices on the domestic currency price of imported goods and services could be only partially offset in a small, open economy. Another member commented that the pass-through of imported inflation was particularly difficult to avoid if the responsiveness of monetary policy to inflation in trading partner economies was falling. One member argued that in the absence of an adverse geopolitical event, oil prices might begin to fall in the future.

In assessing the outlook for inflation, several members cautioned that in order to meet the price stability objective the economy should be brought back on a sustainable growth path, which in turn would help ensure financing for the domestic economy, thereby reducing inflationary risks arising from financial exposure and exchange rate depreciation. It was also argued that rises in commodity prices, considerably exceeding the increase in administered prices, would pose upside risks to the consumer price index in 2013, and future fiscal measures might also lead to a faster-than-expected increase in consumer prices. Some members noted that inflation data for the first two months of 2012 had been a negative surprise and pointed to an increase in inflation expectations in the economy. As a result, the risk that past and potential future cost shocks would feed through more rapidly and persistently into consumer prices had increased. However, it was also argued that the loose labour market, tightening credit conditions, the adjustment of manufacturing sector earnings to growth in unit labour costs and the expected decline in consumption might limit the extent to which cost shocks materialised. All of these factors might prevent anticipatory price increases from being implemented.

Monetary Council members agreed that perceptions of the risks associated with domestic assets had increased slightly recently, despite improving global sentiment. Although the forint exchange rate was more stable and stronger than earlier and non-residents were more active in the government securities market, expected returns on forint and foreign currency-denominated government bonds had increased. Some members again cautioned that although the Government's measures affecting foreign currency debtors had reduced the exchange rate sensitivity of households, exposure to exchange rate risk had not fallen at the whole-economy level – it had only been partly transferred. Several members noted that the weak exchange rate path outlined in the *Report* might continue to pose financial stability risks, in addition to persistently high volatility.

The Council unanimously agreed that perceptions about the Hungarian economy were highly dependent on news about the Government's agreement with the EU and IMF. If reached, the agreement could generate positive market responses in the future, while a delay in negotiations would pose financing risks and result in an increase in required returns on domestic assets.

The Council noted that the Government had implemented structural measures aimed at reducing the fiscal deficit. All this was essential in order to achieve a reduction in debt from its current level. In this context, some members cautioned that long-term potential growth might decline if debt rose above current levels. One member argued that even at a much faster rate of potential growth than currently anticipated, fiscal measures were required to reduce debt. Others noted that the Government was committed to meet the 3% fiscal deficit target, which would have a positive impact on markets in the future.

In discussing monetary policy issues, the majority of members agreed that maintaining the base rate was warranted by the baseline projection in the *Report*. A broad consensus also emerged among members that the alternative risk scenarios presented real and relevant risks; however, none of the risk scenarios warranted a shift in interest rate policy away from the baseline scenario in the short term. Nevertheless, the deteriorating outlook for inflation and increased perceptions of risks warranted greater caution in monetary policy and consistent interest rate policy decision-making for the months to come. Several members cautioned that there was considerable uncertainty surrounding developments over the next month, which also required a wait-and-see approach to monetary policy. It was also argued, however, that an increase in the base rate to signal the stance of policy was justified by the increase in risk perceptions and the deterioration in the inflation outlook. In the current situation, that would contribute to a decline in yields at the longer end of the curve and in financing tensions. Moreover, such a move might lead to a fall in inflation expectations, thereby mitigating the risk of pass-through from temporary cost shocks, while at the same time helping to stabilise the forint exchange rate and reduce the risks to debt financing and financial stability.

One member pointed out that, as an effect of the crisis, monetary policy decisions in a number of countries were driven by the objective of smoothing the path of demand, in addition to maintaining price stability. A number of central banks had implemented interest rate cuts to help mitigate the decline in output and committed to maintain low interest rates for years to come. In this context, other members cautioned that monetary policy was only able to influence the cyclical component of growth by widening or narrowing the output gap; however, it was unable to influence potential growth through interest rate policy. In Hungary, it was the economy's growth potential, rather than managing its cyclical position, which posed an economic policy challenge. Reducing interest rates, therefore, would not stimulate growth, while it would pose upside risks to inflation. Problems with potential economic growth stemmed mainly from weak investment activity and low willingness to lend, which, however, monetary policy was unable to influence.

After the discussion, the Chairman invited members to vote on the proposals put to the Council. Five members voted to maintain the base rate at 7.00%, one member voted to raise it by 25 basis points 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%	**5**	Andrea Bártfai-Mager, Ferenc Gerhardt, Ferenc Karvalits, György Kocziszky, András Simor
In favour of raising the base rate to 7.25%	**1**	Júlia Király
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 24 April 2012. The minutes of that meeting will be published at 2 p.m. on 9 May 2012.